

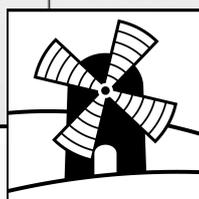
## **Krka Pharmaceuticals D.D.**

LJSE: KRKG

Novo Mesto, Slovenia

Common Shares

EURO



**East Mill  
Capital**

This report outlines the opinions of analysts covering the security listed above. A security snapshot is provided in the executive summary with an appropriate consensus rating.

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## Executive Summary

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Krka d.d. Group, Novo Mesto, Slovenia, hereinafter referred to as “the Company” and/or “Krka”, is a chemicals and pharmaceutical company specialized in healthcare products, prescription pharmaceutical and non-prescription products, as well as therapeutic services. The group attributes most of its revenue to its prescription pharmaceuticals division, which has supplemented the company’s 2.9% yearly revenue growth.

Growing demand for Slovenia’s medical tourism has also contributed to the company’s growth. The company’s production of generic and biosimilar drugs offers shareholders opportunity for outsized returns at a risk-adjusted premium. Growth in generic drug manufacturing is also expected to generate a tailwind to further company sales.

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## Market Capitalization

The Company's total market capitalization stands at 1.895 Billion EUR, accounting for a diverse product portfolio of prescription generic and biosimilar drugs. Historical reports have ranked the Company as a top 100 performer (ranking number 86 in 2016<sup>1</sup>) in pharmaceutical sales in the world, with recent boosts to revenue attributing to higher expected asset valuation towards the end of the 2018 fiscal year.

The growth of the generic and biosimilar prescription and non-prescription drug market has been heavily examined in the last few years, following the heavy depreciation of select US pharmaceutical branded assets that suffering credit downgrades due to poor coverage of the biosimilar sector, and impending ramifications of expiring patents<sup>2</sup>. Celgene Corporation, a notable US pharmaceutical company known for its blockbuster products such as Revlimid, experienced a 1-Year 37.5% drawdown in share price after discontinuing development of several product developments while failing to diversify its portfolio of rendered services and products to back earnings forecasts.

Zion Market Research has estimated that the global generic drug market is expected to grow from 200 B USD to 380.6 B USD by 2021 – at a compounded annual rate of 10.8%<sup>3</sup>.

Krka Pharmaceuticals has firm footing in the market as a company of compelling low-cap size on good track to take advantage of the favouring market circumstances.

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<sup>1</sup> [https://scrip.pharmaintelligence.informa.com/-/media/editorial/scrip-100/2018/league-table/s100-2018\\_01scrip-100\\_league-table\\_online.pdf?la=en&hash=DEEA854FEE9CB726831AB413DA04645C353C9223](https://scrip.pharmaintelligence.informa.com/-/media/editorial/scrip-100/2018/league-table/s100-2018_01scrip-100_league-table_online.pdf?la=en&hash=DEEA854FEE9CB726831AB413DA04645C353C9223)

<sup>2</sup> <http://ivanstruk.com/2017/09/26/why-investors-need-to-reexamine-the-u-s-and-european-pharmaceutical-industry/>

<sup>3</sup> <https://globenewswire.com/news-release/2018/03/21/1443577/0/en/Global-Generic-Drug-Market-Size-Share-to-Reach-380-60-Billion-by-2021-Zion-Market-Research.html>

## Profitability

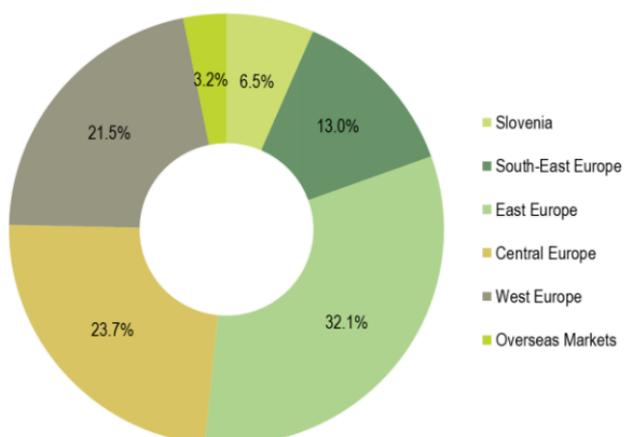
Krka Group has accounted for an increase of revenue of 3.9% over last year, attributed to increased sales in pharmaceutical prescription drugs, non-prescription medicine, animal health products, and an additional medical tourism and hospitality initiative. Cost of Goods Sold increased proportionally to sales, with a negligible deviation of 40 basis points. Gross profit has accordingly increased 3.6%.

### Consolidated Income Statement for Krka Group

| <i>EUR Thousands</i>              | <b>01.06.18</b>          | <b>01.06.17</b>          | <i>Change</i> |
|-----------------------------------|--------------------------|--------------------------|---------------|
| Sales                             | €680,475                 | €655,046                 | 3.9%          |
| COGS                              | (-€280,845)              | (-€269,353)              | 4.3%          |
| <b>Gross Profit</b>               | <b><u>€399,630</u></b>   | <b><u>€385,693</u></b>   | 3.6%          |
| Other Operating Income            | €5,982                   | €5,126                   | 16.7%         |
| Selling and Distribution Expenses | (-€167,215)              | (-€164,434)              | 1.7%          |
| R&D                               | (-€64,257)               | (-€62,219)               | 3.3%          |
| General Admin. Expenses           | (-€38,681)               | (-€40,088)               | -3.5%         |
| <b>Operating Profit</b>           | <b><u>€135,459</u></b>   | <b><u>€124,078</u></b>   | 9.2%          |
| Financial Income                  | €2,553                   | €10,415                  | -75.5%        |
| Financial Expenses                | (-€17,442)               | (-€23,715)               | -26.5%        |
| <b>Net Financial Result</b>       | <b><u>(-€14,889)</u></b> | <b><u>(-€13,300)</u></b> | 8.8%          |
| <b>Pre Tax Income</b>             | <b><u>€120,570</u></b>   | <b><u>€110,778</u></b>   | 8.8%          |
| Income Tax                        | (-€18,832)               | (-€19,115)               | -1.5%         |
| <b>Net Income</b>                 | <b><u>€101,738</u></b>   | <b><u>€91,663</u></b>    | 11.0%         |

The Company attributes most profits to the success of its prescription drug business, with increased sales in most regions. Production takes place in the controlling company in Slovenia and in Krka subsidiaries in the Russian Federation, Poland, Croatia, and Germany, this makes the East Europe and Central European markets the most important for the company. Growth is expected to remain sustained with Eastern Europe despite currency and political risks (outlined in [Risks](#)). Overseas markets remain a relatively low priority for the Company.

### Krka Group sales by Region January–June 2018



### Krka Group sales by Region in first two quarters of 2017 and 2018

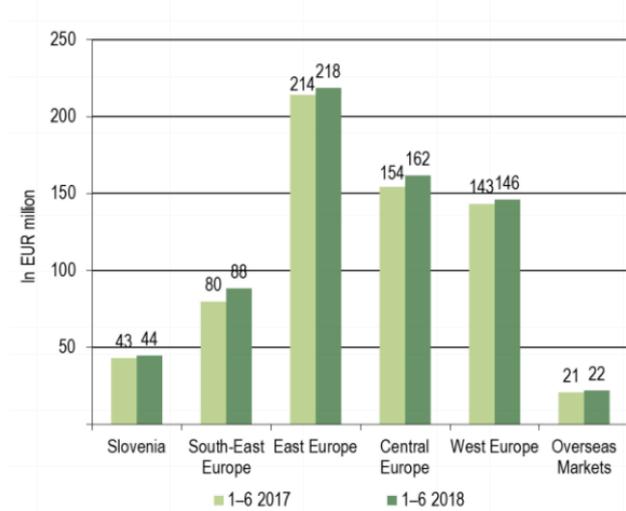


Figure 1: Krka Group and Krka, d. d. Unaudited Interim Report for the Half Year Ended 30 June 2018

The company aligns itself with goals to ensure their regional competitiveness, while expanding their presence within the generic market, as well as devote resources towards keeping their product portfolio diverse. The expansion into healthcare hospitality, with their subsidiary Terme Krka LTD Novo Mesto remains a great case for potentially expanding their scope of operations and de-risking their current revenues.

The profitability of the Company is assessed as stable with positive outlook for the remainder of 2018. Infrastructure investments made by the Company aim to facilitate organic growth supportive of projections.

## Competitors

Competition in the pharmaceutical industry is very high and extensively documented. Due to high barriers of entry, and strict intellectual property protection, all competitors are known. High-cap growth companies attribute most of their revenue to blockbuster products which are patented and protected from competitors, however the generic market offers a more erratic, yet outsized, opportunity for returns. As patents expire, usually protected further through delivery system patents, those products are open to development and production by other companies. While a prescription patented pharmaceutical product may retail for high prices under high margins (compensating for years of R&D), when these products expire prices drop significantly and margins thin as COGS drives the competitiveness of the biosimilar and generic products.

Countries such as India and Russia have been targeted markets for production of biosimilar products, as well as clinical trials, due to low production and staffing costs. However, in the generic pharmaceutical products international distribution and licensing remain issues within these select regions.

The Company has a wide distribution network and product portfolio that allows it to remain competitive in a growing generic pharmaceutical market. It is very important for investors to remain aware of competitors within this sector in all areas of distribution.

Key targeted areas in Europe for generic medication comes from previously heavily protected sectors of medicine. Cancer, asthma, diabetes, Parkinson's disease, and rheumatism drugs all face impending patent cliffs. While the cost of pharmaceutical care in Europe is still 78% attributed from unique medicine, 56% of medicine dispensed in Europe is generic or bioequivalent, with 75% of generic medicine also produced in Europe.<sup>4</sup>

Boehringer Ingelheim<sup>5</sup> offers very strong competition in the generics market in Europe, with high market capitalization regionally, however the company faces diseconomies of scale in managing niche markets outside of Western Europe and the Americas.

Roche AG offers competition within the generic drug market as the company has begun diversifying their product portfolios further, and have a legitimate presence within the CEE region.

Teva Pharmaceuticals<sup>6</sup> offers the most competition to Krka in Eastern Europe. Teva Europe, headquartered in the Netherlands, boasts a cost-effective domestic production process and distribution through Proctor & Gamble. Teva Pharmaceuticals is a leading world generic producer, and is poised to do well within the growing sector. Teva Pharmaceuticals consists of a number of major assets including Actavis Generics (acquired in July 2015), and Proctor & Gamble's prescription drug unit.

In our view Krka pharmaceuticals is capable of remaining competitive despite its lower market cap.

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<sup>4</sup> "Fact Sheet on Generic Medicines" by Generic Medicines Group Europe

<sup>5</sup> <https://www.boehringer-ingelheim.com/>

<sup>6</sup> [http://www.tevapharm.com/teva\\_worldwide/europe/](http://www.tevapharm.com/teva_worldwide/europe/)

## Valuation Multiples

### Financial Ratios Snapshot

*EUR 000's* *period ending 01.06.2018*

|                         |          |
|-------------------------|----------|
| EBIT                    | €135,459 |
| EBITDA                  | €190,930 |
| Net Profit              | €101,738 |
| Net Cash (+equivalents) | €86,172  |

|                     |       |
|---------------------|-------|
| EBIT Ratio          | 19.9% |
| EBITDA Margin       | 28.1% |
| Net Profit Margin   | 15.0% |
| ROE                 | 13.3% |
| ROA                 | 10.4% |
| R&D Expense/Revenue | 9.4%  |

|                |       |
|----------------|-------|
| EPS (€)        | 6.35  |
| P/E Ratio      | 9.10  |
| Book Value (€) | 48.12 |
| P/B Ratio      | 1.20  |

|                       |      |
|-----------------------|------|
| Quick Ratio           | 1.97 |
| Working Capital Ratio | 3.42 |
| Debt to Equity Ratio  | 0.26 |

Highlights from examining semi-annual 2018 financial reports issued by Krka include a low P/B ratio, higher than average quick ratio and high working capital ratio.

In our view Krka pharmaceuticals in good financial standing, and is relatively undervalued.

## Management

The Company's management board consists of five executives with split responsibilities for a management term of six years. The current period is 2015 to 2021.

**Joze Colaric**, President of the Management Board and Chief Executive:

Mr. Colaric is a graduate of the Faculty of Economics in Ljubljana and has been with the Company since 1982. Mr. Colaric is credited for the expansion of Krka and turning the company into a competitive and effective member of the international pharmaceutical industry. The President of the Management Board is accountable for most areas of business, including:

- Sales
- Marketing
- Internal Audit
- Engineering
- Legal Affairs
- Human Resources
- Industrial Property
- Subsidiary; Terme Krka
- Public Relations

Mr. Colaric also plays an active role in the pricing and product scheme at Krka, leveraging his financial background at the company.

**Ales Rotar**, Member of the Management Board and Director of Pharmaceutical R&D and Production:

Dr. Rotar has been with the Company since 1984, and specializes in research and development, production, quality management, new products, and health and safety at work. Dr. Rotar's contribution to the company has been heavily supported by stakeholders of the firm, and was unanimously promoted from the Supervisory Board to the Management Board due to his high performance and impact on the firm.

**Vinko Zupancic**, Member of the Management Board and Director of API R&D, Production and Supply Chain:

Mr. Zupancic has played a crucial role in supply chain management and API R&D at the company. His employment with the firm began with an internship in 1997. Krka manufactures most active pharmaceutical ingredients and raw materials it requires, which is the company's competitive advantage, through a model perfected by Mr. Zupancic, who has risen through every level of the Krka company ladder.

**David Bratoz**, Member of the Management Board:

Responsible for finance, corporate performance, information technology and telecommunications, Mr. Bratoz is credited for his high performance in maintaining the financial integrity of the Company. Mr. Bratoz also acts as a direct liaison to the Works Council and Trade Unions.

**Milena Kastelic**, Member of the Management Board – Worker Director, Head of Semi-Solid, Liquid and Other Products and Head of Plant for the Production of Herbal Medicines:

Milena Kastelic is well-trusted by the employees, so the Works Council proposed her as the new Worker Director at the 15th regular meeting held on 28 September 2015, and the Supervisory Board unanimously appointed her Member of the Management Board for the term of office from 2016 to 2021.

## Balance Sheet

| <b>Krka Group</b>                           |                      |
|---|----------------------|
| Statement of Financial Position             |                      |
| <i>In € thousands</i>                       | <i>at 30/06/2018</i> |
| <b>Assets</b>                               |                      |
| Property, Plant, Equipment                  | 847,858              |
| Intangible Assets                           | 109,272              |
| Loans                                       | 10,978               |
| Investments                                 | 9,600                |
| Deferred Tax Assets                         | 38,842               |
| Other non-current assets                    | 452                  |
| <b>Total Non-Current Assets</b>             | <b>1,017,002</b>     |
| Assets held for sale                        | 41                   |
| Inventories                                 | 334,222              |
| Trade Receivables                           | 470,003              |
| Other Receivables                           | 27,636               |
| Loans                                       | 40,609               |
| Investments                                 | 5,665                |
| Cash and Cash Equivalents                   | 86,172               |
| <b>Total Current Assets</b>                 | <b>964,348</b>       |
| <b>Total Assets</b>                         | <b>1,981,350</b>     |
| <b>Liabilities</b>                          |                      |
| Provisions                                  | 99,436               |
| Deferred Revenues                           | 10,375               |
| Deferred Tax Liabilities                    | 11,997               |
| <b>Total Non-Current Liabilities</b>        | <b>121,808</b>       |
| Trade Payables                              | 110,420              |
| Borrowings                                  | 1                    |
| Income Tax Payable                          | 6,703                |
| Other Current Liabilities                   | 164,536              |
| <b>Total Current Liabilities</b>            | <b>281,660</b>       |
| <b>Total Liabilities</b>                    | <b>403,468</b>       |
| <b>Equity</b>                               |                      |
| Share Capital                               | 54,732               |
| Treasury Shares                             | -46,536              |
| Reserves                                    | 109,434              |
| Retained earnings                           | 1,456,941            |
| Total Equity Holders of Controlling Company | 1,574,571            |
| Non-controlling interests within equity     | 3,311                |
| <b>Total Equity</b>                         | <b>1,577,882</b>     |
| <b>Total Equity and Liabilities</b>         | <b>1,981,350</b>     |

According to the unaudited statement of financial position for 30/06/2018, Krka Group remains in good financial standing. There is no concern regarding leverage or company debt, and the company remains on track to sustain future growth. The company also boasts a higher working capital ratio than competitors and above industry benchmarks. While the company remains in suitable financial health, it is our opinion that the company may put to use their excess resources more effectively in generating more capital gains.

## Historical Performance



### Slovene Blue Chip Index

| Value in points | Date         | Yield in period | Max value in period | Min value in period |
|-----------------|--------------|-----------------|---------------------|---------------------|
| 861.70          | Aug 31. 2018 | 5.79%           | 907.58              | 773.03              |

### KRKA

| Price | Date         | Yield in period | Max value in period | Min value in period |
|-------|--------------|-----------------|---------------------|---------------------|
| 57.00 | Aug 31. 2018 | 0.33%           | 59.80               | 53.20               |

Figure 2: Data courtesy of the Ljubljana Stock Exchange, KRKG performance benchmarked against Slovene Blue Chip Index

Company shares listed on the Ljubljana Stock Exchange have performed adequately in the past 1 year. As liquidity increased on CEE and SEE exchange it is expected that the asset should generate positive results. It is important to note that the LJSE:KRKG asset plays a heavy role within the Ljubljana Stock Exchange Blue Chip Index (SBITOP<sup>7</sup>), making up 30.2% in holdings, attributing a lot of correlation between asset and index. SBITOP benefiting from increased liquidity in the markets should create spill over in more efficient market pricing within its constituent assets.

The price of the security at the time of publishing this report is **56.40 EUR**.

<sup>7</sup> <https://www.wienerborse.at/en/indices/index-cooperation/ljubljana-stock-exchange/sbitop-profile-e/>

## Expectations

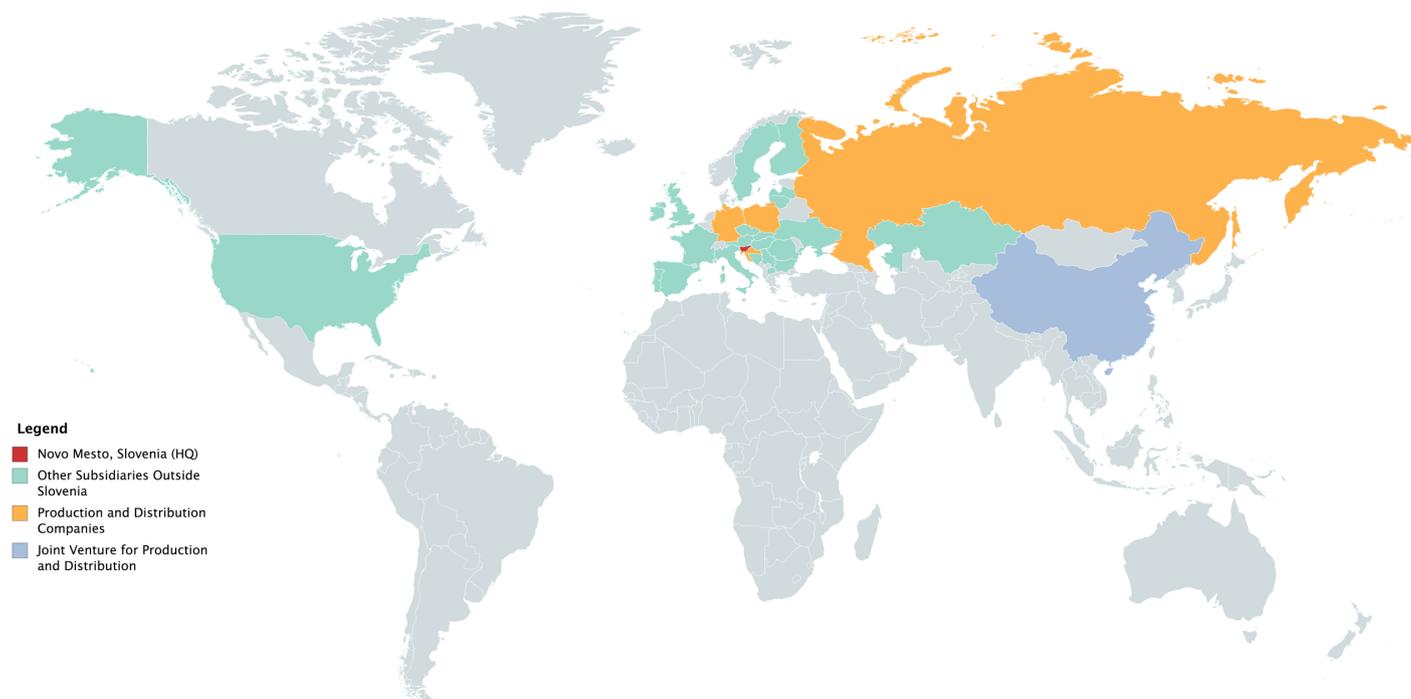
High market expectations are factored into this allocation. The market of generic pharmaceuticals, bio-similar and analogue medication is expected to grow. Investors of bio-pharmaceuticals, blockbuster manufacturers all face challenges re-evaluating the effects of patents expiration. Likewise, large manufacturers must restructure many departments to accommodate for the increasing demand of generic pharmaceuticals and the growth of the industry.

Krka Group remains poised to do well in the expanding market, drawing on their world-wide distribution network in markets that have little exposure to traditional "big pharma". It is also our opinion that given the current financial standing of the company the trading share price (LJSE:KRKG) remains an undervalued assets with opportunity for outsized returns.

It is our expectation that the Company should continue to generate high revenues from prescription and non-prescription products, as well as generate secondary revenue from their expanding medical tourism initiatives with Terme Krka.

## Risks

One of the largest risks attributed to Krka's operations remains its scope of sale and distribution attributable to exchange rate risk. Krka Group addresses this concern by exercising traditional risk management currency exchange hedging through derivative instruments. However, it is valid to note that source of this exchange rate risk comes from regional political instability within certain regions.



The Company's scope of operations includes international subsidiaries worldwide used for distribution, production, and development. Main regions of risk are People's Republic of China, which operates on a joint venture basis for production, distribution, and development, and the Russian Federation, operating directly as a hub for distribution and production. The Russian ruble presents the most foreign exchange risk, however according to the Krka's investor relations department the company is on track to continue to partially hedge any currency risks.

Additional risks arise from the expanding marketplace and producers in India, and Russia who are able to produce generic products at much lower costs than Krka's European factories. Larger market capitalizing pharmaceutical companies also present a risk case for Krka if they were to allocate enough attention towards the same regional markets as Krka.

It is in our opinion that Krka Group is well aware of the risks associated with the company, and their potential impact on investors, and the Board of Directors will provide adequate guidance to represent the shareholders best interests in mitigating these risks.

## **Disclaimer:**

East Mill Capital is an academic endeavour serving as a demonstrative tool in confirming the assumptions of the investment thesis.

Investment Thesis:

**Select investments in public emerging markets equity and debt securities are able to yield outsized, risk-adjusted returns that outperform traditional western benchmarks.**

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