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# ASPEN PHARMACARE


2021 | By Lesego Mthombothi

# Aspen Pharmacare Holdings – Positioned for a comeback?

***We initiate coverage with a one year target price of R185/share using a multiple based approach and assuming an approximate 25% increase in basis earnings per share (EPS). Aspen's strong management team, improving balance sheet and strong revenue prospects point to an impressive comeback that we think is not reflected in the current share price.***

***Elective surgeries, which are a key revenue driver for Aspen, are expected to resume as activities begin to return to some sort of normal and the number of people to receive the coronavirus vaccine increases. The COVID-19 vaccine also presents annuity income for pharmaceutical companies as the variations of the virus emerge in different parts of the globe. The COVID-19 pandemic has also re-prioritised healthcare to communities and governments alike.***

| | **Stock Information** |
|---|---|
| **Valuation** | Undervalued |
| **Share Code** | APN.JSE |
| **Sector** | Pharmaceuticals and Biotechnology |
| **Price** | |
| **52-week range** | 80.00-165.14 |
| | |
| **Market Cap** | 63,332,651,314 |
| **Enterprise Value (LTM)** | 98 996 |
| **Shares Outstanding** | 717 600 000 |
| **Free Float (%)** | 63.6% |
| **1-Year Total Return** | 20.45% |
| **Return YTD** | 14.25% |
| **Beta** | 1.36 |
| **Financial year-end** | 30 June |

## *Company Overview*

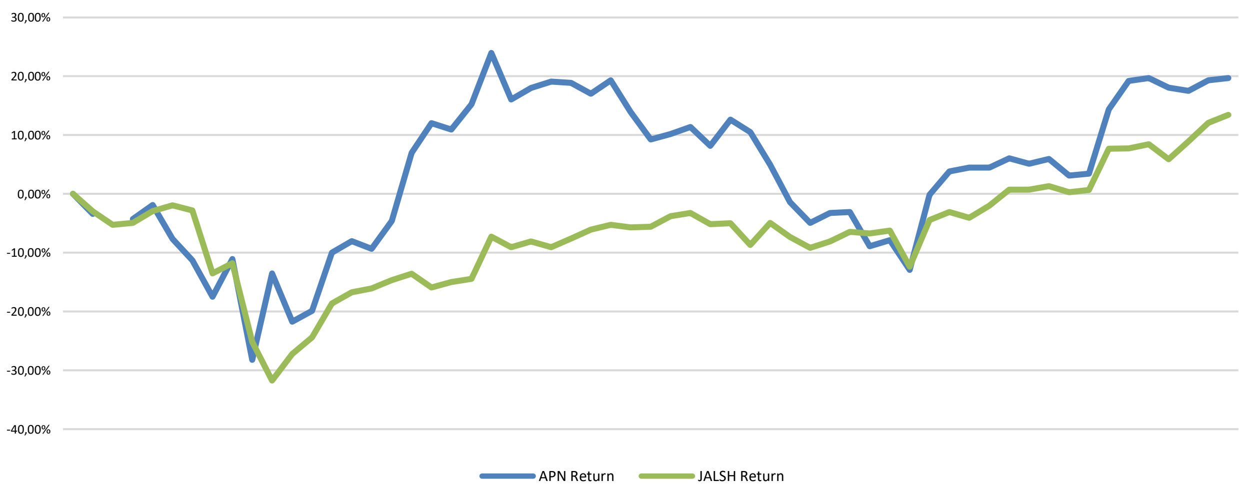
*Aspen Pharmacare is Africa's largest manufacturer and distributor of pharmaceutical products. Founded in Durban, Kwa-Zulu Natal in 1996 by its CEO Stephen Saad and soon to be deputy CEO, Gus Attridge, Aspen transformed through a series of acquisitions from a fundamentally South African generics and over-the-counter (OTC) company into a global specialised pharmaceuticals company. Through its subsidiaries, Aspen manufactures and supplies pharmaceutical products in the form of capsules, liquids, semi-solids, steriles biologicals, and pharmaceutical ingredients for the treatment of acute and chronic conditions.*

*Aspen enjoys a healthy market share across all of its product offerings which have translated into an average of 25% in operating margins over the past half a decade- through their strong global networks in more than 150 countries and successful and competent manufacturing capability with 23 manufacturing facilities in 15 sites.*

*At a forward price-to-earnings (P/E) of only 10.33 times and forward EV/EBITDA (enterprise value-to-earnings before interest expenses, tax expenses, depreciation, and amortization) of only 10.36 times compared to peaks of nearly 30 times and 20 times respectively, in our opinion, Aspen currently trades at a compelling valuation.*

*Aspen took on more debt than it could handle to the point of almost breaking its debt covenants with its lenders (peak net debt/EBITDA of 4.4 in 2018) which sparked a sell-off of its shares dropping the price from R288 in Q3 2018 to approximately R65 in Q3 2019. With debt shooting through the roof and no acquisitions on the cards during peaked debt levels, the source of growth became uncertain. However, Aspen has learned from its troubles and has since improved the health of its balance sheet through the sale of non-core assets (divestment of Nutritionals business to the Lactalis Group, the divestment of a portfolio of prescription medications in Australia to US pharmaceutical company Mylan, and the divestment of its Japanese operations to Sandoz, a division of the Novartis Group all in 2019 and most recently the sale of the commercialisation rights of its European Thrombosis business to Mylan in September 2020) to strengthen its balance sheet and re-strategise.*

*One year share price performance vs. the JSE All Share Index (17/01/2020-15/02/2021)*



*Source: Bloomberg*

## ***Business Segments***

*Aspens operations comprise of commercial and manufacturing operations as follows:*

*Commercial Brands (Regional Brands (50% revenue contribution in FY2020) and Sterile Brands (28% revenue contribution in FY2020))*

*Aspen manufactures and supplies a wide range of both prescription and OTC branded generic products to Southern Africa and other emerging markets where it has established strong brand equity. Although this market is marked with pricing pressures and competition, growth in the number of expired/expiring branded drugs and aging demographics provide opportunities for market growth. The main customers in this segment include governments, households, and private and public hospitals. In FY2020, approximately 60% (56% in FY2019) of Commercial Pharma revenues were generated in emerging markets. We expect strong emerging economies to significantly improve the company's outlook.*

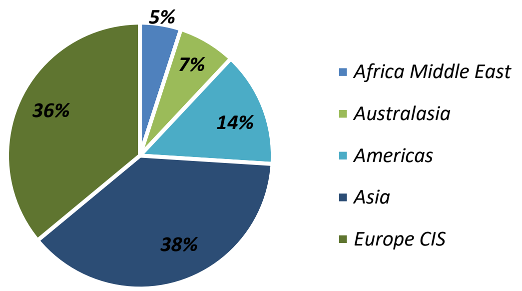
*Aspen has established strong niche positions in anesthetics and thrombotics products where they hold leading positions. In Anaesthetics, Aspen is the largest player outside of the United States, with a 20% market share, while in Thrombotics, Aspen has been the second-largest player after Sanofi, a French multinational pharmaceutical company. These sterile products require complex and extensive manufacturing capabilities thereby providing a competitive advantage, protecting their long-term profits and market share from existing and new competitors. Main customers include private and public hospitals.*

*The sale of the commercialisation rights of its thrombosis business in Europe to Mylan will remove the strain of a sub-critical mass and inefficient sales force (Mylan has 2 000 sales representatives compared to Aspen's 200), allowing it to focus its efforts in areas where they enjoy critical mass (i.e. in emerging markets).*

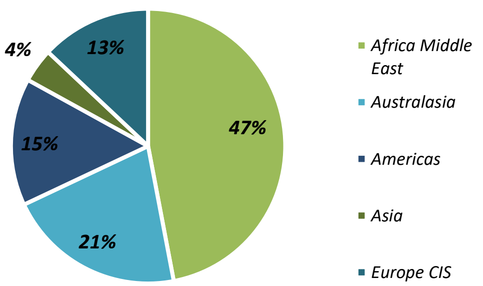
*Manufacturing – (22% revenue contribution in FY2020)*

*Aspen's, manufacturing division is responsible for the production of focused therapeutic products from Active Pharmaceutical Ingredients (API'S) and Finished Dose Form (FDF) products. APIs are key parts of a drug that produce an effect. The production of APIs is chemically intensive and involves reactors for drug substance manufacture whereas drug products such steroids, hormones, peptides, muscle relaxants, narcotics, and veterinary products are known as FDFs. Main customers in this segment include other pharmaceutical companies and generic companies.*

***FY2020 Sterile Brands Revenue (R9.66 billion)***




***FY2020 Regional Brands Revenue (R16.74billion)***




*Source: Company Annual Presentation*

## ***Financial Overview***

*With underperforming assets acquired with huge piles of debt, Aspen had overstretched itself. Sales and earnings were all lower in FY2020 (Sales: R38.6 bn; EBITDA: 10.bn and normalised HEPS: 10 815 cents) as compared to the good days in FY2016 (Sales: R41.2bn, EBITDA: R11.2 bn and normalised HEPS:11 227 cents).*

*To overcome an over-geared balance sheet and muted revenues, the Company was forced to suspend its dividend in FY2019, divest of underperforming assets, re-group and re-strategise. Aspen has since cut its net debt from R45.8 billion in FY 2018 to R35.3 billion in FY2020 and improved cash generation from operations (cash from operations up to R8.26 billion in FY2020 from R7.02 billion in FY2018). Management guidance indicates a reduction in property, plant, and equipment (PP&E) capital expenditure and reduction in manufacturing inventory which should improve its free cash flows indicating strengthening ability to produce cash and profits.*

## ***Investment Thesis***

- ***Growing markets and COVID-19 Vaccine*** *Global markets for anaesthetics, thrombotics, and branded generics are estimated to rise at approximately 3.64%, 9%, and 7.96% respectively by 2026 due to aging demographics and rise in populations suffering from chronic diseases* *and disorders. The branded generics market is highly competitive, and although the number of expired/expiring patented drugs is expected to rise, we expect Aspen to maintain a defensive position in this market with its strong brand equity and strong manufacturing capabilities. Furthermore, Aspen has agreed with global pharmaceutical giant, Johnson & Johnson, to manufacture its COVID-19 vaccine candidate through its sterile fill capacity in Port Elizabeth, which can produce more than 300 million doses per annum. The vaccines will be exported to J&J and will be integrated with its global inventory.*

- ***Global Pharmaceutical Supply Chain Disruption*** *The COVID-19 pandemic exposed key risks within the global pharmaceutical supply chains such as concentration risks and over-reliance on countries in the Asia Pacific, China particularly. The restrictions placed on manufacturing sites in China during the first hard lockdown in 2020 highlighted the need for the pharmaceutical industry to diversify the procurement of drug intermediates such as APIs and prioritise diversity of supply (source, location, and quality) as much as they do pricing.*
- ***Strong manufacturing base*** *Aspen recently announced its plan to bring the manufacturing of its anesthetics brands in-house. The Company targets more than 80% of its portfolio being manufactured in-house by 2024, thereby generating cost efficiencies throughout the value chains of these products. The savings from this strategic decision will materialise gradually (15% in 2022, 35% by mid-2023, and 100% by the end of 2024). We expect increased market share in the medium term by lowering the cost of manufacturing per unit allowing for competitive pricing where they have limited pricing power, thus resulting in increased volumes and revenue.*
- ***Liberal healthcare austerity*** *We expect a relaxing of healthcare austerity measures in developed markets eventually given current ageing demographics (one in five US citizens is expected to be 65 years or older by 2030) and the risks exposed by the COVID-19 pandemic.*
- ***New Product Launches*** *Aspen is set to launch new women's health products in the US in FY2021. Their conjugated estrogen product which is used to treat the symptoms caused by menopause represents material upside.*
- ***Reinstatement of dividends*** *The Company has given guidance that it will reinstate its dividend (no dividend paid in FY2019 and FY2020). The recommencement of dividends or a share buyback might help convince the market of greater capital restraint and strength of free cash flow generation. Aspen pays almost 90% of its annual dividends in the first half of its financial year. We expect a DPS of approx. 2.34 when they report their interim results in March 2021.*

## *Key Investment Risks*

- ***Poorly executed mergers & acquisitions*** *Aspen needs to keep making acquisitions to increase revenues, an activity they have consistently eluded. Management guidance suggests that acquisitions will remain a key part of their strategy as the health of their balance sheet improves. It has yet to prove that its "acquire, improve, de-lever" model results in increased value for shareholders (declining return on common equity (ROCE) over the past half-decade). Although Aspen's management team has proven superior deal-making skills, at current PE multiples in the low double-digits, Aspen runs the risk of acquiring assets at higher multiples and may find it challenging to find pharmaceutical assets priced at 10x-12x earnings and could potentially overspend. It is unclear whether the market will be willing to assign a higher multiple to Aspen until there is sufficient proof through value creation for shareholders that its business model is effective and warrants the business risk associated with it even if future acquisitions do not exceed their targeted 3x leverage cap.*
- ***Weak earnings*** *Aspen's business model has worked well in an environment of good emerging market macroeconomics, rising spending on healthcare, an increasing number of drugs coming off patent, and cheap financing. And, while we think that the pandemic is shifting priorities in government spending, it is unclear how much pricing pressure on the pharma industry will persist. For a high-volume business, price deflation is a headwind for Aspen. A key risk would be missed revenue and earnings expectations and the inability to materialise the long-term cost benefits from bringing the manufacturing of anesthetics in-house. The company is focussing more on its emerging markets base which comprises Africa, Australia, China, and Latin America. Although the Chinese and Indian economies are growing, Africa and Latin America face serious economic and currency pressure.*
- ***Forecast risk*** *Supply chain disruptions and normal trading disruptions from the pandemic make it difficult to reliably estimate Aspens growth. Drugs and medications sales have increased as seen in anecdotal research from Dis-Chem Pharmacies who recently stated in their trading statement that sales of medicines over the quarter increased by x% as people prioritise their health and immunity to be strong to defend themselves from the virus, the number of people getting elective surgeries could yet be delayed, as people still need to be vaccinated and avoid hospitals out of fear of overexposure to the virus.*

***Aspen is set to release its interim results for the six months ended 31 December 2020 on the 11th of March 2021.***

*APN Historical Financial Data and Estimates :*

| Financial Metrics | FY'16 | FY'17 | FY'18 | FY'19 | FY'20 | FY'21E | FY'22E |
|---|---|---|---|---|---|---|---|
| Revenue | R35.6bn | R41.2bn | R38.3bn | R35.5bn | R38.6bn | R40.0bn | R41.3bn |
| Growth (%) | - | 15.7% | -7.0% | -7.3% | 8.8% | 2.1% | 3.5% |
| EBITDA | R10.1bn | R11.4bn | R12,0bn | R10.8bn | R10.9bn | R10.3bn | R10.8bn |
| EBITDA Margin (%) | 28.4% | 27.7% | 31.3% | 30.4% | 28.23% | 25.8% | 26.5% |
| EV/EBITDA | 19.40 | 17.50 | 17.13 | 15.55 | 11.66 | 9.61 | 9.17 |
| EV/EBIT | 21.98 | 20.24 | 19.36 | 19.80 | 14.27 | 11.33 | 10.84 |
| Net debt/EBITDA | 2.92 | 3.43 | 4.44 | 3.81 | 3.38 | | |
| Dividend/share | 2.48 | 2.87 | 3.15 | 0.00 | 0.00 | 2.56 | 2.71 |
| Dividend yield | - | - | - | 0% | 0% | 1.97% | 2.04% |
| Return on Equity (%) | 11.2% | 11.9% | 13.1% | 12.5% | 10.83% | 8.25% | 8.33% |
| Return on Assets (%) | 4.5% | 4.6% | 4.8% | 5.1% | 5.23% | 4.63% | 5% |
| Return on Invested Capital | 8.4% | 8.07% | 7.4% | 3.3% | 5.7% | | |
| Price/Earning (Average) | 27.45 | 34.32 | 21.38 | 9.92 | 8.68 | 11.31 | 10.03 |

*Source: Bloomberg, Consensus Estimates and Iress, Consensus Estimates*