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CLALFINANCE BROKERAGE

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# TEVA

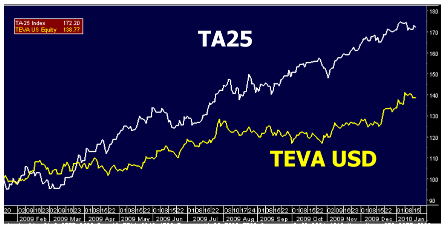
(Bloomberg Ticker: TEVA)

# Teva aiming High
## At current levels, stock is attractive
## Raising PT to $67

**Updates**

- ☐ **Rating**
- ☑ **Price target**
- ☐ **Forecast**

| Key figures | |
|---|---|
| **Rating** | **Outperform** |
| **Price target ($)** | **67.0** |
| **Current price ($)** | **58.7** |
| Market cap ($) | 52b |
| 12-mo. high ($) | 58.7 |
| 12-mo. low ($) | 40.6 |
| 12-mo. Change (ADR) | 39% |
| 12-mo. change TA25 | 73% |
| Daily volume (m**ILS**) | 87 |
| Free float | 90% |
| P/E 2009E | 17.6 |
| P/E 2010E | 13.1 |
| **Previous rating** | **Outperform** |
| **Previous price target** | **$60** |




The company elaborated on its strategic plans for the next few years at its presentation last week. Management has indicated the generic segment will continue to be a major focus, with the aim being to expand into new markets across the globe. Concomitantly, the company will keep expanding its brand-name offerings designed to attain the kinds of high profit margins characteristic of the industry.

**Most growth to come outside the U.S.** Teva has targeted markets outside the U.S. as the main source of revenue growth in coming years in the belief that the worldwide trend of health care cost reductions will open new markets for the company, with generic companies gaining higher penetration rates than those that currently prevail. Management believes Teva will be amongst the top three players in every major generic market it competes in.

**Reducing dependency on Copaxone, a central objective**. Management believes Copaxone will begin experiencing material competition in 2012, when orally administered MS treatments come on line. While it remains possible that competition will be postponed to some later date, Teva intends to substantially expand its line of brand-name drugs aimed at offsetting eventual revenue loss from its flagship MS offering.

**Biogenerics to make only a modest contribution**. Management believes this high-profile business will contribute around $850m in sales by 2015, reflecting less than 2.5% of overall revenue for that year. The company believes biogenerics will only begin representing a major share of its sales in the distant future.

**Future acquisitions to be made in cash**. Management looks to generate $22 billion in cash flow over the next few years. This is an important objective from the company's perspective, seeing that it intends to conduct future acquisitions using cash, thereby avoiding a dilutive impact on existing shareholders.

**Both sales and expenditures to rise**. Despite the hefty top-line growth the company projects for coming years, costs will largely cancel out any favorable operating leverage impact. Gross margins are expected to stay at current levels, but the company will be hiking its R&D investments, and also expects higher tax rates going forward.

**The strategy for coming years will attenuate forex risk**. The Israeli investor has been negatively affected by the U.S. dollar's ongoing slide, with attendant consequences for the company's TASE-listed shares. The revamped focus on markets outside the U.S. is expected to remedy the forex problem, seeing that non-dollar denominated sales will be enhanced when converted into greenbacks.

**Despite its recent rise, the stock is still attractively priced**. Teva currently trades at 12.8 times expected FY2010 earnings. This is a considerably lower multiple than the average level in the market. It's worth underlining that Teva is projecting 13.4% annual bottom-line growth for the coming five years, putting the stocks PEG rate at less than one. In consequence, we believe the current share price is an attractive entry point. What investors are getting for their money is the world's leading generic company, in an expanding market, and at a very reasonable price.

With investors in Israel having focused on higher-beta shares over the past year, Teva has underperformed the TA-25 Index. We wouldn't be surprised if the opposite were to be the case in 2010.
**While maintaining our rating on the stock at Outperform, we've lifted our per-share price target to $67.00, based on fifteen times projected 2010 net income.**

**With greater worldwide receptiveness to generics, Teva is making aggressive plans to exploit the new openness**

Management's geographical growth targets for coming years make it clear the company has realized that the glass ceiling in the U.S. market is looming ever closer. While anticipated growth rates in the North American market are still robust, of the $17 billion of additional sales the company expects to generate by 2015, only $11 billion are expected to originate in the North American market.

Some parts of the world have shown a greater receptiveness to generic products than they used to. Together with higher standards of living, health care costs have been rising in parallel. The use of generic drugs is a concrete method for reducing the costs from this trend.

Japan will serve as a testing ground for Teva's potential in global markets. The country is a huge market for brand-name drugs—in fact, the second largest in the world. But generics still have only an anemic penetration rate. The average Japanese consumer views generic drugs a lower quality product, and hence an unacceptable substitute for brand-name treatments. By tradition, the Japanese respect authority, and patients have been unwilling to argue about prescriptions issued by their doctors, even if cheaper alternatives were available. The doctors, for their part, have shown a marked preference for brand-name drugs. Some of them were never exposed, during their years of training, to generics as a reliable substitute for their brand-name equivalents.

However, Japan's government has deemed it necessary to find cheaper sources of health care, having identified generic drugs as one means to this end. Officials in recent years initiated a campaign to educate the doctors and the general public about the use of such drugs. The government has also established a mechanism to compensate hospitals with the aim at encouraging overall cost reductions and transitioning into the use of generics. And the results are there to be seen. In 2008, the number of prescriptions written that permitted the use of generic substitutes stood at 58.9%, compared with 17.5% in 2007.

Teva hasn't had a significant presence in the Japanese market, where its main competitors already have a foothold. Sandoz has been active in Japan since 2005. Mylan has had a presence in Japan for years. Despite this fact, Teva has rapidly closed the gap, entering the market by making two acquisitions, and at present is the country's fifth largest provider of generic drugs.

As in Japan, other countries are likely to adopt policies favoring the use of generics, which should create a favorable backdrop for Teva. The company has the resources and deep managerial bench to take its place amongst the leading generic firms in any country where it chooses to compete. And while every country presents its own opportunities, difficulties specific to that country can be expected to emerge. Japan, for example, saw the need to educate the market to overcome resistance to cheap products manufactured overseas, in addition to overseeing the implementation of a broad-based manufacturing network aimed attaining compliance with stringent Japanese regulations and to overcome the resistance of local pharmacies to keep generic products on their shelves.

Teva will have to adapt itself to the new markets it enters, and build an efficient, profitable infrastructure of the sort it maintains in North America. This will be a major challenge for the company in coming years.

**Teva prepares itself for declining Copaxone sales**

The company's flagship MS drug has disproven naysayers over the years. Concerns regarding competitive challenges are nothing new. This time, though, Teva itself has marked the date on the calendar when competitive pressures are slated to be felt—namely, 2012. We believe management is being cautious in its projections, and wouldn't be surprised if Teva's blockbuster drug suffers only a minor hit in 2012.

The company has identified women's health care (a product line it got with Barr) and inhalants (which it received in the Ivax acquisition) as two significant growth engines for the company's brand-name division. The two segments are projected to generate $2.5 billion in sales by 2015.

Moreover, managements is convinced that the brand-name products it's currently promoting have the opportunity of becoming rising stars by 2015, adding $1.5 billion to the brand-name division's sales by that date.

**Biogenerics won't have a material impact in the near term**

It would seem that investor have placed too much hope in biogenerics when assessing the company's prospects for the foreseeable future. Management, in fact, projects that sales from this business line will reach only $850m by 2015, representing a mere 2.5% of total sales in that year.

It's worth mentioning that subsequent to 2015, biotech protects coming off patent are expected to slow considerably. In 2015 to 2020 biotech-generated drugs coming off patent will represent $23 billion in brand-name annual sales, marking a 40% decline from those coming off patent in the first half of the decade.

Which isn't to say that global biogenerics won't be a growth engine for Teva. It will—but in the long run. The company has a long-term strategy aimed at attaining market leadership in the segment. But, again, these are long-term prospects, with plenty of uncertainties along the way regarding how the market will develop in practice and how generic companies will actually manage to maneuver the shoals.

**Operating leverage to be hurt by higher outlays**

Teva projects that higher R&D expenditures and rising tax rates will offset the positive impact of enhanced sales on the company's bottom-line results. R&D outlays are expected to increase to 8% of total revenue by 2012 due to the need to develop and promote its brand-name offerings. It's worth recalling that Teva's investments in startup companies don't appear on its income statement, such that the investment in R&D is actually more substantial than the aforementioned figure.

The company's tax rate is expected to reach 20% to 21% of revenue, compared with 17% in 2009, owing to the decline of Copaxone as a percentage of overall sales.

These factors have led management to project annual bottom line growth of 13.4% over the coming five years, slightly lower than projections for top-line growth of 14.3% during the same timeframe.

**Forex to have a lesser impact in coming years**

From the perspective of Israeli investors, the dollar's long-term decline has tarnished Teva's stock. This isn't merely a factor of converting the company's Nasdaq stock price into fewer shekels. Additionally, until now, the company's primary market has been in the U.S. As mentioned, much of the company's future growth will come from beyond America's shores. North American sales as a percentage of total revenue are expected to fall from 62% at present to around 48% in 2015. Management's forecasts even include a slight strengthening of the dollar in coming years, which would favorably impact the company's top line even more than in the past.

**** IMPORTANT DISCLOSURE: AS OF THIS PUBLICATION, THE COVERAGE OF TEVA PHARMACEUTICALS HAS BEEN TRANSFERRED FROM GAL REITER TO AVIRAN REVIVO ****

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