

Company overview

The pharmaceutical company Sopharma (3JR) is the second largest producer of medicines in Bulgaria. The group is vertically integrated and the holding company Sopharma is the majority owner of the leading distributor of pharmaceutical products and cosmetics Sopharma Trading (SO5). Sopharma and its production subsidiaries have 14 pharmaceutical plants in Bulgaria, compliant with EU regulations. One plant in Bulgaria is under construction. The company also operates one plant in Ukraine that has certifications recognized in all CIS states, two production facilities in Serbia, one of which is certified by the local authorities and another newly opened factory in Serbia for solid forms, compliant with EU regulations. With the exception of the plant in Ukraine, all production facilities have undergone procedures for certification to the European Good Manufacturing Practices.

The company has more than 210 products, mainly generics. Sopharma's portfolio includes 15 original products, of which 12 are phyto-based. The original products, in particular Carsil and Tempalgin, are key contributors to the revenues from export markets, while the most important products for domestic sales are generic pharmaceuticals, of which the leading drug is Analgin.

The production portfolio of Sopharma is focused on the following therapeutic areas: cardiology, gastroenterology, pain relief, cough and cold, immunology and dermatology, respiratory and asthma, neurology and psychiatry, urology and gynecology.

The most important pharmaceutical products in terms of their contribution to revenues are:

- **Carsil** - original product plant-based, used to treat gastroenterological disorders (liver disease);
- **Sedal M** - generic analgetic (painkiller);
- **Tempalgin** - original analgetic (painkiller);
- **Analgin** - generic analgetic (painkiller);
- **Broncholytin** - original plant-based product used to suppress cough;
- **Methylprednisolone** - generic drug for cases of severe allergies and certain life-threatening conditions;

- **Tabex** – original plant-based drug used for quit smoking
- **Tribestan** – original plant-based drug used for stimulation of the male reproductive system.

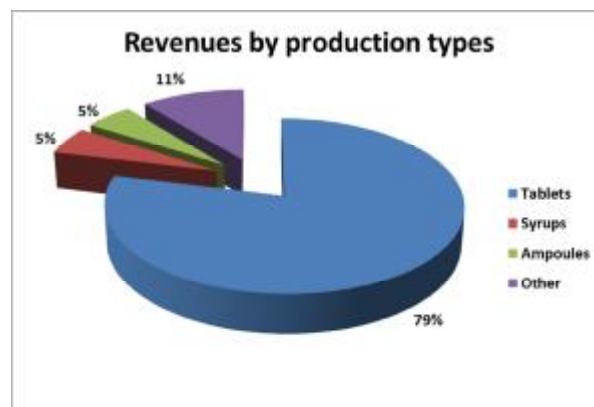
Distribution

Sopharma Trading has 21.3% market share in the distribution of pharmaceutical products in Bulgaria. The company is the only distributor of certain products for leading companies. It offers more than 7 000 products, including the brands of Sopharma, to more than 400 partners and 3 870 customers.

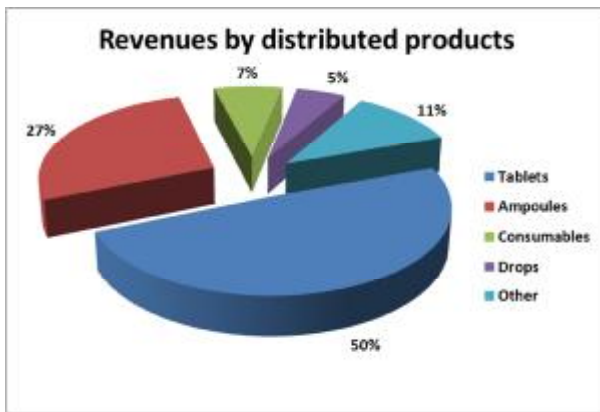
Research and development

Sopharma focuses its R&D on finding and developing new formulas and composition of products in order to adapt them to current market needs. A strategic goal of Sopharma is to achieve the development of eight to ten new products per year. The company's main activity is to submit applications for marketing authorizations of new products, including new forms of products and for existing products into new markets.

Structure of revenues



Sopharma is producing mainly tablets. Their share in revenues from finished products was 79% of total during the first nine months of 2012. The segment is growing substantially – 20% as comparing to the same period of 2011. The other two large groups are syrups and ampoules. They are declining in terms of revenues and as percentage of sales.

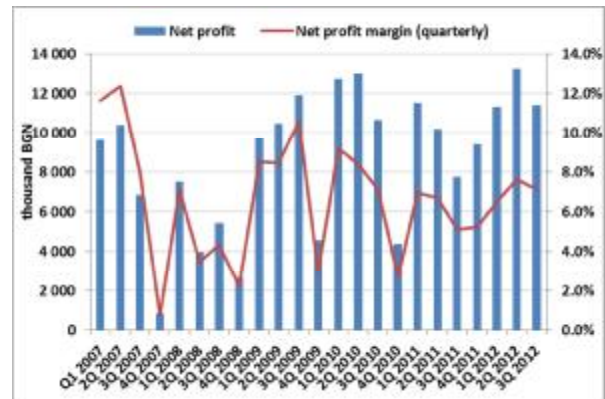


Revenues from the sale of goods to third parties are the distributed products by the subsidiary Sopharma Trading. The structure is representing the demand for different products on the local pharmaceutical market. The main sources of growth are ampoules and consumables, although food supplements and other categories are also contributing with solid double-digit increase.

Financial analysis

Sopharma reported growing sales during the first nine months of 2012, mainly due to the rising export of medicines. Domestic sales declined 9% from January to November, whereas the export gained 6% and managed to offset the troubles on the local market. Reduced payments from hospitals changed the market environment for Bulgarian pharmaceutical companies. The negative media campaign against many producers and importers had also impact on the local apothecary market. The latest data for December showed significant decrease in revenues but it was due to the solid result for the comparable period of 2011. The volatility is not exceptional, although it is rather rare.

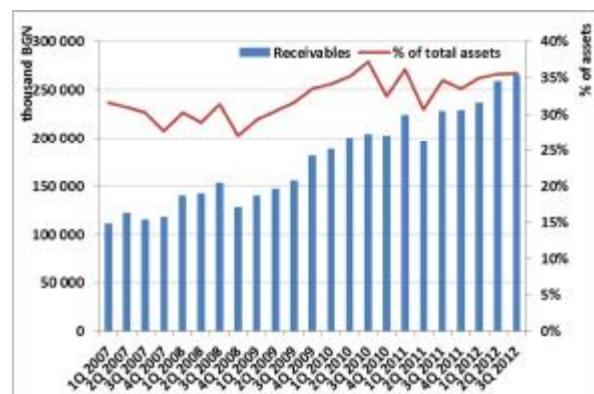
Excluding the revenues and profits from subsidiaries, the non-consolidated report showed 2.7% higher sales and 2.7% lower net profit during first nine months of 2012. The figures are confirming the importance of subsidiaries in the vertical structure of the pharmaceutical holding. Sales of tablets are rising due to new production capacity.



The net profit margin improved during the second and the third quarter on yearly basis. The consolidated net profit for the first nine months of 2012 rose 22% as subsidiaries contributed to the growth with fewer losses. Thus the volatility of net profit margin decreased.

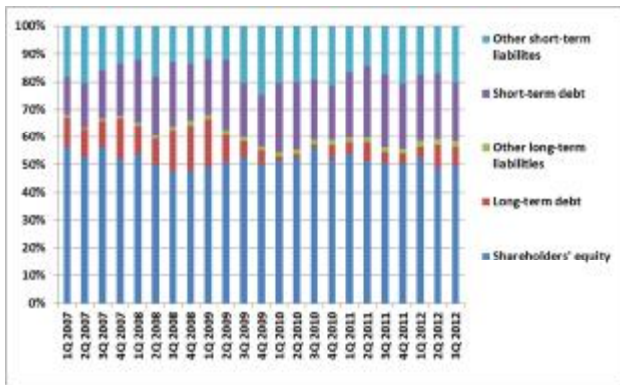
The structure of costs was hardly changed past years. The materials' costs represented 13% of the revenues, whereas labor costs were stable – 10% of sales.

Revenues from financial operations are usually unsubstantial part of total. The holdings interest income includes revenues from deposits and loans to subsidiaries. Sopharma is using mostly the euro in its cross-bordering operations and the effect of changes of foreign exchange rates is very small.



Receivables maintained the level of 35% of the total assets. The consolidated report also showed higher level of receivables as compared to 2011. They increased by 16% for nine months.

They are related mainly to the delay of payments by hospitals and are likely to remain elevated for the next several years due to the tight financial conditions in the health-care system. However, this is an advantage for Sopharma's deliveries to hospitals as the holding is able to afford delays in payments.



Debts represented 57% of Sopharma's assets, mainly short-term bank loans. The company is not facing difficulties in debt servicing. Moreover, it is using its stable financial situation to loan at low interest rate and to lend to its subsidiaries. The current ratio is stable at 1.40, whereas the quick ratio varies around 1.30.

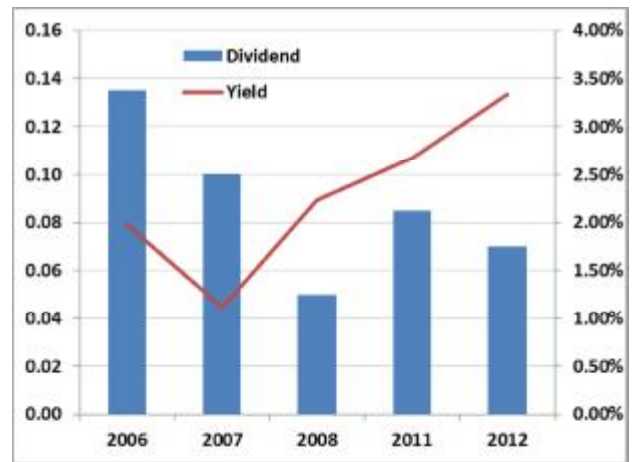


Despite the rising revenues and the stable profit margins, the stock price of Sopharma fell to the crisis level of early 2009. Liquidation of long positions from institutional investors resulted to the steady decline since early 2011.

The recent weakness has been provoked also by the reported sell of one of the largest shareholder in Sopharma – Financial Consultancy Company decreased its stake to 14.56% at the end of 2012, compared to 16.24% in September. Rumors of additional supply could suppress the stock price, although it is also an attractive possibility for acquisition of large packages.

Sopharma is buying-back shares. The program aims at providing shares that will be used for the acquisition of subsidiaries. The next deal is planned to merge the holding company with one of its smaller subsidiaries – Bulgarska Roza Sevtopolis. So far, the company bought-back 3 million shares.

Dividends



Sopharma is among the few blue chips with regular dividend payments. The company suspended payments in 2009 and 2010 despite that the profits were slightly lower. The dividend yield was supported by the huge decline of stock prices.

Valuation ratios
**Table 1
Multiples
Comparison**

	2010	2011	12M
Last Price	3.89	2.85	2.10
Number of Shares	132 000 000	132 000 000	132 000 000
Market Capitalization	513 348 000	376 200 000	277 200 000
Net Profit	40 715 000	38 844 000	45 398 000
P/E	12.61	9.68	6.11
Equity	298 232 000	321 690 000	345 580 000
P/B	1.72	1.17	0.80
Sales	603 062 000	649 572 000	687 851 000
P/S	0.85	0.58	0.40
EV	613 926 000	519 117 000	452 299 000
EBITDA	71 180 000	70 328 000	79 178 000
EV/EBITDA	8.62	7.38	5.71
RoE	13.65%	12.07%	13.14%
RoA	7.54%	6.21%	6.10%

Source: Sopharma
Calculations: ELANA Trading

The stock price of Sopharma declined almost 50% since end-2010, which put the stock among the worst-performing blue chips for the period. The liquidation of long position is mainly attributed to capital withdrawals, rather than deterioration of financial performance. The company managed to improve its results during the period. Both factors had strong effect on company's valuation ratios that declined to the historically low levels. Considering the business with low risk environment and the rapidly growing market such as Eastern Europe, this is an excellent long-term investment. Short-term investors will likely focus their attention on the possible sell from the large shareholder and the market reaction.

Comparison to similar companies

We are comparing Sopharma to other European pharmaceutical companies without taking into consideration details such as region or percent of wholesale trading or production of generic medicines. We are using more conservative approach and we are taking into consideration the median of each multiple.

**Table 2
Comparison
to similar
companies**

Mutiples	P/E	P/B	P/S	EV/EBITDA
Median	15.39	1.59	1.78	11.14
Market Capitalization	698 719 301	550 197 227	1 226 816 651	706 592 686
Price	5.87	4.62	10.30	5.93
Weight	30%	30%	10%	30%
Current Price		2.10		
Fair Price		5.96		
Premium (Discount) to Current Price		183.69%		

Source: Bloomberg
Calculations: ELANA Trading

The valuation based on comparison of ratios in the sector gives low weight of P/S, because the wholesale of medicines has large stake in the consolidated revenues. The indicator is contributing for BGN 1.00 for the fair price of Sopharma. The profit-related multiples (P/E and EV/EBITDA) have almost identi-

cal fair prices and are confirming our view that the stock is undervalued. The fair value to this method is BGN 5.96.

Discounted Cash Flows

The model of discounted cash flows includes future growth opportunities. Sopharma has stable revenues growth and excellent return, which means that the forecasted rates of increase are relatively low, compared to the usual developing economy.

Table 3, Discounted cash flows

Sopharma											Terminal
BGN'000	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Year
EBIT	57 702	62 029	68 232	76 761	84 437	91 192	97 576	103 430	108 602	112 946	116 899
EBIT(1-T)	51 932	55 826	61 409	69 085	75 994	82 073	87 818	93 087	97 742	101 651	105 209
Add: D&A	20 261	21 780	23 958	26 953	29 649	32 020	34 262	36 318	38 133	39 659	41 047
Less: Investments	20 261	21 780	23 958	26 953	29 649	32 020	34 262	36 318	38 133	39 659	41 047
Less: Change NWC	5 727	9 019	12 928	17 776	15 998	14 078	13 304	12 202	10 778	9 054	8 527
FCF	46 205	46 807	48 481	51 309	59 995	67 995	74 514	80 886	86 963	92 598	96 682
PV FCF	42 004	38 683	36 425	35 045	37 252	38 381	38 238	37 734	36 881	35 700	
Sum of PV FCF	376 344										
PV of Continuing Value	573 463										
Total PV Free Cash Flows	949 806										
Less: Outstanding Debt	197 481										
Plus: Financial Assets	22 382										
PV of Equity	774 707										
Number of Shares	119 064										
Price Per share	6.51										
			WACC								
				SA							
				8.0%	8.30	9.55	10.38	11.43	14.56		
				9.0%	6.75	7.57	8.09	8.71	10.43		
				10.0%	5.60	6.16	6.51	6.91	7.95		
				11.0%	4.72	5.11	5.35	5.63	6.31		
				12.0%	4.01	4.30	4.48	4.67	5.13		

Estimations: ELANA Trading

We assume that revenues and profit margins in 2012 will not be strong and will be followed by modest growth in 2013. This is a conservative approach based on the current economic headwinds. 5% growth of consolidated sales and 11% EBITDA margin are achievable targets for this year and surprises should be on the upside. Despite that 2012 proved to be worse than our expectations, the cash flows are solid and provide the base for stable increase in the future.

We calculated intrinsic value of BGN 6.51 per share, which is significantly above the current market price of the company.

Recommendation and price target

Recommendation: The comparison to peers and the DCF showed an attractive valuation of Sopharma. The media noise about the prices of medicines had negative effect on the company's shares last year. The changes to policy of price determining of medicine groups for Bulgarian hospital market are possible, nevertheless we don't expect deterioration of the profit margin. The competition is big enough to not allow monopoly profit. The economic hurdles in Eastern Europe had so far modest impact on the company's revenues. Moreover, the bad news are priced in.

BUY

Target price:

BGN 3.00

Upside:

50%

We are giving BUY recommendation to Sopharma's shares with price target of BGN 3.00 that reflects the fundamentally undervalued stock and difficulty to reach the fair prices.

Financial Data

Statement of Income (in '000 BGN)	2008	2009	2010	2011	9M 2012
Sales	462 508	503 983	603 062	649 572	508 326
Production expenses	364 833	390 996	479 384	515 097	400 977
Personnel expenses	47 162	46 990	51 547	65 200	50 310
Net income from financial activities	(4 029)	1 919	259	614	3 671
Other revenues and expenses	(10)	29	790	439	270
EBITDA	46 474	67 945	73 180	70 328	60 980
Depreciation	13 905	17 741	16 329	18 139	14 205
EBIT	32 569	50 204	56 851	52 189	46 775
Interest expense	10 206	8 427	7 961	8 608	5 675
Pretax income	22 363	41 777	48 890	43 581	41 100
Taxes	3 150	4 473	5 333	4 964	2 652
After-tax income	19 213	37 304	43 557	38 617	38 448
Minority interest	(296)	692	842	(227)	2 459
Net income	19 509	36 612	42 715	38 844	35 989
Earnings per share in BGN	0.15	0.28	0.32	0.29	0.27

Balance Sheet (in '000 BGN)	2008	2009	2010	2011	9M 2012
Total Assets	475 877	540 158	625 190	683 362	744 063
Equity subscriptions receivable	0	0	0	0	0
Fixed assets	230 258	230 162	264 451	293 902	339 616
Tangible fixed assets	180 774	182 770	208 550	237 751	275 459
Financial investments	19 317	24 170	20 927	20 043	23 974
Current assets	245 619	309 996	360 739	389 460	404 447
Inventory	106 078	111 251	111 685	126 247	115 347
Receivables	128 491	181 226	202 731	228 973	265 357
Financial assets	0	0	0	0	0
Cash and cash equivalents	9 916	16 843	45 069	32 377	22 382
Total liabilities + equity	475 877	540 158	625 190	683 362	744 063
Equity	217 208	257 543	298 232	321 690	345 580
Registered capital	132 000	131 974	127 357	120 780	119 064
Capital funds	25 803	88 958	128 789	162 066	190 527
Earnings	59 405	36 611	42 086	38 844	35 989
Liabilities	258 669	282 615	326 958	361 672	398 483
Long-term payables	8 766	7 567	10 256	10 228	14 052
Long-term bank loans	73 541	25 115	31 182	23 496	48 852
Short-term bank debt	92 445	94 995	114 465	151 798	148 629
Short-term payables	61 503	126 860	122 008	131 694	141 285
Other liabilities	0	0	0	0	0
Working capital	91 671	88 141	124 266	105 968	114 533

Cash Flow Statement (in '000 BGN)	2008	2009	2010	2011	9M 2012
Net income	19 509	36 612	42 715	38 844	35 989
Depreciation	13 905	17 741	16 329	18 139	14 205
Changes in Working capital	(14 227)	(3 530)	36 125	(18 298)	8 565
Other operating cash flow items	(22 235)	(18 506)	(28 072)	10 207	(68 293)
Net cash from operating activities	(3 048)	32 317	67 097	48 892	(9 534)
Capital expenditures	(29 354)	(6 940)	(9 089)	(37 141)	(43 814)
Other investing cash flow items	(6 266)	(16 636)	(38 675)	(24 027)	(1 243)
Net cash from investing activities	(35 620)	(23 576)	(47 764)	(61 168)	(45 057)
Issuance/ Retirement of Stock, Net	0	0	(2 392)	(6 741)	(1 466)
Issuance/ Retirement of Debt, Net	20 601	878	12 285	21 415	47 245
Dividends paid	(7 124)	(1 199)	(924)	(12 790)	(2 002)
Other financing cash flow items	(1 519)	(1 244)	(761)	(2 767)	78
Net cash from financing activities	11 958	(1 565)	8 208	(883)	43 855
Net change in cash	(26 710)	7 176	27 541	(13 159)	(10 736)
Beginning-of-period cash	36 376	9 667	16 843	44 384	31 225
End-of-period cash	9 666	16 843	44 384	31 225	20 489
Cash per share	0.07	0.13	0.34	0.24	0.16

Financial and Performance Indicators	2008	2009	2010	2011	9M 2012
Valuation Ratios					
Price/Earnings (P/E)	15.12	14.28	12.02	10.81	7.70
Book Value (BV)	1.65	1.95	2.26	2.44	2.62
Price/Book (P/B)	1.36	2.03	1.72	1.30	0.80
Sales Per Share	3.50	3.82	4.57	4.92	3.85
Price/Sales (P/S)	0.64	1.04	0.85	0.65	0.55
Price/Cash per share	8.83	9.62	8.69	7.37	5.52
EV (in BGN)	451 090	625 987	613 926	562 677	452 299
EV/Sales	0.98	1.24	1.02	0.87	0.89
EV/EBITDA	9.71	9.21	8.39	8.00	7.42
EV/EBIT	13.85	12.47	10.80	10.78	9.67
Liquidity					
Current ratio	1.60	1.40	1.53	1.37	1.40
Quick ratio	0.91	0.90	1.05	0.93	1.00
Debt Management					
Debt to total assets	0.54	0.52	0.52	0.53	0.54
Interest coverage	3.19	5.96	7.14	6.06	8.24
LT Debt/Equity	0.38	0.13	0.14	0.10	0.18
Total Debt/Equity	1.19	1.10	1.10	1.12	1.15
Asset Management					
Inventory turnover	4.36	4.53	5.40	5.15	4.41
Days sales outstanding	100	129	121	127	188
Fixed asset turnover	2.01	2.19	2.28	2.21	1.50
Total asset turnover	0.97	0.93	0.96	0.95	0.68
Profitability					
Profit margin on sales	4.2%	7.3%	7.1%	6.0%	7.1%
EBITDA margin	10.0%	13.5%	12.1%	10.8%	12.0%
Basic earning power	6.8%	9.3%	9.1%	7.6%	6.3%
Return on assets	4.1%	6.8%	6.8%	5.7%	4.8%
Return on equity	9.0%	14.2%	14.3%	12.1%	10.4%
Return on investments	6.5%	12.6%	12.6%	10.9%	8.8%
Dividend Information					
Dividend Yield	-	-	2.19%	2.20%	-
Dividend per share	-	-	0.09	0.07	-
Number of shares:					
	132 000 000	132 000 000	132 000 000	132 000 000	132 000 000
Price in BGN - period end:					
	2.24	3.96	3.89	3.18	2.10
Market cap in BGN - period end:					
	295 020 000	522 720 000	513 348 000	419 760 000	277 200 000

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BUY	More than 5% higher as compared to SOFIX and BG40 performance
HOLD	Market performance, +/-5% as compared to SOFIX and BG40
SELL	More than 5% lower as compared to SOFIX and BG40 performance

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