Teva Pharmaceutical Industries, Ltd. TEVA

by Morningstar Equity Analysts

Analyst Note 03-22-2010 | by Matthew Coffina

In a climactic finish to a year of debate, the House of Representatives passed comprehensive health reform legislation late Sunday night. The bill was passed by the Senate last December, and as such will head directly to President Obama for his signature without another vote. The House also passed a package of relatively small changes to the original Senate bill, which now heads to the Senate. The main details of the reform legislation haven't changed from the expectations built into our models, and we do not anticipate changing any fair value estimates as a result of this bill's passing.

According to the nonpartisan Congressional Budget Office, the final bill--including the package of changes anticipated to be passed in the Senate--is expected to reduce the number of people without health insurance by 32 million by 2019. That will still leave 23 million people uninsured, or about 8% of the nonelderly population. A significant portion of the remaining uninsured will be illegal immigrants. By 2019, the number of people receiving employer-sponsored and individual insurance is expected to decline by about 8 million, which is more than offset by 16 million new people in the Medicaid program and 24 million people purchasing private health insurance through newly established insurance exchanges.

The cost of expanding insurance coverage is estimated to be $938 billion over the next 10 years. About half of that cost is financed by spending cuts, primarily to the Medicare program. The other half is financed by increased taxes. The bill is expected to reduce federal budget deficits by $143 billion over the next 10 years and by 0.5% of gross domestic product over the subsequent 10 years.

Under the bill, most Americans will be required to carry health insurance or else will be subject to a tax penalty starting in 2014. The penalty will be phased in, but by 2016 it will be the greater of $695 per person or 2.5% of taxable household income. Anyone earning less than 133% of the federal poverty level will be eligible for Medicaid. Individuals earning between 133% and 400% of the federal poverty level will be eligible for federal subsidies that will cap their contribution to insurance premiums and cost-sharing based on a sliding scale. The bill imposes penalties on larger employers who don't offer insurance coverage and provides tax credits for certain small businesses that choose to offer health insurance.

The final bill excludes a government-run insurance option but has provisions for the government to negotiate certain plans with private insurers and to encourage the creation of nonprofit insurance co-ops. The bill creates state-based insurance exchanges where individuals and small businesses can buy standardized health insurance policies. Insurers will be forced to offer a policy to any applicant and can vary

Morningstar Rating
★★★

Stock Price
As of 03-22-2010
$64.43

Fair Value Estimate
$59.00

Consider Buying
$41.30

Consider Selling
$82.60

Fair Value Uncertainty
Medium

Economic Moat
Narrow

Stewardship Grade
A

Bulls Say

- The Barr acquisition allows Teva to regain its king-of-the-hill status for generic drugs.
- Teva is well positioned to offer generic biologics, an important frontier in U.S. generic drugs.
- By manufacturing about half of its own active ingredients, Teva captures the markup on raw materials that would typically accrue to its suppliers.
- Teva's purchase of Bentley Pharmaceuticals established an important foothold in the significantly underpenetrated Spanish market for generic drugs.

Bears Say

- Increased consolidation activity could cause Teva to overpay for future acquisitions.
- Authorized generics and competition from India decrease the profitability of Teva's first-to-file patent challenges.
- Teva's branded Copaxone participates in the competitive multiple sclerosis market and may

premiums based only on age, region, family composition, and tobacco use within defined ranges. Premiums cannot vary based on health status.

The bill also includes a number of provisions affecting various segments within the health-care industry, although the entire industry is expected to see a volume boost stemming from newly insured individuals entering the system. While the impact of many of these provisions is difficult to quantify precisely, health-care stocks should benefit from the improved investor sentiment due to the removal of the regulatory uncertainty surrounding its prospects. The investor focus should now shift on the sector fundamentals and the companies-specific factors, which remain attractive.

Pharmaceutical companies are the likely "net winner" of the reform. With the exception of the $85 billion fee the industry will pay over the 10-year period, most of the reform language appears favorable to drugmakers. In addition to the volume boost, the House bill rewards drug companies with a stronger patent protection for biologics and closes the "donut hole," but most importantly doesn't include any provisions that would allow the government to negotiate prices directly with pharmaceutical companies.

Device-makers are not likely to see as significant of a volume boost from the bill. Additionally, the excise tax to be imposed on this sector appears disproportionately harsh. That said, the device fee will not come into effect for several years, which should give device companies ample time to devise operating strategies to offset its impact. We are anticipating most of this industry fee will be passed on to consumers via price hikes, and even if unsuccessful, device-makers should only see a mild (ranging from low- to mid-single-digit) reduction to their valuations.

Managed care organizations (MCOs) will be negatively impacted by reductions to Medicare Advantage reimbursements, although we expected these cuts to occur even in the absence of comprehensive reform. Some of the more profitable MCOs could be negatively impacted by explicit limits on gross margins, although they should be able to offset this effect by reclassifying some administrative costs as medical costs. We expect industry taxes and fees to generally be passed on to customers. On the positive side, MCOs stand to benefit from increased demand for individual insurance. Companies that participate in Medicaid managed care programs will benefit from expanded Medicaid eligibility.

We expect drugstores and pharmaceutical and medical supply distributors to be net beneficiaries of the legislation, as they gain from increased demand for health-care goods, especially prescription drugs. Diagnostic companies and makers of generic drugs should also see higher utilization rates, providing strong support to these industries' growth.

Alex Morozov, CFA contributed to this note.

Thesis 07-30-2009 | by Brian Laegeler, CPA

Teva Pharmaceutical's competitive advantage eroded as competitors like Mylan MYL gained substantial scale through cross-border consolidation. In 2007, three players, including Novartis' NVS Sandoz division, claimed the size, global reach, and vertical integration to challenge Teva as the king of the hill. However, Teva distanced itself from competitors in 2008 with the acquisition of Barr.

Teva discovered early that the best way to survive the commodified generic drug industry was to get big. Size allowed the firm to squeeze more pennies out of every revenue dollar, providing the financial flexibility to beat its competitors on price. Teva built a virtual one-stop shop

face competition from better substitutes in the years ahead.

through the purchase of high-quality assets such as Sicor, a leading provider of hard-to-make injectables, and globally diversified Ivax. Ivax boosted Teva's respiratory and oncology technology base, and it provided instant leadership in growth markets like Russia, France, and Mexico. Teva also lowered its costs and improved service levels by making its own active ingredients. Before 2006, only Sandoz challenged Teva in terms of size.

The recent combinations of Barr with Croatia's Pliva and Mylan with Germany's Merck KGaA and India's Matrix Labs stole a page from Teva's playbook. These midsize players added geographies, technologies, and active ingredients and they lowered costs, eliminating duplicative competition along the way. They could now charge less across the board and possibly capture a bigger share of generic biologics and patent challenges. This also gave drug chains and distributors more choices for one-stop shopping, making it harder for Teva to differentiate itself on the generic drug side of the business. Teva reversed this trend in late 2008 by absorbing the number-four global player, Barr.

Teva's branded drugs still have an edge with Copaxone, a leading multiple sclerosis therapy accounting for 8% of sales. A stronger version of Copaxone recently failed to show greater efficacy in late-stage clinical trials, which could mean earlier-than-expected generic competition. An oral multiple sclerosis drug is still in development. The profitability of Copaxone should increase once the drug's royalties expire in 2010. Teva's Ivax purchase added a branded respiratory franchise, which provides the technology to create new products for the inhalant market. We expect to see more from this side of the business as the company has committed significant dollars to research.

Valuation

We're raising our fair value estimate to $59 per share from $52, primarily to account for cash flows generated since our last report, but also because Teva had modestly stronger-than-expected sales in the first half of 2009. We place a 60% probability on the emergence of generic Copaxone competition near 2014. We also assume increasing sales for Azilect, which treats Parkinson's disease. Not all of our projected growth is internal; we model about $700 million of revenue per year from acquisitions to help Teva achieve its long-range targets. We assume future acquisitions are priced around 2.5 times sales, considering the significant cost savings Teva brings to the table. We exclude the launch of generic biologics from our projections, as we believe the majority of these products are more than five years out.

Risk

Teva's gross margin is at risk from earlier-than-expected Copaxone competition, higher-than-expected pricing pressure, and a lack of big product launches. There is some risk that Teva will not achieve the cost savings associated with recent transactions.

Close Competitors	TTM Sales $Mil	Market Cap $Mil
Teva Pharmaceutical Industries, Ltd.	**13,899**	**54,028**
* Novartis AG	47,533	117,255
* Watson Pharmaceuticals Inc.	2,793	5,295
* Mylan Laboratories, Inc.	5,093	6,676

* Morningstar Analyst Report Available

Data as of 03-31-10

Strategy

Teva's diverse product portfolio allows it to offer one-stop shopping to powerful buying groups. The company provides active pharmaceutical ingredients to third parties, as well as for its own manufacturing. Through internal efforts and acquisitions, the company continues to advance its leading position in global generics, generic biologics, and branded pharmaceuticals.

Management & Stewardship

Teva has demonstrated excellent corporate governance. Other than not disclosing individual executive compensation, the company has all the little things that matter for a high Stewardship Grade, such as straightforward accounting, the separation of the CEO and chairman duties, and meaningful insider ownership. In 2007, Shlomo Yanai took the top spot from Israel Makov, who served as president and CEO from 2002 through 2006. Yanai recently led Makhteshim Agan Industries, an Israel-based maker of generic pesticides. While Yanai is an outsider, many of Teva's top executives have been with the company for decades. Previous CEO and 25-year Teva veteran Eli Hurvitz remains chairman. Capital allocation seems appropriate, as management plows excess cash flow into internal research efforts, value-adding acquisitions, and a modest dividend.

Profile

Established in 1901 as a drug wholesaler, Teva Pharmaceutical has become the world's largest generic drug company. Based in Israel, Teva develops, manufactures, and commercializes generic and branded drugs. It supplies raw materials to competitors through its bulk pharmaceutical business. On the branded side, Teva produces Copaxone, a multiple sclerosis therapy with annual sales of around $1.7 billion, although only a portion of this amount is recognized as revenue to Teva.

Growth

We assign Teva midteens projected growth for the next five years, consistent with management's plan. However, we believe significant acquisitions are necessary to get there.

Profitability

We expect Teva to maintain a mid-20s operating earnings margin over the next five years, which assumes steady growth in the generic and branded segments.

Financial Health

Teva's debt burden is still modest after the Barr acquisition.

Authors can be reached at analyst feedback.