Pharmstandard: OTC Spin-off and Bever Acquisition Sound Alarm Bells

Investment Summary

Pharmstandard is preparing spin-off of the OTC business and possible purchase of the pharma producer Bever. The first deal offers a low buy-back and the second deal has worrying insider aspects. We recommend to SELL company stock.

Spin-off of OTC business

The Pharmstandard BoD voted unanimously for spin-off of branded OTC business into a separate legal entity. The action is subject to approval by three-quarters of shareholders at an EGM on September 27. The new company ("NewCo") will be headed by Olga Mednikova, currently the head of marketing and sales at Pharmstandard.

Shareholders will receive shares of NewCo proportionally to their stakes in Pharmstandard. Shareholders who vote against or do not vote on the spin-off can apply for buyback up to November this year at 2% discount to local shares and 18% discount to LSE quotes prior to the announcement. Pharmstandard shares will be traded ex-OTC business. NewCo should obtain listings on MICEX and possibly a foreign stock exchange, but we question liquidity of the asset.

Acquisition of Bever

Pharmstandard is also considering acquisition for $630m of Bever Pharma, which will then be made into a subsidiary of NewCo. Bever was created and is owned by a Pharmstandard BoD member and has exclusive contracts to buy the active ingredients for Arbidol and Afobazol and sell them to Pharmstandard (in the future to NewCo).

Purchase of Bever requires approval by majority of Pharmstandard voting shares, but the main shareholder (the company Augment with 54% stake) is allowed to vote, as Bever is not affiliated with any shareholders of Pharmstandard. There will be no specific buyback offer, but shareholders can sell their stock to Citibank as part of an ongoing buyback program, launched in February.

	OTC spin-off	Bever acquisition
Record date	July 5	July 5
EGM date	September 27	August 17
Approval	¾ of participating shareholders	Majority of shareholders
Buy back	R2180 per common, $16.5 per GDR	Not implied by PHST, but buyback program from February is still on
Buy back budget	10% of applications will be fulfilled, should all minorities submit their stakes	R8b was approved, company already spent R6.5

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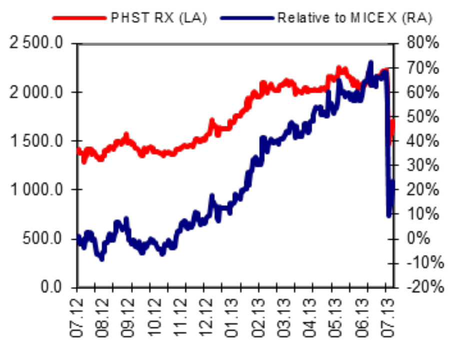
PHST RX	SELL
PHST LI	SELL

Current market cap, $m	1 823
EV, $m	1 450
ADT (30 days), $000	504
Common share	
- ticker (MOEX)	PHST RX
- number, m	37.8
- market price, $	48.3
- fair price, $	U/R
- up/down, %	n/a
- previous fair price, $	80.0
GDRs (4 GDRs = 1 share)	
- ticker (LSE)	PHST LI
- number, m	151.2
- market price, $	12.7
- fair price, $	U/R
- up/down, %	n/a
- previous fair price, $	20.0

IFRS, $m	11	12	13E	14E
Revenues	1 451	1 654	1 678	1 708
EBITDA	406	433	441	458
- margin, %	28%	26%	26%	27%
Op. income	366	387	404	415
Net income	300	321	324	333
- margin, %	21%	19%	19%	19%
EPS per local, $	7.95	8.49	8.58	8.80

	11	12	13E	14E
EV/S	1.0	0.9	0.9	0.8
EV/EBITDA	3.6	3.3	3.3	3.2
EV/FCFF	7.2	7.6	6.4	6.0
P/E	6.1	5.7	5.6	5.6



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As a result of the planned deals, investors will own two stocks. Pharmstandard will develop its business with institutional players (i.e. participation in regional tenders and development of TPP products) with lower margins (20-22% gross margin) and act as subcontractor for NewCo.

Details and rationale

The rationale for the NewCo spin-off, according to the Pharmstandard CEO, is that OTC business needs to be separated from institutional business due to more rapid expansion of the latter. Branded OTC showed 6.2% sales contraction in 2012, when it contributed 25% of Pharmstandard sales (R12.7b) and offered 36% EBITDA margin. Contraction was due to strong competition to Arbidol on the antiviral market and regulatory changes (shift of codeine-containing drugs to Rx category), and despite launch by Pharmstandard of new OTC drugs (Next) and codeine-free versions of its other main brands (Codelac, Pentalgin).

NewCo will own licenses for 27 OTC brands, marketing infrastructure and related contracts. Production assets, however, will remain in Pharmstandard, which will act as subcontractor to NewCo by manufacturing its drugs.

According to the Pharmstandard CFO, NewCo will operate with 60% gross margin and margins of NewCo should increase further after the acquisition of Bever, as NewCo will then purchase active ingredients for Arbidol and Afobazol at lower prices than Pharmstandard has paid up to now.

Our assessment

We are unpleasantly surprised by low standards of corporate governance at Pharmstandard, which we had viewed as investor friendly company. The proposed buyback price for minorities is disappointingly low and there are several other reasons for disquiet.

In a conference call the company gave no information about Bever shareholders, estimated sales and margin, or rationale for the deal price ($630m). The information provided is also insufficient to estimate future contribution of Bever to sales and EBITDA of NewCo. We are concerned that Bever is greatly overpriced, as it is owned by one of Pharmstandard's BoD members.

It was rumored earlier that Pharmstandard would sell the OTC business to a multinational player for $2.5b. We think that $1.2b would be a more likely price, since OTC has traditionally brought 40% of company EBITDA and our fair market cap prior to the latest announcements was $3b. We regret that sale to a major player has not gone ahead, as the buy-back would probably be more generous. We still think that NewCo may be sold to a major player in the future.

Conclusion and recommendations

We see no obvious drivers in NewCo, apart from the speculative idea that is may be sold to a multinational in the future. We recommend to vote against the spin-off. If it goes ahead we recommend speculative BUY of NewCo shares directly from the market as prices are likely to be low (reflecting the current heavy discount of Pharmstandard shares). We also recommend to vote against the Bever merger.

Pharmstandard GDRs were traded at P/E of 8x before the announcements. We see 50% discount as fair for company stock in current circumstances. Shares are currently traded at P/E of 6.0x. We give a SELL recommendation for Pharmstandard stock and put target prices Under Revision due to lack of clear data on synergy between NewCo and Bever Pharma.

Operating income model, $m

	2008	2009	2010	2011	2012	2013E	2014E	2015E	2016E
Revenue	576	756	978	1 451	1 654	1 678	1 708	1 739	1 772
- OTC sales	417	466	513	525	476	481	494	506	519
- Rx sales	55	73	109	129	182	188	196	205	214
- Third-party product sales	58	193	326	739	910	903	908	913	918
Cost of sales	224	388	550	909	1 046	1 064	1 080	1 096	1 113
Gross profit	352	368	428	542	608	614	628	643	659
Operating profit	192	256	286	366	387	404	415	426	437
EBITDA	243	302	319	406	433	441	458	475	492
EBITDA margin, %	*42.2%*	*40.0%*	*32.6%*	*28.0%*	*26.2%*	*26.3%*	*26.8%*	*27.3%*	*27.8%*
Net income	141	215	236	300	321	324	333	341	350
Net margin, %	*24.4%*	*28.4%*	*24.1%*	*20.7%*	*19.4%*	*19.3%*	*19.5%*	*19.6%*	*19.7%*

Source: Company data, RMG estimates

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