

## KRKA - KRKG SV

26.11.2018

Market price	55.2
EV (in millions)	1,728.5
52 Week High	60.0
52 Week Low	53.1
Avg. Volume (20d)	4,135.4
No. Shares in millions	32.1
Market Cap (in millions)	1,810.2
Total Assets (in millions)	1,919.1
Equity (in millions)	1,487.7
Net debt (in millions)	-45.9
CASH (in millions)	45.9
Earnings Date	22.3.2019
Dividend Date	19.7.2018
Dividend Yield	5.4

12 - month price target 71 EUR  
Recommendation: BUY

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 Eastern Europe with strong penetration into West 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 consisting with 51 percent of all its employees. Krka operates in 6 sales regions in over 70 markets, with manufacturing sites in Slovenia, Germany, Croatia, Poland and Russia.

A large majority of the business for Krka comes from prescription pharmaceuticals with top sellers belonging to Cardiovascular, Central Nervous System and Alimentary Tract and Metabolism groups. There are 20 ongoing investment projects that will allow the company to increase its production by more than one third in the coming years. Krka's R&D expenditure stands at 10% of sales.

As of 26 November 2018, the Company's share traded at €55.20 on the Ljubljana Stock Exchange, a 2.41% yearly increase to date. The Company's marketcapitalization is as of 26 November 2018 €1.8 million EUR and there are 51.000 shareholders.

million €	2016	2017	TTM	2018F	2019F
Sales	1,174.4	1,266.4	1,310.1	1,300.4	1,341.2
EBITDA	228.2	306.6	324.1	321.3	334.0
EBITDA Margin	19.4	24.2	24.7	24.7	24.9
EBIT	122.4	198.7	209	209.3	216.3
Net income	108.5	152.6	163.4	163.0	176.0
Profit Margin	9.2	12.1	12.5	12.5	13.1
EV/EBITDA	7.3	5.9	5.3	5.5	5.2
EV/Sales	1.4	1.4	1.3	1.3	1.3
Net debt/EBITDA	-0.2	-0.1	-0.2	-0.2	-0.2
ROE	7.6	10.4	10.6	10.6	10.8
EPS	3.4	4.7	5.1	5.1	5.6
P/E	15.8	12.1	10.7	10.7	9.9
Net debt	-38.7	-45.9	-57.3	-57.3	-83.4
EV	1,671.0	1,800.9	1,728.5	1,753.9	1,727.8

9M FY2018

9M FY2018

In the 9M FY2018 period Krka Group sold €971.9 million worth of products and services, while the Company sales amounted to €916.0 million, where the East Europe region recorded the highest absolute sales growth (by €16.2 million), and Region South East Europe recorded the highest relative growth (by 14%). Accounting for a 29.6% share in total sales, East Europe region is the largest sales region.

In 9M 2018 all sales regions outside of West Europe have seen gains in sales. West Europe region sales decreased by 3% due to the Krka's lesser application to the tender offers in German market as *margins* were considered unsatisfactory. This resulted in 3% decrease of sales in the West Europe region in 9M FY2018. However, the decrease of the period is to be compensated in the last quarter.

The biggest sales region of the company is East Europe as Russia is Krka's key and largest individual market, where the sales volume increased by 18 % in the 9M FY2018 period and Krka remains the leading supplier of medicines for cardiovascular diseases. In a year over year change the sales in the region increased by 6 percent.

Russia is the key market for the Company and as Krka has the favorable position in the Russian market due the status of a domestic manufacturer, the recent transition from economic contraction to economic growth from the start of 2017 in Russia along with the rising oil prices were a beneficial factor for the sales growth of Krka's pharmaceuticals, hence 18% volume increase in sales in 9M FY2018.

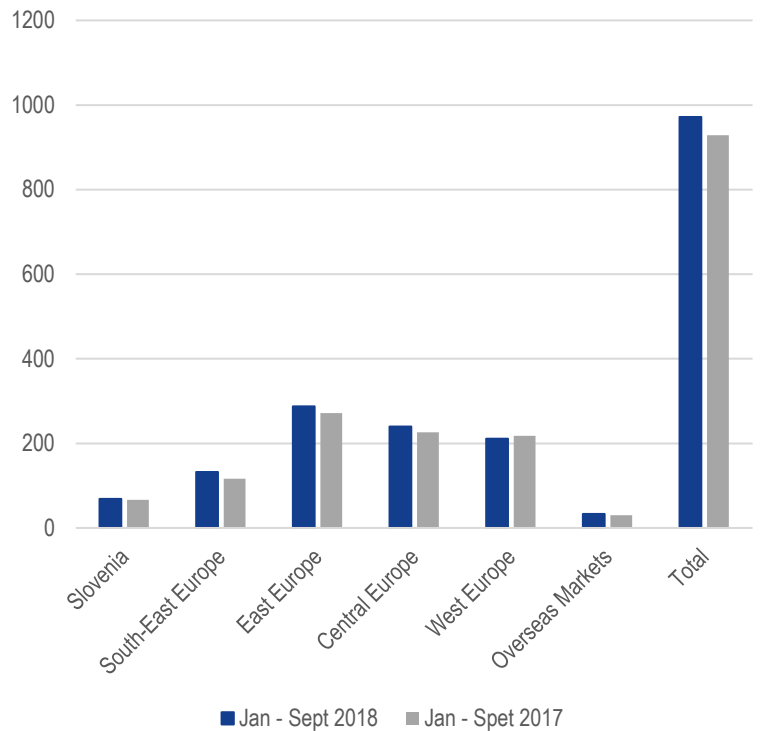
**FY2018 Krka Group Expectations:**

Annual sales of products and services are estimated around €1,300 million, which is slightly higher by as were last year expectations, yielding around 2,7% increase over 2017 level of sales. Region East Europe is expected to remain the largest sales region, with the Russian Federation as Krka's largest individual market. Region Central Europe with Krka's second largest individual market (Poland) is expected to record second strongest sales. The third largest area in terms of sales is expected to be Region West Europe with Krka's third largest individual market (Germany). Net profit is expected to exceed value of EUR 153 million.

**Krka Group Strategy 2018 – 2022:**

**R&D expenditure at a 10% level of sales, EBITDA margin in the range of 21% and 25%, Capex of 136 million EUR on average.** Krka also states to pursue a stable dividend policy where the company is planning to allocate at least 50% of the net profit of controlling company's equity holders for dividend payout.

9M FY2018 Geo sales (in mio EUR)



Investment considerations

Positive

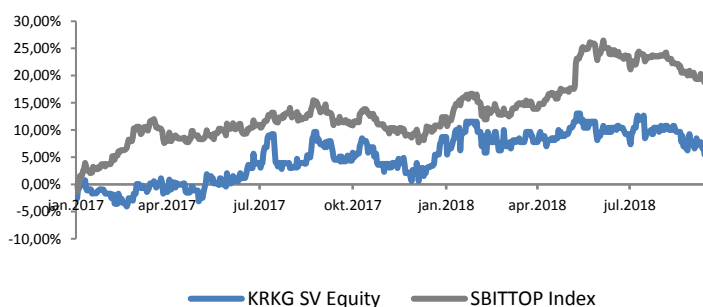
+ Chinese venture: Krka has established a joint venture Ningbo Krka Menovo with their long-term Chinese partner Menovo in the city of Ningbo, which is a sub-provincial city in northeast Zhejiang province in China. The Memorandum and the company's Articles of Association were signed in November 2017, and the company was established at the beginning of 2018. If the company succeeds to become a seller of pharmaceuticals with local recognition, in terms of being awarded a status of domestic producer, similar as in Russia, then that would be a major new business step in the Krka's near future. Zhejiang province is regarded as above average affluent Asian urban area with total population above 55.6 million and with GDP comparable to Switzerland, which would make the province around 19th economy in the world on its own. The goal of the new company is to acquire as many marketing authorizations in China for products from Krka's portfolio and then to manufacture them in the province. First sales results in China are expected in 2019. 6 products on the Chinese markets already in pre-registration phase.

+ Krka's competitive advantage also lies in its vertically integrated model from development, production to marketing, which enables the company to efficiently exercise quality control and oversight over its processes. As a result, Krka's medication Valsacor, a common heart drug, was not recalled this year, as it was the case with many other manufacturers across many countries.

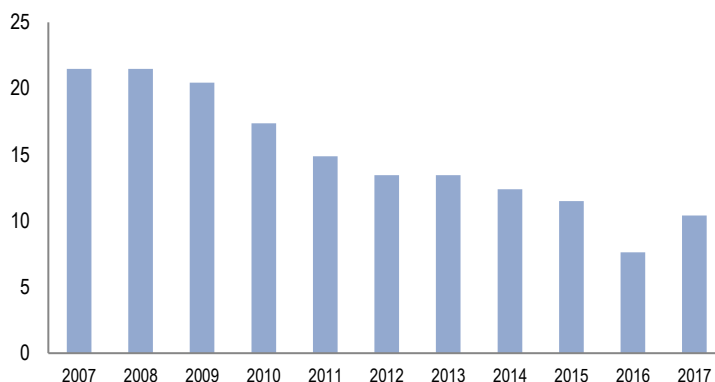
+ European market: As Krka's market stretches from Vladivostok to Lisbon and the company had increasing sales in all regions, we can expect that with the continuation of economic growth in Europe the sales numbers could rise across all main markets in the rest of this and in the following years.

Stock returns and SBITOP index comparison

% Growth	1 M	3 M	YTD
KRKG	0.0%	-2.1%	-2.4%
SBITOP Index	1.6%	-5.1%	0.9%
Gain over Index	1.6%	3.0%	-1.5%



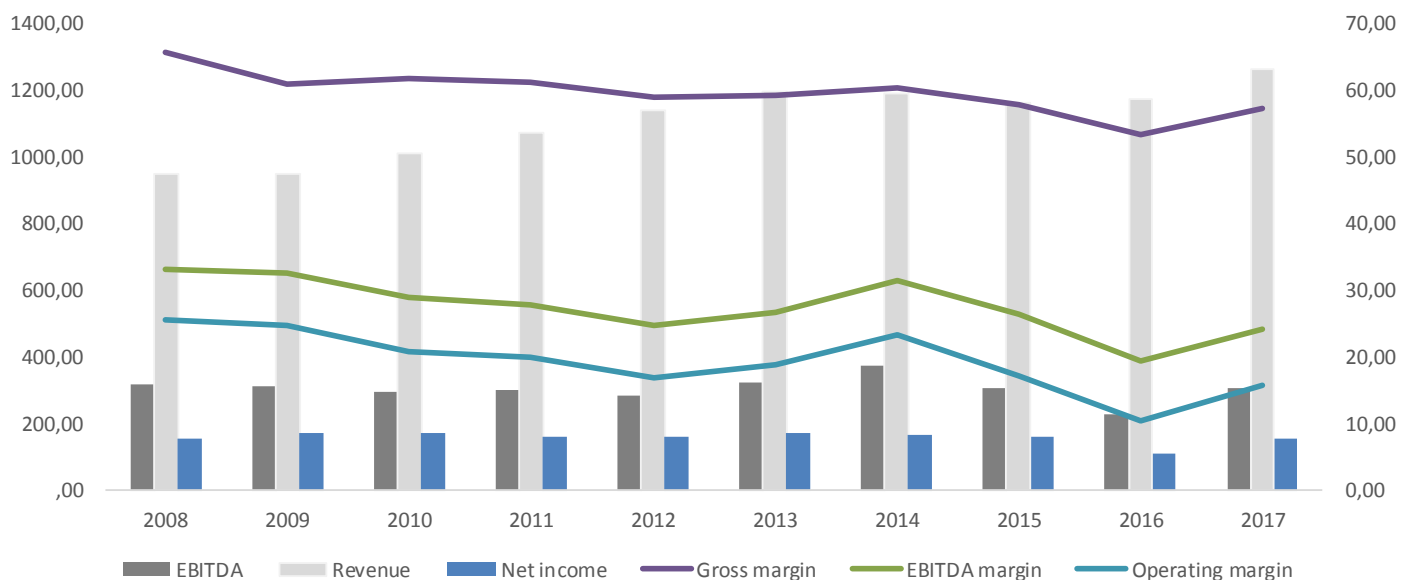
Return on Equity in %



**Negative**

- Russian market: As Russia is the key market for the Company and as Krka has the favorable position in the Russian market due to the status of a domestic manufacturer, the recent transition from economic contraction to economic growth from the start of 2017 in Russia along with the rising oil prices was a beneficial factor for the sales growth of Krka's pharmaceuticals. However, falling oil prices since the start of the October 2018 could have provided some downside for last quarter of 2018.
- Krka has a very conservative attitude in relation to financing through debt and pays a high dividend. The company's Net Debt/EBITDA is in negative territory at -0.25 percent and the current dividend yield is 5.4 percent. The first factor brings up to a higher average cost of financing for the company which drives down Krka's price evaluations. The second factor brings up a higher tax burden for long-time horizon investors.

**Past financial trends (2008 – 2017)**



Krka's revenue grew 7.8 percent in 2017 compared with revenue levels of 2016. CAGR for revenue for last ten years for Krka is 4.95 percent, while 10-year CAGR for EBITDA is 2.78 percent. This shows the reality of declining margins in the last decade given the growth in revenue:

- Gross profit margin has decreased 2.76 percent in the period since 2012
- EBITDA margin has in 10 years decreased from 29.84 to 24.21 percent, which is 18.86 percent decrease in the margin, while the EBITDA margin has decreased for 1.93 percent between 2012 and 2017.
- Operating margin has in the 10-year period also dropped from 22.55 percent to 15.69 percent, which represents a 30.41 decrease in operating margin.

CAGR of revenue for the last 10-year period was 4.95 percent, the CAGR of COGS was at 7 percent and R&D expenditure went from 59.07 million EUR in 2007 to 125.86 million EUR in 2017, representing an 8 percent CAGR for R&D for last 10-year period. In the same 10-year period the company's total debt went from 149.71 million EUR to zero debt, with Net debt/EBITDA being -0.15% in 2017.

**Valuation**

My price target for the following 12-month period based on our property valuation stands at 71 EUR per share. This is 28,62% percent higher than current market price, which commands a buy signal according to our internal criteria, after careful consideration of the points stated under negative investment consideration segment of this equity research representation.

The price is based on the on the assumption of 1.375 million EUR of sales revenue in 2019 and subsequent 4.5 percent sales growth in the following 4 years, with Gross profit margin being estimated at 57,4 percent. Capex for the year 2018 is estimated at 97 million EUR and 136 million EUR for the rest of the forecasted period.

Peer and DCF valuation metrics	
EV/Sales	2.28
EV/EBITDA	6.75
P/E	24.69
P/B	2.46
WACC	9.00
Continuation value	2.00

**Pro forma – Income statement**

In Millions of EUR	Dec 16 A	Dec 17 A	Dec 18 E	Dec 19 E	Dec 20 E	Dec 21 E	Dec 22 E	Dec 23 E	Year 5
<b>Revenue (Estimate Comparable)</b>	<b>1.174</b>	<b>1.266</b>	<b>1.300</b>	<b>1.375</b>	<b>1.436</b>	<b>1.501</b>	<b>1.569</b>	<b>1.639</b>	
(-) Cost of Revenue	548	539	554	586	612	639	668	698	
% of Revenue	47%	43%	43%	43%	43%	43%	43%	43%	
<b>(=) Gross Profit</b>	<b>627</b>	<b>728</b>	<b>746</b>	<b>789</b>	<b>824</b>	<b>862</b>	<b>900</b>	<b>941</b>	
% Margin	53%	57%	57%	57%	57%	57%	57%	57%	
(-) Operating Expenses/Income	504	523	532	565	587	613	641	670	
% of Revenue	43%	41%	41%	41%	41%	41%	41%	41%	
<b>(=) Operating Income</b>	<b>123</b>	<b>205</b>	<b>214</b>	<b>224</b>	<b>237</b>	<b>249</b>	<b>259</b>	<b>271</b>	
% Margin	10%	16%	16%	16%	17%	17%	17%	17%	
(-) Tax on Operating Income	8	28	22	21	25	25	28	27	
% Tax Rate	7%	14%	10%	9%	10%	10%	11%	10%	
<b>(=) NOPAT</b>	<b>115</b>	<b>177</b>	<b>193</b>	<b>203</b>	<b>213</b>	<b>224</b>	<b>232</b>	<b>244</b>	

**Pro forma – FCF statement**

In Millions of EUR	Dec 16 A	Dec 17 A	Dec 18 E	Dec 19 E	Dec 20 E	Dec 21 E	Dec 22 E	Dec 23 E	Year 5
<b>(=) NOPAT</b>	<b>115</b>	<b>177</b>	<b>193</b>	<b>203</b>	<b>213</b>	<b>224</b>	<b>232</b>	<b>244</b>	
% Margin	10%	14%	15%	15%	15%	15%	15%	15%	
(+) Depreciation & Amortization	106	108	112	121	127	127	130	136	
% of Revenue	9%	9%	9%	9%	9%	8%	8%	8%	
% YoY Growth	-1%	2%	4%	8%	5%	0%	3%	4%	
(-) Capital Expenditure	117	107	97	136	136	136	136	136	
% of Revenue	10%	8%	8%	10%	9%	9%	9%	8%	
% YoY Growth	14%	-9%	1%	26%	0%	0%	0%	0%	
(-) Changes in Net Working Capital	(11)	47	17	28	21	23	31	27	
% of Revenue	-1%	4%	1%	2%	1%	2%	2%	2%	
<b>(=) Free Cash Flow</b>	<b>111</b>	<b>124</b>	<b>176</b>	<b>155</b>	<b>178</b>	<b>186</b>	<b>188</b>	<b>211</b>	<b>209</b>

## Peer comparison

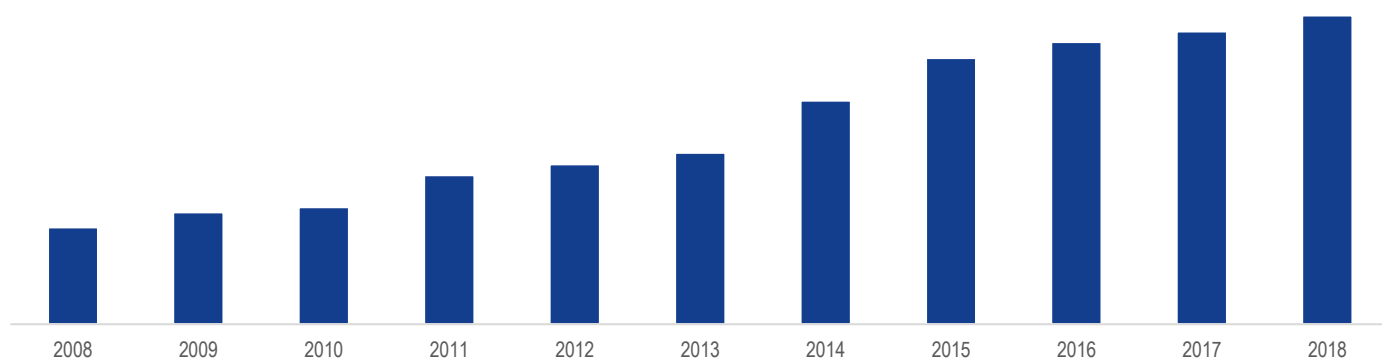
Name	Ticker	Mkt Cap	EV/EBITDA	P/E	P/B	EV/Sales	Net Debt to EBITDA	ROA	ROE	GM	OPM
<b>Median</b>		<b>3882.3</b>	<b>6.7</b>	<b>24.6</b>	<b>2.5</b>	<b>2.3</b>	<b>0.4</b>	<b>3.6</b>	<b>6.4</b>	<b>54.3</b>	<b>16.2</b>
<b>Average</b>		<b>3638.9</b>	<b>7.2</b>	<b>38.9</b>	<b>2.7</b>	<b>2.1</b>	<b>0.3</b>	<b>-1.3</b>	<b>-2.1</b>	<b>55.4</b>	<b>14.9</b>
KRKA	KRKG SV	1803.6	5.1	10.8	1.2	1.3	-0.3	8.6	11.1	54.3	9.7
HIKMA PHARMACEUTICALS	HIK LN	4734.2	3.3		3.5	2.6	1.0	-20.8	-40.6		17.6
STADA ARZNEIMITTEL AG	SAZ GR	4987.4	11.9	24.6	4.7	2.7	2.8	5.8	19.5	52.8	16.5
RICHTER GEDEON NYRT	RICHT HB	3030.4	8.4	81.3	1.4	2.0	-2.4	1.5	1.7	59.2	15.9

## Shareholder Composition

Shareholders	Number of shares	Ownership share (in %)
KAPITALSKA DRUZBA	3,493,030	10.7%
SLOVENSKI DRZAVNI HO REPUBLIC OF SLOVENIA	2,949,876	9.0%
SOC GENERALE SPLITSK	2,365,126	7.2%
HYPO ALPE-ADRIA BANK	1,662,968	5.1%
AVIVA GROUP	1,196,138	3.7%
KRKA	858,482	2.6%
CLEARSTREAM BANKING	840,776	2.6%
KRAJOWY DEPOZYT PAPI	717,313	2.2%
UNICREDIT BANK AUSTR	466,344	1.4%
LUKA KOPER	445,270	1.4%
ZAVAROVALNICA TRIGLA	433,970	1.3%
CAPITAL GROUP COMPAN	388,300	1.2%
NORGES BANK	335,262	1.0%
EATON VANCE CORP	320,706	1.0%
CAISSE DE DEPOT ET P	236,081	0.7%
CONSEQ FINANCE	140,800	0.4%
NLB SKLADI	117,168	0.4%
SEI INVESTMENTS CO	93,359	0.3%
TRIGLAV ASSET MANAGE	89,146	0.3%
	59,439	0.2%

## Dividend policy

Dividend payments in EUR by years



### Income statement

In € thousand	Jan–Sept 2018	Jan–Sept 2017	Index
Revenues	971,92	928,251	105
Costs of goods sold	-414,047	-398,518	104
<b>Gross profit</b>	<b>557,873</b>	<b>529,733</b>	<b>105</b>
Other operating income	7,77	8,174	95
Selling and distribution expenses	-245,725	-237,537	103
R&D expenses	-97,719	-92,877	105
General and administrative expenses	-58,378	-58,27	100
<b>Operating profit</b>	<b>163,821</b>	<b>149,223</b>	<b>110</b>
Financial income	4	9,892	40
Financial expenses	-24,832	-29,87	83
<b>Net financial result</b>	<b>-20,832</b>	<b>-19,978</b>	<b>104</b>
<b>Profit before tax</b>	<b>142,989</b>	<b>129,245</b>	<b>111</b>
Income tax	-22,228	-19,194	116
<b>Net profit</b>	<b>120,761</b>	<b>110,051</b>	<b>110</b>
<b>Attributable to:</b>			
– equity holders of the controlling company	120,836	110,059	110
– non-controlling interest	-75	-8	938

### Balance Sheet

In € thousand	30.sep.18	31.dec.17	Index
<b>Assets</b>			
Property, plant and equipment	840,043	864,842	97
Intangible assets	108,845	110,992	98
Loans	11,636	9,543	122
Investments	9,644	8,815	109
Deferred tax assets	39,539	38,475	103
Other non-current assets	463	341	136
<b>Total non-current assets</b>	<b>1,010,170</b>	<b>1,033,008</b>	<b>98</b>
Assets held for sale	41	41	100
Inventories	340,967	310,671	110
Trade receivables	426,014	500,735	85
Other receivables	28,735	27,302	105
Loans	20,155	1,426	1,413
Investments	5,835	0	
Cash and cash equivalents	79,94	45,948	174
<b>Total current assets</b>	<b>901,687</b>	<b>886,123</b>	<b>102</b>
<b>Total assets</b>	<b>1,911,857</b>	<b>1,919,131</b>	<b>100</b>
<b>Equity</b>			
Share capital	54,732	54,732	100
Treasury shares	-47,975	-40,588	118
Reserves	105,922	111,477	95
Retained earnings	1,381,758	1,361,107	102
<b>Total equity holders of the controlling company</b>	<b>1,494,437</b>	<b>1,486,728</b>	<b>101</b>
Non-controlling interests within equity	3,207	971	330
<b>Total equity</b>	<b>1,497,644</b>	<b>1,487,699</b>	<b>101</b>
<b>Liabilities</b>			
Provisions	100,199	98,075	102
Deferred revenues	10,086	10,953	92
Deferred tax liabilities	11,862	12,154	98
<b>Total non-current liabilities</b>	<b>122,147</b>	<b>121,182</b>	<b>101</b>
Trade payables	104,731	108,34	97
Income tax payable	5,018	16,142	31
Other current liabilities	182,317	185,768	98
<b>Total current liabilities</b>	<b>292,066</b>	<b>310,25</b>	<b>94</b>
<b>Total liabilities</b>	<b>414,213</b>	<b>431,432</b>	<b>96</b>
<b>Total equity and liabilities</b>	<b>1,911,857</b>	<b>1,919,131</b>	<b>100</b>

### Cash Flow

In € thousand	Jan–Sept 2018	Jan–Sept 2017
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
<b>Net profit</b>	<b>120,761</b>	<b>110,051</b>
<b>Adjustments for:</b>	<b>99,722</b>	<b>102,533</b>
– amortisation/depreciation	82,613	79,734

– foreign exchange differences	-4,585	-1,924
– investment income	-5,454	-10,848
– investment expenses	3,098	15,039
- financial income	-82	0
– interest expenses and other financial expenses	1,904	1,338
– income tax	22,228	19,194
<b>Operating profit before changes in net operating current assets</b>	<b>220,483</b>	<b>212,584</b>
Change in trade receivables	73,671	26,331
Change in inventories	-30,296	-24,109
Change in trade payables	-4,713	-1,638
Change in provisions	968	1,139
Change in deferred revenues	-867	-905
Change in other current liabilities	-3,072	-29,535
Income tax paid	-36,322	-6,894
<b>Net cash from operating activities</b>	<b>219,852</b>	<b>176,973</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Interest received	349	402
Proceeds from sale of current investments	0	2
Dividends received	975	15
Proceeds from sale of property, plant and equipment	3,217	1,279
Purchase of intangible assets	-3,352	-2,899
Purchase of property, plant and equipment	-61,883	-77,41
Non-current loans	-1,978	-1,911
Proceeds from repayment of non-current loans	951	983
Payments to acquire non-current investments	-156	-124
Proceeds from sale of non-current investments	24	11
Payments/Proceeds in connection with current investments and loans	-24,746	8,281
Payments in connection with derivative financial instruments	-2,278	-25,82
Proceeds from derivative financial instruments	2,386	9,474
<b>Net cash used in financing activities</b>	<b>-86,491</b>	<b>-87,717</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Interest paid	-748	-268
Dividends and other profit shares paid	-92,809	-88,748
Purchase of treasury shares	-7,387	-7,856
Proceeds of payments from non-controlling interests	2,343	0
<b>Net cash used in financing activities</b>	<b>-98,601</b>	<b>-96,872</b>
<b>Net increase/decrease in cash and cash equivalents</b>	<b>34,76</b>	<b>-7,616</b>
Cash and cash equivalents at the beginning of the period	45,948	38,63
Effect of exchange rate fluctuations on cash held	-768	-78
<b>Net cash and cash equivalents at the end of the period</b>	<b>79,94</b>	<b>30,936</b>

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