EQUITY RESEARCH

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February 20, 2020

Galapagos NV

Downgrade to Underperform: At $17B+ Cap, Too Much Value On Pipeline Given Remaining Risks

Our view: Downgrading to Underperform on what we believe is a valuation that, following substantial appreciation, reflects overly optimistic expectations for GLPG's pipeline based on our DCF and sum-of-the-parts analyses. While we remain positive on lead drug filgotinib's regulatory and commercial prospects, we believe GLPG's share of the drug is now more than baked in, and while we believe the company does have a promising autoimmune-focused R&D platform, we believe the Street may be underappreciating that risks remain to their early/mid-stage pre-POC programs. We acknowledge there may be structural reasons - e.g., scarcity value of European biotechs, the company's low tax rate, uniquely strong cash position - that likely help increase shares, and that valuation calls in the face of strong momentum can be challenging. Nonetheless, given the difficulty we have justifying a fair value near where the stock currently trades, and the low likelihood of M&A catalyzing additional upside, even absent a discrete expected negative driver we believe any clinical or regulatory setback with filgotinib or the rest of the pipeline would catalyze a substantial downside reversion to fairer valuations. Price target unchanged at $175.

Key points:

Despite our encouragement on filgotinib, we believe high expectations already more than baked in. We expect a smooth RA approval path (PDUFA potentially 3Q20), especially given recent FDA comfort around preclinical concerns, and see a good likelihood of positive UC data (1H20) given results from other Jak inhibitors. However, this will need to be balanced against a challenging competitive landscape in RA, where they and partner GILD have less entrenchment and their label could be slightly less robust, and we expect the competitive landscape among orals in both RA and IBD (other Jaks, S1Ps, Tyk2, etc.) to continue to be increasingly crowded. Net-net, based on this and historical sales of other successful inflammation drugs across their most advanced overlapping indications, we believe ~$3.5B in out-year probability adjusted sales should be realistic. While we do not consider this particularly cautious, our assessment of the discounted fair value of our calculated 43% effective share GLPG has in the drug - even in a best-case exclusivity scenario where polymorph patents hold until the mid-2030s - would be $6B, half of the company's current $12B enterprise value.

Remainder of pipeline remains high-risk and/or early and we do not believe GLPG's portion warrants the currently-ascribed value of $5B+.

- Autotaxin inhibitor GLPG1690 has a promising target with favorable initial signals on FVC trends, placebo declines akin to natural history, and correlative biomarker and lower lobe airway resistance data...

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Sector: Biotechnology

Underperform (prev: Sector Perform)

NASDAQ: GLPG; USD 266.68

Price Target USD 175.00

WHAT'S INSIDE	
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Scenario Analysis*

Downside Scenario	Price Target	Current Price	Upside Scenario
100.00	175.00	266.68	290.00
↓ 63%	↓ 34%		↑ 9%

*Implied Total Returns

Key Statistics

Shares O/S (MM):	61.9	Market Cap (MM):	16,507
Dividend:	0.00	Yield:	0.0%
		Avg. Daily Volume:	151,666

RBC Estimates

FY Dec	2018A	2019E	2020E	2021E
EPS, Ops Diluted	(0.56)	3.67	(2.10)	(0.27)
Prev.			(2.35)	(0.61)

EPS, Ops Diluted	Q1	Q2	Q3	Q4
2018	(0.73)A	(0.42)A	0.28A	0.27A
2019	(0.89)A	(0.86)A	6.03A	(0.52)E
2020	(0.44)E	(0.53)E	(0.56)E	(0.56)E
Prev.	(0.51)E	(0.59)E	(0.63)E	(0.63)E

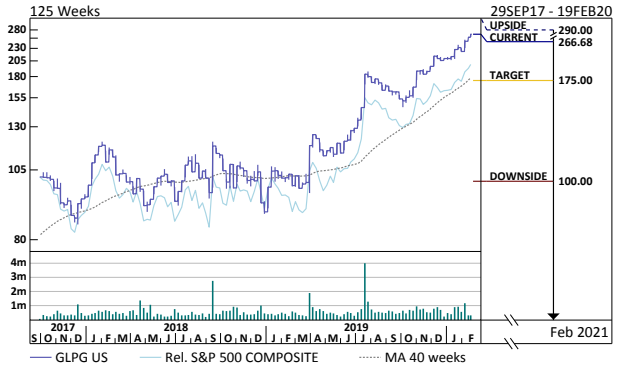
EPS, Ops Diluted: financial data in EUR
All market data in USD; all financial data in EUR.

Disseminated: Feb 20, 2020 05:00ET; Produced: Feb 20, 2020 00:48ET Priced as of prior trading day's market close, EST (unless otherwise noted).

For Required Conflicts Disclosures, see Page 6.

Target/Upside/Downside Scenarios

Exhibit 1: Galapagos NV



Source: Bloomberg and RBC Capital Markets estimates for Upside/Downside/Target

Price target/base case

Our base case assumes an 85% POS for filgotinib in RA, and 67% in IBD, with sales of $6.3B by 2029. Our $175 price target is derived from a DCF analysis of the base business with a 10% discount rate and 3.0% terminal growth rate.

Upside scenario

Should filgotinib and ’1690 reach the market, this would lead to upside to our estimate; in such a scenario, we believe fair value, based on a blend of DCF and multiples analyses, would be $290.

Downside scenario

If there are any safety or efficacy hiccups for filgotinib or ’1690, or the competitive space limits ultimate commercial sales, we believe cash value in SOTP analysis (which blends potential residual value of programs if risk increases with the cash spend) could be $100.

Investment summary

Though we believe GILD-partnered filgotinib and ’1690 have significant revenue potential, with filgotinib having the highest likelihood of success, current valuation appears to reflect a best case scenario for filgotinib regulatory approval and commercialization, along with multiple successes in the earlier stage pipeline. We acknowledge GLPG’s drug development engine, strong balance sheet, and favorable tax structure, but believe there is legitimate clinical, regulatory, and competitive risk to their programs and note out-year revenues are capped by their partnership split with GILD. Given the recent share appreciation, we believe any clinical or regulatory setback with filgotinib or the rest of the pipeline would catalyze a substantial downside reversion to fairer valuations.

Key positives: (1) large market opportunity for GILD-partnered filgotinib, with promising data and validated mechanism; (2) some promising early signals from ’1690 and '1972; (3) strong balance sheet; (4) favorable tax structure should elevate potential future profit margins; and (5) prolific drug discovery engine.

Key risks: (1) Partnerships with GILD and others significantly reduce peak revenue potential for pipeline programs; (2) significant competition in RA for filgotinib from entrenched biologics and newly approved oral competitors; (3) high regulatory bar in rheumatology/inflammation will apply to the majority of their pipeline; (4) limitations to interpreting ’1690 pilot data and having full confidence in replicability; (5) lack of long term safety and relevant efficacy data with '1972 in OA; and (6) early stage, known tox considerations, and novel MOA for Toledo program.

Potential catalysts: (1) data from the first clinical trial with GLPG3312 (first-generation Toledo) (1H20); (2) data from the ph.III SELECTION trial of filgotinib in UC (2Q20); (3) potential readouts from ph.II filgotinib CD studies (2020); (4) filgotinib regulatory approval and launch for RA in the U.S. (3Q20).

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…continued from cover

Remainder of pipeline (cont'd):

- …suggesting some chance the agent's activity is real. However, with small patient numbers, imbalances in baseline characteristics, meaningful variability in lung function measurements, and several differences in trial design between ph.II and ph.III (e.g. combo with SOC) (discussed fully here), we see risk to this early data being replicated in ph.III and believe it could stop for futility at next year's interim data cut. (2H20 ph.II systemic sclerosis data, if negative, could also highlight potential risk).
- Their osteoarthritis program with '1972 (ph.II data 2H20) addresses a large potential market with a novel mechanism and supportive ph.Ib data, though long term safety, and efficacy (beyond exploratory biomarkers) in relevant patients, has not been established, and we believe the regulatory bar for safety will be very high in this indication. Additionally, GLPG's economics on this program are limited, with GILD having a U.S. option and Servier having ex-U.S. rights.
- We remain conservative on the Toledo program (which we are fairly confident targets the salt-inducible kinase family) despite strong preclinical activity data, given the known tox risks around systemic pan-inhibition of this target, unknowns about the novel mechanism, and early stage of development.

Additionally, with GILD opted into '1690, and having the option for rights to opt in for U.S. OA and Toledo program commercialization, we note that even if these programs are successful in ph.III and achieve regulatory approval, GLPG's future cash flows on the programs would be capped by the partnership split. Overall, our DCF-based fair value est. for GLPG shares remains $175 – corresponding to a still-healthy $12B mkt cap – consisting of 39% filgotinib, 10% for '1690, 4% for OA, and 47% in cash.

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Exhibit 2: GLPG Income Statement

Galapagos (GLPG)				2019					2020										
(€ in thousands except per share items)	2016A	2017A	2018A	1Q19A	2Q19A	3Q19A	4Q19E	2019E	1Q20E	2Q20E	3Q20E	4Q20E	2020E	2021E	2022E	2023E	2024E	2025E	2026E	2027E
Filgotinib royalties/profit split (1)									€ 0	€ 0	€ 2,374	€ 8,276	€ 10,650	€ 36,932	€ 91,043	€ 215,610	€ 387,026	€ 582,580	€ 800,837	€ 1,052,653
GLPG1690 sales/royalties														-	5,462	66,539	245,432	391,967	522,693	634,204
GLPG1972 sales/royalties													-	-	-	-	-	27,693	104,465	208,759
Other income	151,600	155,900	317,845	40,919	67,590	643,954	118,435	870,898	127,986	127,986	127,986	127,986	511,945	650,753	905,233	673,887	664,634	363,884	336,123	340,749
Total revenues, net	**151,600**	**155,900**	**317,845**	**40,919**	**67,590**	**643,954**	**118,435**	**870,898**	**127,986**	**127,986**	**130,360**	**136,263**	**522,595**	**687,684**	**1,001,738**	**956,036**	**1,297,092**	**1,366,124**	**1,764,117**	**2,236,365**
Costs of sales	-	-	-					-					-	-	(273)	(3,327)	(12,272)	(20,983)	(31,358)	(42,148)
R&D expenditure	(139,600)	(218,500)	(322,876)	(83,195)	(94,372)	(120,680)	(124,500)	(422,747)	(136,500)	(141,250)	(145,750)	(151,250)	(574,750)	(609,235)	(633,604)	(658,949)	(682,012)	(695,652)	(709,565)	(716,661)
G&A and S&M expenses	(23,500)	(27,200)	(39,777)	(10,966)	(17,585)	(32,643)	(26,000)	(87,194)	(19,750)	(20,250)	(20,500)	(21,000)	(81,500)	(97,800)	(122,250)	(146,700)	(176,040)	(202,446)	(222,691)	(231,598)
Total operating expenses	**(163,100)**	**(245,700)**	**(362,653)**	**(94,161)**	**(111,958)**	**(153,323)**	**(150,500)**	**(509,942)**	**(156,250)**	**(161,500)**	**(166,250)**	**(172,250)**	**(656,250)**	**(707,035)**	**(756,127)**	**(808,976)**	**(870,323)**	**(919,081)**	**(963,614)**	**(990,407)**
Income from operations	**(11,500)**	**(89,800)**	**(44,808)**	**(53,242)**	**(44,367)**	**490,631**	**(32,065)**	**360,957**	**(28,264)**	**(33,514)**	**(35,890)**	**(35,987)**	**(133,655)**	**(19,351)**	**245,611**	**147,061**	**426,768**	**447,043**	**800,504**	**1,245,958**
Non-cash adjustment on short-term financial asset	57,500	-	-	-	-	(146,226)	-	(146,226)	-	-	-	-	-	-	-	-	-	-	-	-
Other financial result	8,200	(25,700)	15,599	4,655	(2,820)	-	-	1,834	475	450	475	450	1,850	1,869	1,887	1,906	1,925	1,944	1,964	1,983
Net pre-tax income	**54,200**	**(115,500)**	**(29,210)**	**(48,588)**	**(47,188)**	**344,405**	**(32,065)**	**216,565**	**(27,789)**	**(33,064)**	**(35,415)**	**(35,537)**	**(131,805)**	**(17,482)**	**247,498**	**148,967**	**428,693**	**448,987**	**802,467**	**1,247,942**
Income taxes	(200)	(200)	(50)	(68)	(61)	16,828	-	16,699	-	-	-	-	-	-	-	(7,448)	(21,435)	(22,449)	(40,123)	(62,397)
Net result for the period	**54,000**	**(115,700)**	**(29,259)**	**(48,656)**	**(47,249)**	**361,233**	**(32,065)**	**233,264**	**(27,789)**	**(33,064)**	**(35,415)**	**(35,537)**	**(131,805)**	**(17,482)**	**247,498**	**141,519**	**407,259**	**426,538**	**762,344**	**1,185,545**
Earnings per share	**€ 1.14**	**(€ 2.34)**	**(€ 0.56)**	**(€ 0.89)**	**(€ 0.86)**	**€ 6.03**	**(€ 0.52)**	**€ 3.67**	**(€ 0.44)**	**(€ 0.53)**	**(€ 0.56)**	**(€ 0.56)**	**(€ 2.10)**	**(€ 0.27)**	**€ 3.49**	**€ 1.97**	**€ 5.59**	**€ 5.78**	**€ 10.18**	**€ 15.63**
Shares Outstanding (Basic)	45,696	49,129	52,834	54,615	54,823	61,954	62,204	58,399	62,454	62,704	62,954	63,204	62,829	64,204	65,204	66,204	67,204	68,204	69,204	70,204
Shares Outstanding (Diluted, est.)	47,308	50,729	56,969	59,242	59,450	67,608	67,858	63,539	68,108	68,358	68,608	68,858	68,483	69,858	70,858	71,858	72,858	73,858	74,858	75,858

Source: RBC Capital Markets estimates; Company reports

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Valuation

Our $175 price target is derived from a DCF analysis of the base business with a 10% discount rate and 3.0% terminal growth rate. This valuation supports our Underperform rating.

Risks to rating and price target

Risks include greater than expected uptake for filgotinib in RA, potential BD activity, and better than expected clinical data for ’1690 in IPF, Toledo compounds in inflammatory disease, and/or '1972 in osteoarthritis.

Company description

Galapagos is a clinical-stage biotechnology company headquartered in Belgium and with facilities across Europe. The company has a platform for target discovery and development of small molecule inhibitors to address the root cause of diseases. Lead drug filgotinib is a Jak-1 inhibitor partnered with Gilead, currently in phase III in RA and inflammatory bowel diseases. GLPG1690 is a wholly owned autotaxin inhibitor in phase II for IPF. Galapagos also has partnerships with MorphoSys/Novartis and Servier for programs in atopic dermatitis and osteoarthritis.

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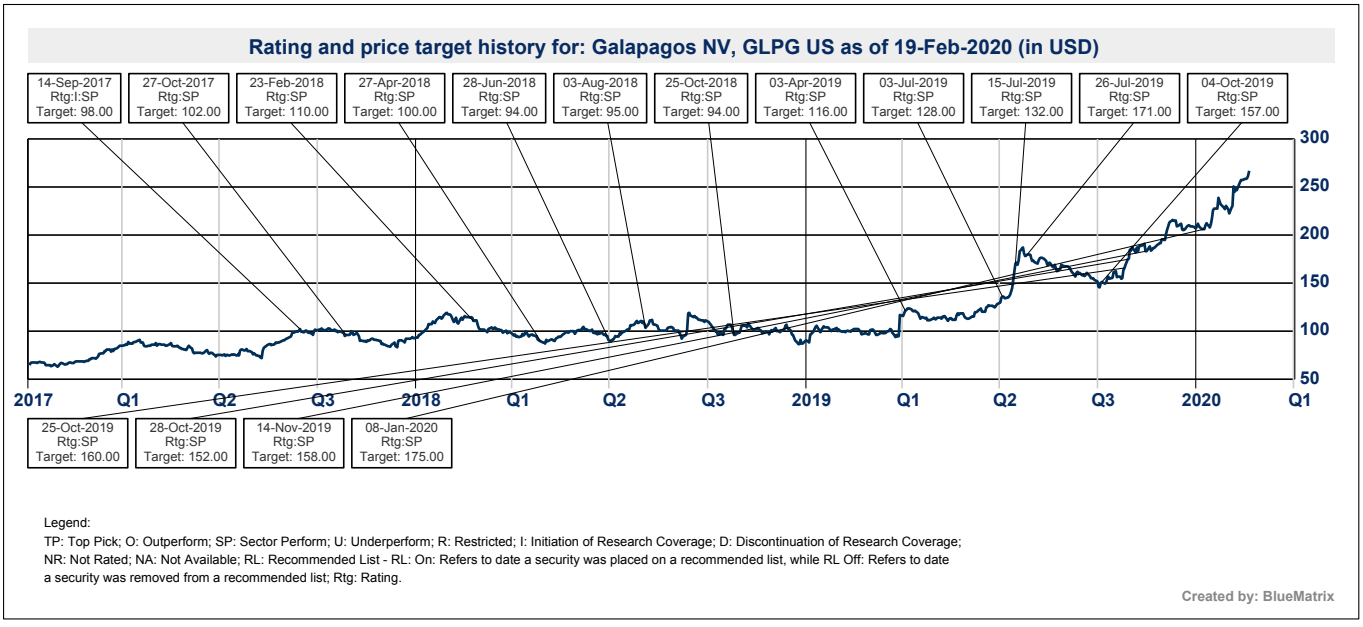

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Galapagos NV

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