Fagron

Equity Report

07/12/2015

ValueScan.be

Easy Cash Built a House of Cards

Summary

Share Price	**6.40**	**EUR**	Number of shares	31.8	m
Fair Value	**9.60**	**EUR**	Market Cap	203	mEUR
Upside	50%		Enterprise Value	654	mEUR
Symbol	ENXTBR:FAGR		Credit Rating	NA	
Ising Code	BE0003874915				

Growth, company is hit by failed US acquisition strategy, organic growth returns in 2017
Profit margin, reverses to average margin the Fagron division achieved pre-2012
Investment needs, will decline strongly after investment spree that broke the firm

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Sales	355	391	424	492	338	343	447	480	456	474
Growth	16.5%	10.4%	8.4%	16.1%	-31.4%	1.5%	30%	7.3%	-5.0%	4.0%
EBITDA	35	35	41	53	62	74	106	105	82	93
Margin	9.8%	9.0%	9.8%	10.7%	18.4%	21.7%	23.8%	21.9%	18.0%	19.5%
EPS	0.48	0.65	0.75	0.94	1.44	-1.05	0.53	1.13	0.71	0.97
P/E	15.7	10.9	13.0	11.7	9.0	-20.7	66.0	5.6	9.1	6.6
EV/EBITDA	11.5	11.1	13.0	11.3	11.8	14.6	16.5	6.9	9.5	7.7
Dividend	0.30	0.36	0.44	0.50	0.60	0.72	1.00	0.00	0.00	0.00
Dividend Yield	4.0%	5.1%	4.5%	4.6%	4.6%	3.3%	2.9%	0.0%	0.0%	0.0%

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Contents and methodology

Value = Growth x Profitability / Capital needs

A. Growth Expectations

The growth expectations are modelled by reported segment on a 10y history and 3y forward.
The long term drivers by segment are evaluated, **company expectations vs. sector dynamics**.
Recent results are discussed and a growth conclusion is discussed with the segment table.

B. Profitability

The profit margins are modelled by reported segment on a 10y history and 3y forward.
Competitive situation and operating costs are discussed per segment, peer comparison.
Profitability conclusion in a segment EBIT table, including corporate or exceptional costs.

C. Capital Needs

Equity reports often spent too little attention to the capital needs to realise growth and profitability.
Hence, **Capex, Working Capital, Debt and Dividends** are discussed.
The **Capex is modelled towards the maintenance level** at the end of the 3Y forecasting horizon.

We use a **DCF** to translate the future free cash flows into a fair value estimate.
The WACC is set at 8% for all companies as our expected return for the Equity investor.
ValueScan.be measures value with the same yardstick, independent of noise or hype.
For companies with higher risk profiles, a higher WACC is possible and will be justified.

A ROIC analysis backtests the valuation with an EVA analysis. The historic Equity value is compared to the historic EVA calculation. This indicates whether the market has been over- or undervaluing the company in the past.

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I. Company Description

Fagron (formerly Arseus) is a pharmaceutical company headquartered in the Netherlands. The company is the world market leader in pharmaceutical compounding and supplies to pharmacies, clinics and hospitals in 32 countries. Fagron operates 22 sterile, nuclear and non-sterile compounding facilities in Europe, North America, South America and South Africa.

History, M&A accelerates in 2014 in a quest to reproduce Benelux success globally

1990 Fagron Farmaceuticals BV was founded in Rotterdam by **Ger van Jeveren**, the current CEO

2000 Fagron Farmaceuticals BV was acquired **by Omega Pharma** (Marc Coucke)

2006 Arseus, was spun off, the Omega crown jewel Fagron and a low return dental and medical activities,

2013 The FDA implements a 'Compounding Quality Act' **that**

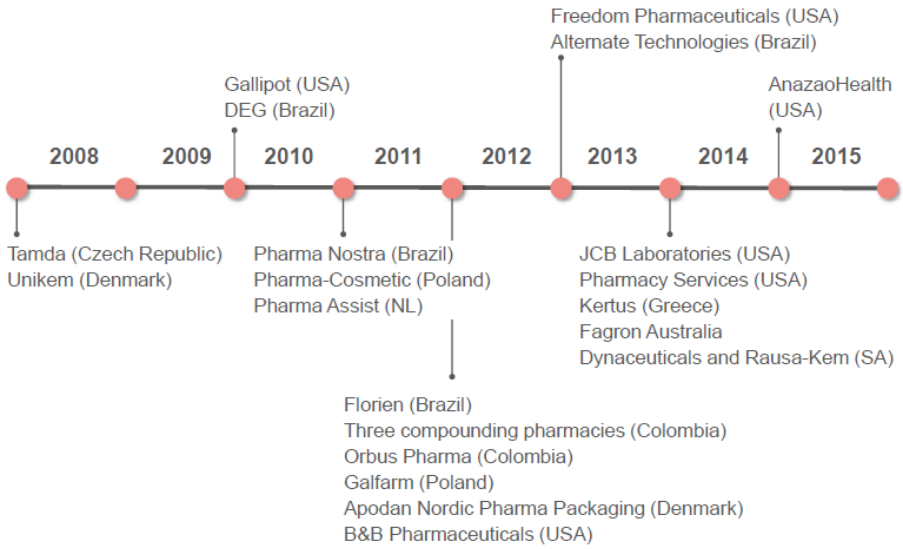
2014 Arseus sold the dental and medical activities for 50m EUR, (0.7x sales)

2014 Big acquisition year in the US with **Pharmacy Services (Bellevue)** that is now under investigation

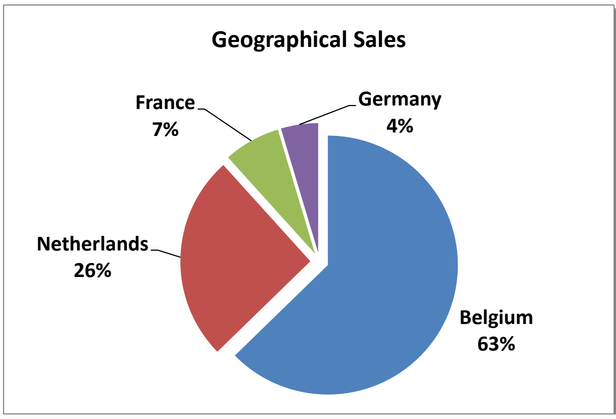
2014 Waterland private equity sells its 27% stake at 35**,** also Marc Coucke sells his balance

2015 Arseus sold the **medical ICT division Corilus** and the company was renamed **Fagron,**

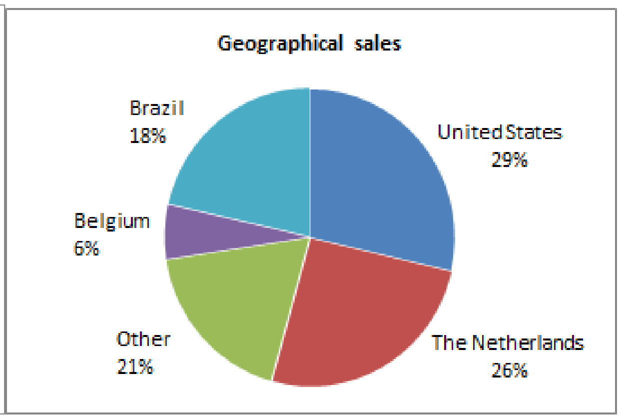
2015 Fagron acquired the Belgian company **ABC Chemicals**,



2005 Fagron in Omega Pharma, 155m Sales



2014, Fagron 500m M&A later : 480m Sales



(Source: Company data)

Fagron was a stable source of cash in the Omega Pharma group. Omega also grew in quantum steps by M&A driven by its CEO Mark Coucke. Omega also stretched the balance sheet, but never ran into serious trouble in the early years after large acquisitions.

Activities

After the divestment of the medical and dental divisions, Fagron consists today of two divisions: HL technologies (2% of sales) and Fagron. HL Technology produces precision components for dental and medical professionals. As from 2015, Fagron reports only three segments :

Compounding Services (37% of sales), Fagron as drug compounder

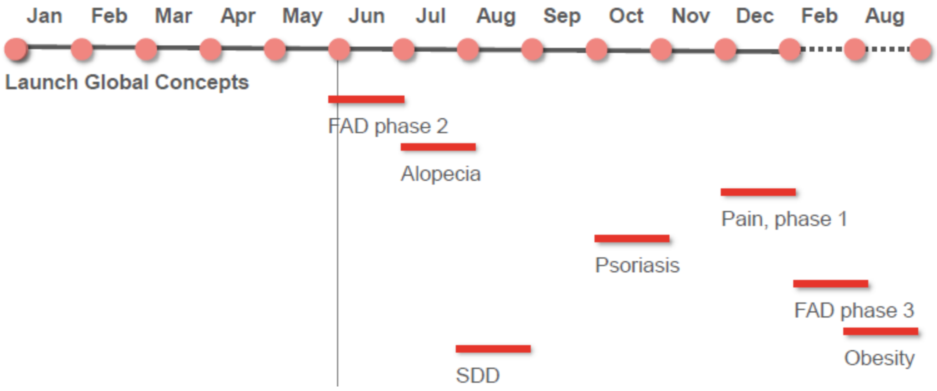
Fagron Compounding Services compounds tailor-made medication for patients with specific needs or patients for who no standard medication is available. Fagron has 19 sterile and non-sterile compounding facilities in Europe, United States, Colombia and South Africa and applies an active buy-in strategy. The compounding services division compounds sterile, nuclear, aseptic and non-sterile products. Examples of sterile and aseptic compounding are IV-bags, ampoules, vials, prefilled syringes, prefilled morphine cassettes and prefilled elastomeric devices. Examples of non-sterile compounding are tablets, capsules, liquids, creams/ointments and suspensions.
In 2015 Fagron acquired the American company AnazoaHealth (turnover 30m USD), specialized in nuclear, pain and intrathecal compounding. Nuclear compounding is a specialty area of pharmacy practice dedicated to radioactive materials.

Compounding Essentials (53% of sales), Fagron as supplier of compounds

The Fagron Compounding Essentials division covers all pharmaceutical raw materials, equipment and supplies that are needed to compound medication. Fagron supplies around 5000 raw materials which include amino acids, antibiotics, corticosteroids, hormones, opiates, vitamins, alcohol and excipients. Examples of equipment and supplies include scales, pestles and mortars, ointment mills, packaging equipment and packaging materials (bottles, vials, strips, boxes). Fagron operates a central purchasing and audit office in Shanghai, China.

Trademarks (10% of sales), Fagron owned brands

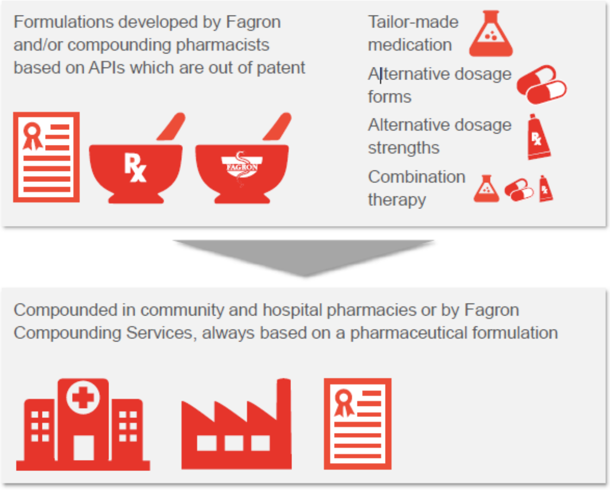
Fagron Trademarks are all products, materials, concepts, know-how and combinations of these related to compounding developed by Fagron's R&D team. Fagron trademarks include Versatile® and Pentravan®, pharmaceutical base creams that can administer medication via the skin (transdermally) and that are used for treatments involving hormones, anti-inflammatories and pain medication. In 2014, Fagron globally introduced SyrSpend® SF, a vehicle range for compounding oral liquid dosage forms. Its starch-based technology allows for more accurate dosing accuracy and drug compatibility. Fagron currently also focuses on the Advanced Derma line, specialized in tailor-made skin solutions.

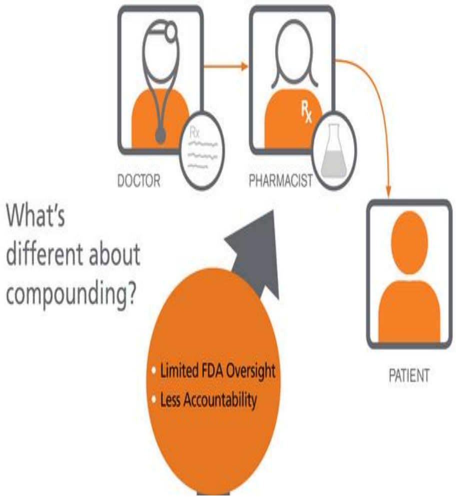


(Source: Company data)

II. Market Overview

Compounding is a grey area between generics and off-patents, but has conquered its place
Pharmaceutical compounding is the creation of a particular pharmaceutical product to fit the unique needs of a patient. To do this, compounding pharmacists combine appropriate ingredients using various tools. This may be done for medically necessary reasons, such as to change the form of the medication from a solid pill to a liquid, to avoid an ingredient that the patient is allergic to, or to obtain the exact dose needed of a particular active pharmaceutical ingredient. It may also be done to add flavours to a medication or change the texture. Compounding is **most routine in hospital pharmacies**, but is also offered by certain retail pharmacies for various forms of medication. Anytime a given drug product is made or modified to have characteristics that are **specifically contemplated for an individual patient** - this is known as **"traditional" compounding**. The increasing number of blockbusters coming off-patent create more opportunity for compounders as well as generic producers.





More recently, **drug shortages and cost pressures** have sometimes led to reliance by some hospitals upon larger-scale compounding pharmacies to meet their regular supply needs, particularly for sterile-injectable medications. Compounding is non-traditional if used for mass-production of a given product rather than patient-specific production. This has attracted more FDA scrutiny.

Benefits of Pharmacy Compounding (Pharmacyowners.com)
Allowing Access to Discontinued Medications
Making Medication Easier to Use, Allowing Alternative Dosage Forms
Making Medication Allergy-Friendly and Offer Unique Services that Pharmacy Chains Don't

Regulation impacts sales over 2015, but the regulation change was well documented in 2013

Regulation US became stricter in 2013, after meningitis case in a clinic
On September 25, 2012, the Center for Disease Control notified the FDA that it was investigating a cluster of meningitis cases at a single clinic, which might be associated with product contamination. On September 26, a voluntary recall began of three implicated lots of MPA.
Drugs from compounding pharmacies can be cheaper, and can alleviate shortages, but as a result of health and security questions and the fact that compounding pharmacies are often acting like drug manufacturers in practice, the US Food and Drug Administration (FDA) incorporated a 'Compounding Quality Act' **in the DQSA Drug Quality and Security Act of 2013**.

Industrial compounding pharmacies are thus not regulated anymore by less strict state agencies. The law distinguishes between traditional compounding pharmacies (section 503A) and industrial compounding pharmacies ('outsourcing facilities', section 503B). **In short, regulations for 503A (traditional, patient oriented) pharmacies became a lot stricter while 503B (outsourced, drug specific) pharmacies are able to apply for exemptions regarding cross-state trade, marketing and labeling.** Hospitals and other health care providers are allowed to provide their patients with drugs coming from outsourcing facilities. The demand for outsourcing is thus strongly growing in the US as the rules for section 503A are becoming more stringent. The law requires that every single compounding ingredient should be approved by the FDA and registered on the corresponding FDA list. As a result, healthcare systems are basing their coverage on this list which places a limit on reimbursements. Meanwhile, outsourcing facilities are also not allowed to compound copies of drugs already on the market, unless they are on a drug shortage list. Fagron's non-sterile compounded products are impacted most from these rules.

Regulation Europe

In Europe, a recent resolution also implemented quality standards for pharmaceutical compounding which forces hospital pharmacies to invest. As a result, countries like Belgium approved changes in legislation which enable pharmacists to outsource the compounding of their medication. As in the United States, the European Court of Justice recently judges that compounding pharmacies should not supply compounded products if a registered market is already on the market. In July 2015 the European Court of Justice made an end to the wide definition of pharmaceutical compounding. It explicitly stated that compounded products always have to be made on the basis of a specific prescription for an identified individual person. Products that are made on a large scale should comply with all the rules of a normal drug company which will strongly influence many activities of outsourcing facilities.

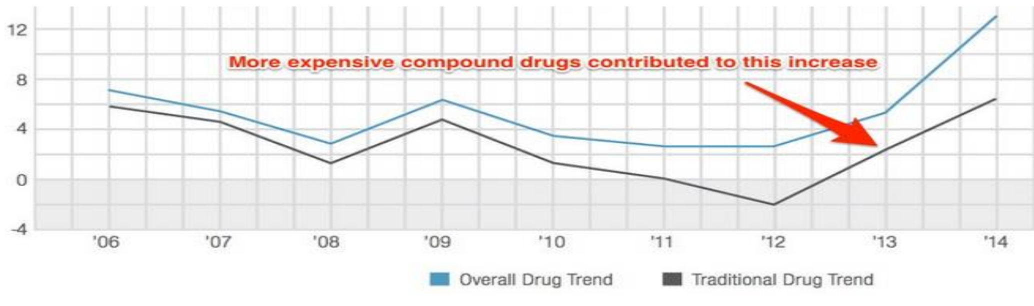
2013-2014 price increases and the Express Scripts complaint results in price declines over 2015

As compounded drugs add some value above the generic version, the pricing can differ. In the US, PBM's (Pharmacy Benefits Manager)like Express Scripts control the re-imbursement process with the health insurance company. It is clear that the prices of some compounded drugs have risen to abnormal levels in relation to the cost of the compounds. This is not a typical problem with compounded drugs. Over the last 5 years prices have risen strongly across the pharmaceutical spectrum.

Retail prices for selected dermatology drugs from 2009 and 2015

DRUG COMPANY	TREATS	PRICE 2009	PRICE 2015	PERCENTAGE CHANGE
Targretin gel Valeant Pharmaceuticals	Skin cancer	$1,687	$30,320	1,700%
Carac cream Valeant Pharmaceuticals	Skin cancer	$159	$2,865	1,700%
Oxistat cream Novartis	Jock itch, athlete's foot	$77	$545	610%

The deflation of US compounded drug prices has run its course over 2015. The investigation can eventually lead to fines for the companies involved. The cumulative price increases can be estimated between 15-25%.



Cheap money causes human error, fuzzy communication compounded the problem into panic

This is an excerpt of the conference call of 4 August 2015 after the 1H15 results that sets the scene :
Jan Peeters (CFO) : "But you should know that **cost of debt is still a lot cheaper than cost of equity**, I mean that's clear." If a company like us would be taken private they would leverage up to 5, 6 times of EBITDA".
In April 2014, a Fagron US Private Placement was initially offered for US$ 100 million, but was **oversubscribed by US$ 85 million because of "strong demand"**(central bank manipulation).
The irony is that instead of levering the company 6 times, its **private equity partner will exit** its stake around the time of the 185m bond placement and US acquisition spree. Now they are negotiating with private equity players with an equity value that decreased 75%.

It is puzzling how seasoned managers (and shareholders) like Van Jeveren (CEO) and Jan Peeters (CFO) shot themselves (and shareholders) in the foot with the US acquisitions. As free money has become a level playing field, they might have felt the urgency to buy left, right and center in the US. This culminated in a bid for a company they will call "Pharmacy Services Inc.", a well-chosen name if you want to stay hidden on public information sources as it is a generic term. It has been confirmed on the Augustus call that it concerns a company named Bellevue or BellevueRX. Public sources like Hoover do not offer conclusive results on consolidated sales.
The company did not communicate transparently on the acquisition and the sales implosion. Instead it decided to change the reporting structure. This left the company vulnerable to blogs that built on anecdotal evidence that followed the "Tricare scandal" and Express Scripts (largest PBM) actions to reduce the reimbursement of compounded drugs. However, this was an accident waiting to happen as price trends were "too good to be true" and stricter regulation was implemented in 2013. Nevertheless, the previous "Pharmacy Services" were granted an earn-out of 440k shares at the end of 2014. They were new shares that have a lock-up. The shares have fallen victim to a panic circle as the market has no handle on how much value has been destroyed with the cheap money. It is however clear that consensus expectations had been carried away with the "cheap money" M&A cash machine and underestimated the execution risk in the early years of high leverage.

Our estimation of the Pharmacy Services Inc. damage, based on deduction of facts, company statements
Main Facts : 200m Euro M&A in 2014, US sales mix rises from 15% in 2013 to 2014
Estimates : Fagron paid 140m USD for BellevueRX with sales of 85m USD in 2014, EBITDA 28m (=5x)
Damage estimation : Sales -40% in 2015 => -34m sales = 51m at 1x sales they overpaid +-90m USD
Investigation : It is clear that Bellevue can be fined for excessive pricing => 0.5x sales = 42m USD
Conclusion : Fagron **overpaid between 90m and 132m for "Pharmacy Services Inc."** (+440k shares earn-out). The later acquisition of Anazoa of 30m is less impacted.

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