

Company Focus

5 November 2007 | 13 pages

Polska Grupa Farmaceutyczna SA (MDIC.WA)

 Target price change
 Estimate change

Limited Upside; Rather a Defensive Play – We Keep HOLD Rating

- New acquisitions** — PGF has invested in the Lithuanian market, acquiring stakes in Limedika (third-largest wholesaler) and Gintarine Vastine (pharmacy chain with €25m of revenues). The company is also in the process of acquiring Polish wholesaler Aptekarz. Given PGF's good acquisition track record, we believe these investments should be value-accretive for PGF shareholders.
- Profitable properties** — PGF has accelerated the disposal of its non-core business properties. It is hard to estimate a precise value for these assets; however, given the substantial increase in property values in Poland and considering only the value of PGF properties already listed for sale, we assume that the company will be able to report some ZI 10m profit a year in 2007-09E.
- Changes to law** — The old parliament voted for changes to pharmaceutical law that could be problematic to interpret. This could result in short-term market turbulence, but we believe that the situation should be resolved soon.
- Forecast revisions** — We are raising our EPS numbers for 2007E-09E by 9%, 16% and 16%, respectively, mostly after accounting for profit on property sales and including the impact of newly acquired companies.
- Valuation Update** — We lift our target price to ZI 101 from ZI 85. Our revised valuation includes the impact of acquisitions, extra value from the property bank (ZI 6 per share) and the roll-forward of our valuation base to end-2008E.

Hold/Low Risk	2L
Price (02 Nov 07)	ZI97.85
Target price	ZI101.00
	<i>from ZI85.00</i>
Expected share price return	3.2%
Expected dividend yield	3.1%
Expected total return	6.3%
Market Cap	ZI1,214M
	US\$483M

Price Performance (RIC: MDIC.WA, BB: PGF PW)



Polska Grupa Farmaceutyczna SA (PLN)

Year to 31 Dec	2005A	2006A	2007E	2008E	2009E
Sales (ZIM)	3,890.7	4,007.6	4,434.6	5,297.0	5,586.7
Net Income (ZIM)	52.6	62.5	73.3	87.7	98.4
Diluted EPS (ZI)	4.26	5.03	5.83	6.97	7.82
Diluted EPS (Old) (ZI)	4.26	5.04	5.33	6.02	6.75
PE (x)	23.0	19.5	16.8	14.0	12.5
EV/EBITDA (x)	16.9	14.2	14.2	11.7	10.7
DPS (ZI)	2.18	2.37	2.40	3.00	3.00
Net Div Yield (%)	2.2	2.4	2.5	3.1	3.1

See Appendix A-1 for Analyst Certification and important disclosures.

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¹Dom Maklerski Banku Handlowego SA

Fiscal year end 31-Dec	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	23.0	19.5	16.8	14.0	12.5
EV/EBITDA adjusted (x)	16.9	14.2	14.2	11.7	10.7
P/BV (x)	5.7	5.0	4.2	3.6	3.1
Dividend yield (%)	2.2	2.4	2.5	3.1	3.1
Per Share Data (ZI)					
EPS adjusted	4.26	5.03	5.83	6.97	7.82
EPS reported	4.26	5.03	5.83	6.97	7.82
BVPS	17.15	19.61	23.04	27.00	31.83
DPS	2.18	2.37	2.40	3.00	3.00
Profit & Loss (ZIM)					
Net sales	3,891	4,008	4,435	5,297	5,587
Operating expenses	-3,815	-3,921	-4,334	-5,173	-5,451
EBIT	75	87	100	124	135
Net interest expense	-6	-6	-11	-9	-8
Non-operating/exceptionals	3	0	4	5	6
Pre-tax profit	72	81	93	121	133
Tax	-18	-18	-18	-23	-25
Extraord./Min.Int./Pref.div.	-2	0	-2	-10	-9
Reported net income	53	63	73	88	98
Adjusted earnings	53	63	73	88	98
Adjusted EBITDA	92	108	108	132	144
Growth Rates (%)					
Sales	6.9	3.0	10.7	19.4	5.5
EBIT adjusted	13.4	15.5	15.0	23.9	9.0
EBITDA adjusted	15.8	17.3	-0.7	22.7	8.9
EPS adjusted	11.0	18.1	15.9	19.6	12.3
Cash Flow (ZIM)					
Operating cash flow	58	105	36	76	104
Depreciation/amortization	17	21	7	8	9
Net working capital	-9	35	-37	-25	-4
Investing cash flow	-57	20	-168	-3	-57
Capital expenditure	-31	-30	-57	-18	-58
Acquisitions/disposals	-26	53	-111	15	1
Financing cash flow	-6	-111	125	-64	-44
Borrowings	27	-76	155	-26	-6
Dividends paid	-27	-30	-30	-38	-38
Change in cash	-5	14	-8	9	3
Balance Sheet (ZIM)					
Total assets	1,445	1,490	1,793	2,010	2,138
Cash & cash equivalent	39	52	44	53	55
Accounts receivable	432	467	532	628	654
Net fixed assets	217	148	199	209	259
Total liabilities	1,188	1,199	1,457	1,615	1,673
Accounts payable	737	826	922	1,091	1,151
Total Debt	372	300	455	429	423
Shareholders' funds	257	291	336	396	466
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	2.4	2.7	2.4	2.5	2.6
ROE adjusted	26.3	27.2	27.3	27.9	26.6
ROIC adjusted	10.0	11.9	13.4	14.9	15.1
Net debt to equity	129.6	85.1	122.2	95.1	78.9
Total debt to capital	59.1	50.7	57.5	52.0	47.6

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Forecast & Valuation Revision

New Acquisitions and Result on Property Sale Are the Major Reasons for Forecast Change

The acquisitions of Lithuanian operations (both retail and wholesale), the purchase of a Polish tier 2 wholesaler (Aptekarz) and expected additional profits from property sales are the major reasons behind the increase to our earnings estimates. We have also raised our forecast for 2007 pharmaceutical market growth to 7% (vs. our previous estimate of 6%).

We expect PGF's incremental expansion in the retail segment in 1H07 to drive improved sales and margins. The merger with Hurtownia Aptekarz will deliver an additional ZI 300 million of revenue from 2008E, but should be neutral for margins, on our estimates. We assume that PGF's Lithuanian acquisitions will be consolidated from November 2007. This should impact the company's earnings profile, as 8% of sales will derive from the Baltic region from 2008E, bringing higher margins and a slightly lower tax rate. We conservatively estimate the overall impact of new acquisitions at around ZI 8 million a year in 2008-09E with no impact in 2007E. The upward revisions to our 2008-09E net profit forecasts are much higher, however, reflecting expected profits from the sale of land/properties, which is included in the other operating income line. PGF has decided to set up a developer company (AB7), which will be able to use PGF land as its own investment to create a JV partnership with a development company. It is hard to estimate the total value of profits that PGF may achieve from selling its properties (or from a potential JV with a developer). However, given the substantial increase in property values in Poland over the last two years and considering only the value of PGF properties already listed for sale (i.e. above ZI 70 million), we assume that the company will be able to report some ZI 10m profit a year in 2007-09E.

Figure 1. PGF — Forecast Revision Summary, 2007-09E (Zloty in Millions)

	2007 old	2007 new	Chg New/Old	2008 old	2008 new	Chg New/Old	2009 old	2009 new	Chg New/Old
Revenues	4,169.7	4,434.6	6.4%	4,340.2	5,297.0	22.0%	4,517.6	5,586.7	23.7%
Gross Profit	446.8	474.4	6.2%	466.4	577.2	23.8%	487.5	609.1	24.9%
SG&A	343.4	379.8	10.6%	351.8	455.7	29.5%	361.7	475.9	31.6%
Other operating income/costs	0.9	13.0	>1000%	0.9	10.6	>1000%	0.9	10.6	>1000%
Operating profit	86.0	100.2	16.5%	95.7	124.1	29.7%	105.8	135.3	27.9%
Pretax	83.7	93.5	11.6%	94.5	120.6	27.6%	106.0	133.0	25.4%
Net Profit	67.1	73.3	9.3%	75.7	87.7	15.8%	85.0	98.4	15.9%
EPS (ZI)	5.33	5.83	9.3%	6.02	6.97	15.8%	6.75	7.82	15.9%

Source: CIR/DM BH estimates

Valuation Update

Following the updates to our forecasts and valuation model, we have increased our target price for the company to ZI 101 from ZI 85. At the same time, we reiterate our Hold/Low Risk recommendation. The valuation has benefited from:

- Revisions to our forecasts to include the impact of new acquisitions
- Roll-forward of our DCF valuation date by one year (from end-2007E to end-2008E)
- Accounting for properties that are slated for sale, which we conservatively value at ZI 75m (or ZI 6 per PGF share)

In considering valuation multiples for PGF, too, we now focus on 2008E (vs. 2007-08E previously). We consider 15-18x forward P/E (excluding one-offs) plus the value of properties for sale (ZI 6/share, on our estimates) an appropriate trading band for PGF. The implied valuation range of ZI 100-119 supports our new target price.

Some Details on New Acquisitions and Business Developments

Poland

PGF has spent more than ZI 35m on acquisitions of small pharmacy chains, adding them to its retail operations as well as to the DoZ partnership scheme of more than 1,600 visually identical pharmacies. We believe that PGF's expansion in proprietary pharmacies should improve operating margins after the reorganization of group's capital structure; however, in the medium term, it could have negative impact on the cost base.

The Polish pharmaceutical wholesale segment is a latecomer to the M&A party. PGF is an active player that aims to maintain its leadership position. Its latest acquisition (Hurtownia Aptekarz) will strengthen the company's presence in Eastern Małopolska, where its market share was previously relatively low (11.1%). Moreover, through Hurtownia Aptekarz PGF will get access to unique clients (i.e. those it has hitherto not served); on this basis, we project its market share in the region to increase to c. 35%. The acquisition will also bring PGF three warehouses and c. ZI 300 million of annual revenues.

Restructuring of group's structure and operations has resulted in the creation of AB7. This subsidiary is intended to act as a real estate holding & development company, and will manage all PGF's land holdings that are not involved in its operating activities. While dormant for the time being, this start-up should be able to capitalize on PGF's land bank and contribute to PGF's results in future, either by selling land or using it for construction purposes.

Lithuania

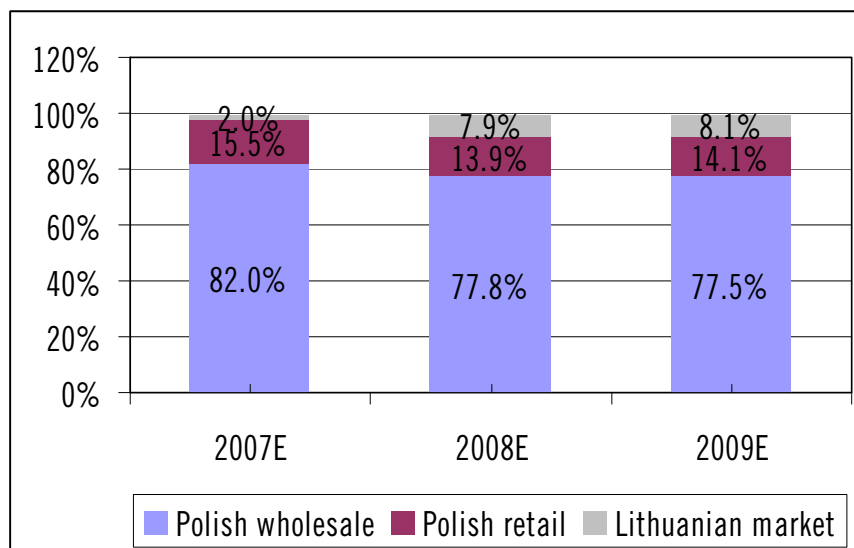
As the initial steps in its plan to become one of the major players in the Lithuanian pharmaceutical market, PGF has acquired Limedika and Gintarine Vastine. These acquisitions make PGF the third player in wholesale market, challenging Finnish group Tamro and Euroapteka. The Lithuanian pharmaceutical market was worth c. ZI 1,500 million in 2006 (+10% yoy) and is expected to grow annually by 7.2% until 2010E. Moreover, PGF will be able to benefit from certain characteristics of Lithuanian market:

- A far more 'free market' approach to pharmaceutical regulations by the Lithuanian legislative authorities (lack of anti-concentration restrictions or statutory margins) compared with Poland.
- The Lithuanian market structure, whereby Lithuanian pharmaceutical distributors typically consist of a wholesaler and a chain of pharmacies, with these chains controlling 80% of the market

Limedika's net margin of 4.6% is more than twice as high as PGF's and the Polish pharmaceutical market average. We expect Gintarine Vastine – the retail part of the Lithuanian investment – to be profitable from 2007E and to contribute positively to PGF's financials in 2008E, with an expected net margin of 2%. Due to this expansion, PGF can expect to add ZI 430 million of Lithuanian revenues and c. ZI 8-9 million of net profit in 2008E and 2009E.

Developments in the Lithuanian market – i.e. competition between five major wholesale players – may drive a reduction of wholesale margins in future. However, this may be offset by the retail part of the business, where we expect a fall in the number of individual pharmacies in favour of chains. Furthermore, we think PGF can expect to see synergies from this acquisition in terms of product selection, greater bargaining power and new distribution channels.

Figure 2. PGF – Breakdown of Sales, 2007E-09E



Source: CIR/DM BH estimates

The UK

PGF's announced plans to open pharmacies in the UK (two by the year-end) suggest to us that the company is focusing increasingly on opportunities for expansion beyond Poland's borders. While an interesting indication of the company's strategy, the UK investments are not of a material size, in our view.

Legal Environment – Hopefully, It Should Crystallize Soon

The introduction of legal changes (amendments to the pharmaceutical bill voted in September 2007), which restrict the stimulation of sales via anti-discount measures, aims at unifying wholesale prices for reimbursed drugs. This could result in an inability on the part of wholesalers to offer discounts subject to turnover, which could lead to reduced competition (and potential client-switching away from companies that were previously able to offer higher discounts).

In order to avoid this, wholesalers may offer lower prices to all clients in order to keep their existing client bases – and that could result in lower margins. Another potential negative impact of this legal change relates to the introduction of controls to ensure compliance with the new law – as market leader, PGF will have to allocate some time to provide inspectors with the required information.

However, due to a certain semantic ambiguity and lack of coherency, interpretation of the new law will be far from straightforward – hence, it is very difficult to estimate its impact on the industry. Moreover, there remains doubt as to whether the new law impedes companies’ freedom to draw up contracts – a potential basis for revoking the law. We think the negative financial impact of the new law is avoidable via a shift in discounts policy more towards OTC products.

It should be noted that the new pharmaceutical bill was intended to:

- introduce fixed margins;
- limit pharmacies’ domestic market share to 1%; and
- force companies to separate their wholesale and retail operations (giving them five years to sell either part of the business) – however, this was postponed due to dissolution of parliament.

In our view, the composition of the newly elected parliament, with its pro-free market approach, is likely to result in amendments to or rejection of this bill. We would also expect the new government/parliament to be able to provide reasonable interpretation of the amendments that were voted in September.

Financials

Figure 3. PGF — Profit and Loss Account, 2003-09E (Zloty in Millions)

	2003	2004	2005	2006	2007E	2008E	2009E
Consolidated Revenues	3,566.1	3,639.4	3,890.7	4,007.6	4,434.6	5,297.0	5,586.7
Cost of Revenue	-3,213.7	-3,287.6	-3,518.1	-3,587.1	-3,960.1	-4,719.8	-4,977.6
Gross Profit	352.4	351.8	372.6	420.5	474.4	577.2	609.1
SG&A	-219.2	-273.7	-292.9	-325.1	-379.8	-455.7	-475.9
Other operating Income/(Cost)	-42.9	1.6	12.6	13.1	13.0	10.6	10.6
EBITDA	90.3	79.8	92.4	108.4	107.6	132.1	143.9
Depreciation	-16.5	-13.2	-17.0	-21.3	-7.5	-8.0	-8.6
Operating Profit	73.8	66.5	75.4	87.1	100.2	124.1	135.3
Financial Income/(Cost)	-8.6	-3.3	-3.3	-5.7	-6.7	-3.5	-2.3
Amortisation of Goodwill	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Extraordinary Items	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Income Before Taxes	65.2	63.2	72.1	81.4	93.5	120.6	133.0
Income Tax	-27.3	-16.6	-18.0	-18.3	-18.2	-23.1	-25.5
Share in (profit) loss of companies subject to acquisition accounting	0.0	0.1	0.1	-0.1	-0.1	-0.1	-0.1
Minority (Profits)/Losses	-1.4	0.3	-1.6	-0.5	-1.8	-9.7	-9.0
Net Income	36.6	47.0	52.6	62.5	73.3	87.7	98.4
INCOME STATEMENT MARGINS	2003	2004	2005	2006	2007E	2008E	2009E
Gross Margin	9.9%	9.7%	9.6%	10.5%	10.7%	10.9%	10.9%
EBITDA Margin	2.5%	2.2%	2.4%	2.7%	2.4%	2.5%	2.6%
Operating Margin	2.1%	1.8%	1.9%	2.2%	2.3%	2.3%	2.4%
Pre -Tax margin	1.8%	1.7%	1.9%	2.0%	2.1%	2.3%	2.4%
Net Margin	1.0%	1.3%	1.4%	1.6%	1.7%	1.7%	1.8%

Source: Company reports and CIR/DM BH estimates

Figure 4. PGF — Balance Sheet, 2003-09E (Zloty in Millions)

	2003	2004	2005	2006	2007E	2008E	2009E
Current Assets:							
Cash and Equivalents	34.9	43.6	38.6	52.2	44.0	52.5	55.4
Other Marketable Current Assets	15.9	41.6	65.7	63.5	66.7	70.0	73.6
Receivables	595.6	423.9	431.5	467.3	532.1	627.7	653.6
Inventory	408.9	484.3	502.4	549.1	620.8	725.7	765.4
Total Current Assets	1,055.4	993.5	1,038.2	1,132.2	1,263.7	1,476.0	1,548.0
Fixed Assets:							
Tangible Assets	178.8	221.9	217.3	148.3	199.2	209.1	258.8
Existing Intangibles	5.6	21.9	25.8	28.9	28.0	28.0	28.0
Consolidation Goodwill	1.1	114.4	115.9	155.6	155.6	155.6	155.6
Investments	13.4	14.4	39.3	13.2	133.5	125.7	130.8
Other Assets (Long -Term Receivables)	0.2	0.1	0.6	0.6	0.7	0.8	0.8
Total Fixed Assets	199.2	372.8	398.9	346.6	516.8	519.1	574.0
Prepayments	5.0	5.9	8.3	11.6	12.9	15.4	16.2
TOTAL ASSETS	1,259.6	1,372.1	1,445.4	1,490.4	1,793.4	2,010.4	2,138.3
Liabilities:							
Accounts Payable	801.5	718.5	737.2	826.1	922.4	1,091.2	1,150.9
Other Current Liabilities	37.4	36.0	36.1	32.7	36.1	43.2	45.5
Short -Term Debt	66.7	51.3	86.6	167.6	254.0	239.5	236.1
Long -Term Debt	117.8	294.2	285.5	132.4	200.8	189.3	186.6
Other Long - Term liabilities	12.5	12.5	7.1	4.1	3.6	3.3	3.0
Deferred Income	7.1	5.1	9.6	9.1	10.1	12.1	12.7
Provisions	16.3	25.4	26.0	27.2	30.1	36.0	37.9
Other (Reserves)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Minority Interest	38.0	42.7	44.0	44.5	46.4	56.1	65.1
Total Stockholders' Equity	162.3	186.3	213.3	246.7	289.9	339.8	400.5
TOTAL LIABILITIES & EQUITY	1,259.6	1,372.1	1,445.4	1,490.4	1,793.4	2,010.4	2,138.3
BALANCE SHEET RATIOS	2003	2004	2005	2006	2007E	2008E	2009E
Current Ratio	1.2	1.2	1.2	1.1	1.0	1.1	1.1
Quick Ratio	0.7	0.6	0.6	0.6	0.5	0.5	0.5
Total Debt/Equity	652.7%	613.5%	556.9%	486.0%	502.7%	475.2%	417.7%
Bank Debt/Equity	113.7%	185.4%	174.4%	121.6%	156.9%	126.2%	105.5%
ROE	22.5%	25.2%	24.7%	25.34%	25.3%	25.8%	24.6%
ROA	2.9%	3.4%	3.6%	4.2%	4.1%	4.4%	4.6%

Source: Company reports and CIR/DM BH estimates

Figure 5. PGF — Cash Flow Account, 2003-09E (Zloty in Millions)

	2003	2004	2005	2006	2007E	2008E	2009E
Net Income from Operations	36.6	47.0	52.6	62.5	73.3	87.7	98.4
Depreciation and Amortisation	16.7	13.3	17.0	21.3	7.5	8.0	8.6
Net Working Capital Change	75.2	3.2	-1.9	-10.7	-28.6	-33.1	-6.5
Other	40.7	-3.7	7.1	45.4	7.0	36.4	28.2
Cash Flows from Operating Activities:	169.2	59.8	74.8	118.6	59.2	98.9	128.8
Acquisitions, net of Cash Acquired	-2.5	-68.7	-1.2	1.8	-120.3	7.9	-5.2
Capital Expenditures, Net	-30.4	-56.1	-31.2	-30.2	-57.3	-18.0	-58.4
Investments and Marketable Securities	-1.7	-43.7	-48.5	-37.5	-3.2	-3.3	-3.5
Other	22.7	10.7	29.9	89.4	12.5	10.0	10.0
Cash Flows from Investing Activities:	-11.9	-157.8	-51.0	23.5	-168.3	-3.5	-57.1
Debt Short -Term	-206.7	-15.4	35.3	76.9	86.5	-14.5	-3.5
Debt Long -Term	109.8	168.3	-8.5	-153.0	68.3	-11.4	-2.7
Dividends Paid	-12.2	-24.5	-27.1	-29.9	-30.2	-37.7	-37.7
Issuance of Shares	2.0	1.2	0.3	0.0	0.0	0.0	0.0
Interest paid	-14.7	-17.9	-23.1	-17.5	-23.7	-23.3	-25.0
Other	-23.3	-3.5	-5.8	-5.0	0.0	0.0	0.0
Cash Flows from Financing Activities:	-145.2	108.3	-28.8	-128.5	100.9	-86.9	-68.9
Beginning Cash	22.8	33.2	43.6	38.6	52.2	44.0	52.5
Increase/(Decrease) in Cash	12.1	10.4	-5.0	13.6	-8.2	8.6	2.9
Ending Cash	34.9	43.6	38.6	52.2	44.0	52.5	55.4

Source: Company reports and CIR/DM BH estimates

Polska Grupa Farmaceutyczna SA

Company description

PGF is the leading pharmaceutical distributor in Poland, with an estimated market share of 17-20%. The profitability of the business depends on government regulation (wholesale gross margin on sales is currently at about 8.5-9.7%). The key growth driver is development of the domestic pharmaceutical market. Long-term prospects for the Polish pharmaceutical market are good, in our view - we forecast the pharmaceutical market to grow at a long-term CAGR of around 6%.

Investment strategy

We rate shares of PGF Hold/ Low Risk (2L), with a target price of ZI 101 and a 2007E DPS of ZI 3. In our view, the key growth driver for the company will be development of the domestic pharmaceutical market, although expected expansion in the Lithuanian market will also be an important factor for value creation in the future. We like the company's fundamentals and believe that its earnings expansion will on average surpass GDP growth. However, we tend to believe that, at current share price levels, the upside potential is rather limited.

Valuation

Our primary valuation method for PGF shares is DCF, assuming a weighted average cost of capital (WACC) of 9.1% between 2008 and 2015 and a nominal terminal growth rate of 3% (real 0%). We forecast a CAGR for PGF revenues of 6.8% and an average operating margin of 2.55%. Our target price is ZI 101 per share, which reflects our DCF valuation. To cross-check our findings, we run a 2008E P/E analysis, excluding one-off gains but adding the value of properties for sale (ZI 6 per share). This approach yields an estimated valuation range of ZI 100-119. We assume that the stock should trade between 15x and 18x forward P/E, which we find appropriate for industrial mid-cap Warsaw-listed stocks.

Risks

We rate PGF Low Risk. The rationale behind our risk rating is higher-than-average quality of management and PGF's leading position in the domestic marketplace. On the other hand, profitability of the business depends to some extent on government regulation. Other risks that may prevent achievement of our target price are: 1) the drug reimbursement level affects the total value of the pharmaceutical market; and 2) the financial situation of major clients - Hospitals and Pharmacies - affects the level of bad receivables.

Appendix A-1

Analyst Certification

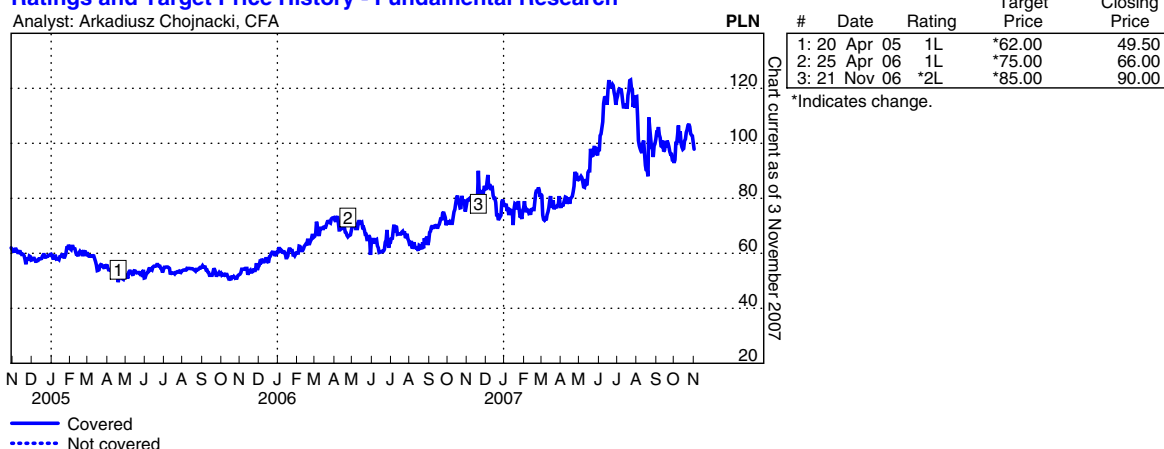
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