

KRKA Q1 - FY2019 - KRKG SV

12 - month price target 71.6 EUR
Recommendation: BUY

4.6.2019

Market price	61
EV (in millions)	1,842.4
52 Week High	61.6
52 Week Low	53.6
Avg. Volume (20d)	4,812.2
No. Shares in millions	31.9
Market Cap (in millions)	2,000.4
Total Assets (in millions)	1,985.1
Equity (in millions)	1,540.3
Net debt (in millions)	-120.7
CASH (in millions)	120.7
Earnings Date	1.8.2019
Dividend Date	18.7.2019
Dividend Yield	5.1

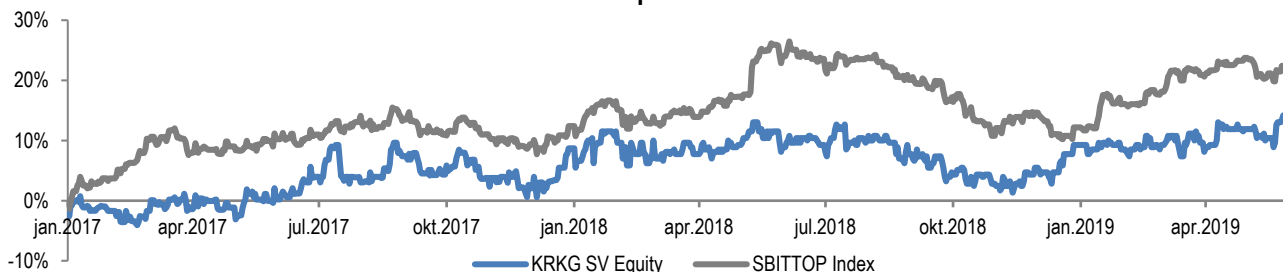
The Krka Group (Krka) is picking up momentum as its gross profit margin grew by 8.44% in the 2016 – 2018 period, while the operating margin has increased for 67.58% in the same period. Krka's main line of business is the production and sale of prescription pharmaceuticals, non-prescription products and animal health products. Krka's main market spreads from Vladivostok to Lisbon making it one of the top-ranking pharmaceutical companies in the Central and East Europe with strong penetration into Western European markets. Krka is entering in new markets such as the Chinese market, from where the first revenue streams are expected in 2019.

Currently 45 million patients use Krka's medicines every day. Outside Slovenia Krka has 28 subsidiaries and 20 representative offices. Krka operates in 6 sales regions in over 70 markets, with manufacturing sites in Slovenia, Germany, Croatia, Poland and Russia.

Prescription pharmaceuticals in Cardiovascular, Central Nervous System and Alimentary Tract and Metabolism groups are Krka's top sellers. Krka is planning to expand production by more than one third in the coming years, as R&D expenditure stands at 10% of sales.

million €	2017	2018	TTM	2019F	2020F
Sales	1,266.4	1,331.9	1,372.0	1,336.5	1,375.0
EBITDA	306.6	343.3	352.8	327.0	339.0
EBITDA Margin	24.2	25.8	25.7	24.5	24.7
Net income	152.6	174.6	195.5	171.0	170.0
Profit Margin	12.1	13.1	14.2	12.8	12.4
EPS	4.7	5.5	6.1	5.7	5.7
P/E	12.1	10.6	10.7	10.7	10.7

Stock performance



% Growth	1 M	3 M	YTD
KRKG SV	3.0%	4.9%	5.2%
SBITOP Index	-0.5%	6.2%	8.7%
Gain over Index	3.5%	-1.3%	-3.4%

Q1 FY2019

In the first quarter of this year, The Krka Group (Krka) achieved a profit per share in the amount of EUR 2.24, which is a 44.5% YoY increase. Krka's revenues rose by 12% YoY to EUR 378.5 million, while The Group has seen its operating profit grow by 17% to EUR 72.7 million and managed to increase its net profit by more than 42% to EUR 70.3 million in Q1 19. The Group allocated EUR 23.7 million to investments, of which EUR 19.6 million went to the controlling company. The price of Krka's share was up only 0.35% this year until the up-beat earnings report, when the stock gained 2.78% in a day.

Krka recorded sales growth in all its main sales regions in the first quarter. In the region of Eastern Europe, which is the largest sales region for Krka (32.4% share of sales), sales increased by 15%. In the region of Central Europe (22.8% share of sales), a 6% sales growth was achieved. Sales in the Western (22.3% share of sales) and Southeastern Europe (13.4% share of sales) increased by 14%. In Slovenia (5.8% share of sales) sales increase stood at 3%, while on the Overseas Markets region, the sales amounted to EUR 12.6 million, a 16% increase and the largest increase of any sales group.

Given the operating results of last five quarters and future expectations for the 2019 – 2022 period the market price of Krka shares stands on the undervalued side, as there is good evidence for reliable and steady growth of the sales and profit for The Group in the coming years. Due to The Group's current geographical sales distribution, the company is less exposed to the current world political risks compared to some of its peers. The share price would additionally benefit if the shares of the company would be traded in Western equity markets (such as London markets). Stock price would benefit, as well, with introducing debt financing for possible acquisitions, which would also reduce the cost of financing the company. Krka's shares have a 5.1% dividend yield. Shareholders of Krka will decide on the proposal for the distribution of accumulated profit for last year at a general assembly which will be held at July 4th, 2019. According to the proposal of the management board, the dividend will be EUR 3.20 gross per share, which is 10.3% more than last year. The planned date for the payment of dividends is July 18, 2019.

Investment considerations

+ Still peer undervalued

Current P/B ratio for the Group is 1.20, while the median for our peer group currently stands at 3.5. As well the P/E ratio is below the peer comparison average at 10.00, while the median for the peer group is it 19.8.

+ Competitive advantage

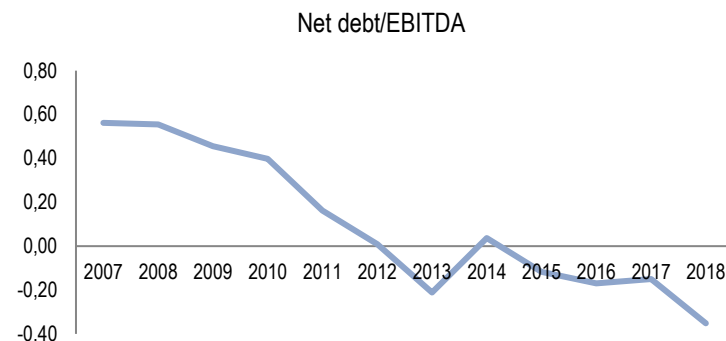
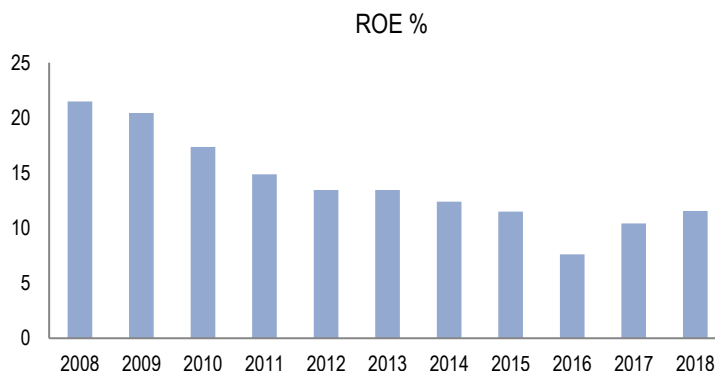
The competitive advantage of Krka lies primarily in pursuing a vertically integrated model for products from development to production and marketing. This enables the company to effectively monitor and ensure quality. The Krka strategic plan by 2022 contains a 5-year average sales growth rate. In addition to organic growth, the company also wants to ensure growth through acquisitions and long-term business ventures, such as Ningbo Krka Menovo Pharmaceutical project with Chinese partner.

+ Short term isolation from negative effects of current world political risk while having a strong balance sheet

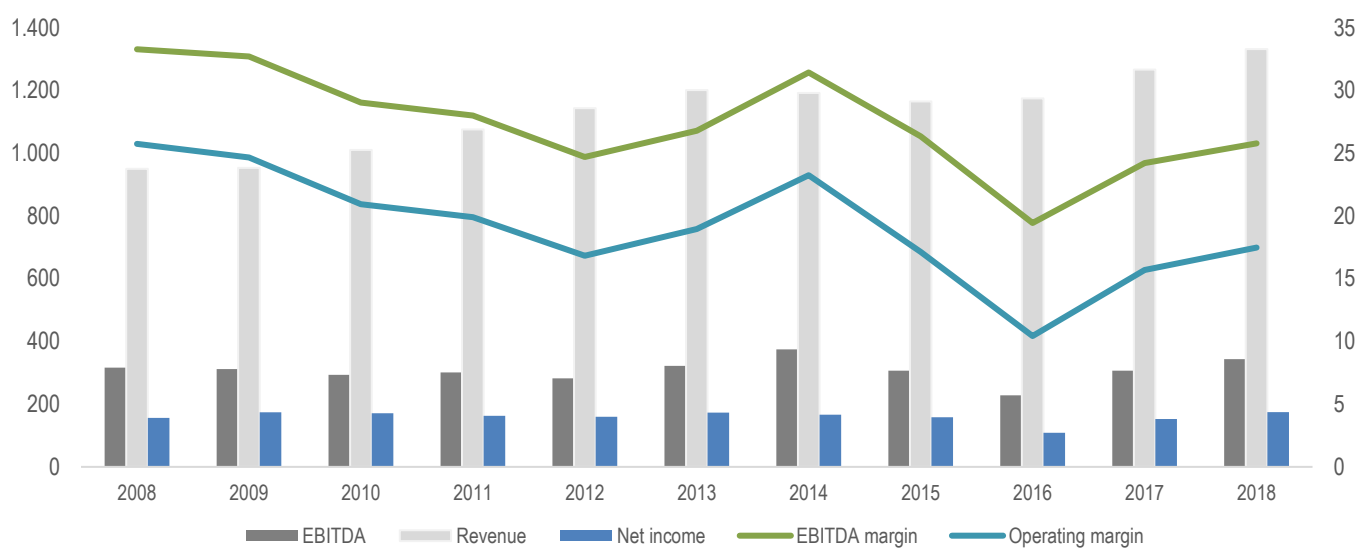
Krka's strong balance sheet in combination with its geographical sales distribution is putting the company in favorable position during the current market conditions. Krka's minimal exposure to current world political risks, as well as legal risks, is putting the company in a potentially advantageous position compared to many of its peers around the world. This combined with Krka's strong balance sheet is increasing the probability of future acquisitions by the company.

- Conservative attitude to financing through debt

Krka has a very conservative attitude regarding taking on debt and pays a high dividend. The company's Net Debt/EBITDA is in negative territory at -0.35 and the current dividend yield is 5.1%. Conservative debt financing produces a higher average cost of financing that might not be needed, which drives down Krka's price evaluations. The high dividend payout puts a higher tax burden on long term individual investors, which is in part being offset by regular share buybacks.



Past financial trends



Valuation

The price target for the following 12-month period is based on our mixed DCF and valuation multiples proprietary valuation model. Our target price currently stands at EUR 71.6 per share, which is a EUR 0.6 or 0.8% increase in valuation since the start of 2019. The underlying income statement and balance sheet assumptions remain unchanged. The increase in target price is due to the change in peer multiples and higher risks in the world economy. The price is based on the on the assumption of EUR 1.375 million of sales revenue in 2019 and subsequent 4.5% sales growth in the following 4 years, with gross profit margin being estimated at 57.4%. Capex for the year 2018 is estimated at EUR 97 million and EUR 136 million for the rest of the forecasted period.

Valuation metrics	
EV/Sales	2.8
EV/EBITDA	10.9
P/E	19.8
P/B	3.5
WACC	9.00
Continuation value	2.00

Pro forma – Income statement

In Millions of EUR	Dec 18 A	Dec 19 E	Dec 20 E	Dec 21 E	Dec 22 E	Dec 23 E	Year 5
Revenue (Estimate Comparable)	1.300	1.375	1.436	1.501	1.569	1.639	
(-) Cost of Revenue	554	586	612	639	668	698	
% of Revenue	43%	43%	43%	43%	43%	43%	
(=) Gross Profit	746	789	824	862	900	941	
% Margin	57%	57%	57%	57%	57%	57%	
(-) Operating Expenses/Income	532	565	587	613	641	670	
% of Revenue	41%	41%	41%	41%	41%	41%	
(=) Operating Income	214	224	237	249	259	271	
% Margin	16%	16%	17%	17%	17%	17%	
(-) Tax on Operating Income	22	21	25	25	28	27	
% Tax Rate	10%	9%	10%	10%	11%	10%	
(=) NOPAT	193	203	213	224	232	244	

Pro forma – FCF statement

In Millions of EUR	Dec 18 A	Dec 19 E	Dec 20 E	Dec 21 E	Dec 22 E	Dec 23 E	Year 5
(=) NOPAT	193	203	213	224	232	244	
% Margin	15%	15%	15%	15%	15%	15%	
(+) Depreciation & Amortization	112	121	127	127	130	136	
% of Revenue	9%	9%	9%	8%	8%	8%	
% YoY Growth	4%	8%	5%	0%	3%	4%	
(-) Capital Expenditure	97	136	136	136	136	136	
% of Revenue	8%	10%	9%	9%	9%	8%	
% YoY Growth	1%	26%	0%	0%	0%	0%	
(-) Changes in Net Working Capital	17	28	21	23	31	27	
% of Revenue	1%	2%	1%	2%	2%	2%	
(=) Free Cash Flow	176	155	178	186	188	211	209

Peer comparison

Name	Mkt Cap	EV/EBITDA T12M	P/E	P/B	EV/Sales T12M	EBITDA to Net Sales:Q	Net Debt to EBITDA LF	ROA	ROE	OPM LF
Median	2465.9	10.9	19.8	3.5	2.8	26.4	0.1	8.6	12.5	18.7
Average	2585.0	17.4	32.4	3.6	6.8	32.2	-0.2	8.0	14.3	21.5
KRKA	2000.4	4.8	10.0	1.2	1.2	26.4	-0.5	9.6	12.4	19.1
RICHTER GEDEON NYRT	2931.4	7.1	21.9	1.3	1.9	21.4	-1.6	5.3	6.2	14.1
CELON PHARMA SA	428.8	33.6	64.5	4.0	14.0	42.9	-2.9	5.1	6.3	24.7
STADA ARZNEIMITTEL AG	5410.1	11.3	17.6	5.1	2.8	23.3	2.6	9.1	30.4	16.1
TCHAIKAPHARMA HIGH QUALITY	399.3	37.3	62.9	7.1	18.0	46.8	0.6	10.7	12.6	36.7
HIKMA PHARMACEUTICALS PLC	4340.1	10.5	17.3	2.9	2.7	Na	0.7	8.2	17.6	18.2

Shareholder Composition

Shareholders	Number of shares	Ownership share (in %)
KAPITALSKA DRUZBA	3,493,030	10.7%
SLOVENSKI DRZAVNI HO	2,949,876	9.0%
REPUBLIC OF SLOVENIA	2,365,126	7.2%
SOC GENERALE SPLITSK	1,662,968	5.1%
HYPO ALPE-ADRIA BANK	1,196,138	3.7%
KRKA DD NOVO MESTO	974,627	3.0%
AVIVA GROUP	946,999	2.9%
CLEARSTREAM BANKING	717,313	2.2%
KRAJOWY DEPOZYT PAPI	466,344	1.4%
UNICREDIT SPA	445,270	1.4%
LUKA KOPER	433,970	1.3%
ZAVAROVALNICA TRIGLA	388,300	1.2%
NORGES BANK	353,716	1.1%
CAPITAL GROUP COMPAN	335,262	1.0%
EATON VANCE CORP	185,460	0.6%
CAISSE DE DEPOT ET P	156,800	0.5%
CONSEQ FINANCE	109,428	0.3%
NLB SKLADI	95,359	0.3%
SEI INVESTMENTS CO	79,858	0.2%
TRIGLAV ASSET MANAGE	59,433	0.2%

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**Analyst: Lojze Kozole - Msc Fin, Msc Eco,
+38613002273,
lojze.kozole@ilirka.si,
Ilirika d.d.,
Slovenska 54a,
1000 Ljubljana**

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