Teva Pharmaceutical Industries, Ltd. TEVA

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Thesis 07-30-2009

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 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

Morningstar Rating
★★★

Stock Price
As of 07-30-2009
$52.82

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

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.	**12,237**	**46,038**
* Novartis AG	42,046	117,656
* Watson Pharmaceuticals Inc.	2,631	3,639
* Mylan Laboratories, Inc.	5,337	4,959

* Morningstar Analyst Report Available

Data as of 06-30-09

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

face competition from better substitutes in the years ahead.

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.

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