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## Erste Bank Analysts: CEE pharma companies, opportunity for long-term, fundamentally-oriented investors

- CEE pharmas hit hard, despite defensive nature and healthy prospects
- Thriving Russia, improving sales mix (and low comparative base) bode well for outlook
- Krka and Richter as top picks

Stock markets around the globe continued to tumble over the past weeks, weighed down by fears of a prolonged crisis in the financial sector and slowing global economic growth. Emerging markets, including CEE, were hit hard. In spite of its defensive nature (and still healthy growth prospects), the CEE pharmaceutical sector was not spared. The firming forint along with persistent pricing pressures magnified the slump in Hungary.

Despite rather defensive character, CEE pharma stocks headed south, in line with their home markets. The massive selling wave across the board did not pay any attention to the reported 1Q2008 performance data, nor the (fundamentally unchanged) driving forces set to propel the fortunes of key CEE players, such as the strong y/y rebound of the Russian pharmaceutical market.

*“The rising interest rate fever already hit Europe, with the European Central Bank raising its key interest rate to 4.25%. A slowdown in Western European economic growth can be anticipated. Rate hikes are also on the agenda in the CEE countries and bond yields are on the rise. With respect to the rather minimal external indebtedness of CEE companies, the implications for their financial results are minimal. Thus, the main factors to be considered are the applied risk-free rates and changing currency outlooks”,* states Vladimira Urbankova, pharma sector analyst at Erste Bank.

While the situation varies from country to country, the weakness of the US dollar seems to last for longer than envisaged. In addition, appreciation of CEE currencies vs. the Euro is more pronounced than originally anticipated, further magnifying the negative currency impact on heavily export-g geared pharmaceutical companies, which (e.g. Richter, Krka) recently – in an attempt to minimize the negative effects associated with the US dollar weakness - switched to the Euro as their invoicing currency in the traditionally US dollar denominated Russian market. *“The Hungarian forint hit an all-time high vs. the Euro recently, prompting us to adjust our currency forecasts for 2008 and upcoming periods for Richter and Egis. Similarly, the Polish zloty’s strength calls for adjustments to our Bioton model and the record highs of the Czech crown force us to make adequate changes to our Zentiva forecast assumptions”,* says Urbankova. *“The last (but not least) factor to be taken into consideration is the impact of the healthcare reform package introduced by the Czech government from January 2008 (involving payments for doctor visits, drug prescriptions and hospital stays), as well as the lingering effect of the Hungarian reform measures, putting increasing pricing pressure on the reimbursed drug market segment”,* she adds.

While pressure on drug pricing is inevitable, in the medium to long term, CEE pharmaceutical producers (offering affordable generics) should be affected rather marginally, as the ultimate goal is to cover the rising needs for high-quality treatment from the generics medicine pool with possibly higher co-participation of patients in healthcare services, including paying for the drug bill. The latter is painful and, as evidenced by the latest developments, results in an initial slowdown of market growth. However, in the long run, the CEE pharmaceutical markets are set to rise, narrowing the gap in health care (and drug) spending between the CEE region and the EU-15 average.

Vladimira Urbankova: *We think that the CEE markets could witness increased volatility in the upcoming reporting season and can not even rule out further downward pressure. On the other hand, for long-term, fundamentally-oriented investors, top CEE pharma companies currently represent a good value at bargain prices. The business outlook is still very promising, supported by a sales pickup in Russia, the key export territory of the CEE pharma players. On top of that, the region's best companies (particularly Krka) enjoy significant running space in Western markets as well, based on patent expirations and/or efficient niche strategies.*

Company	Currency	Current Price (LC)	Year high (LC)	Current price vs YH (%)	Target price (LC)	Upside potential (%)
Krka	EUR	93.8	129.0	-27.7%	125.0	33.9%
Richter Gedeon	HUF	32,595	41,845	-22.1%	41,100	26.1%
Egis	HUF	14,620	23,900	-38.8%	21,010	43.7%
Zentiva	CZK	1,065	1,448	-26.5%	1,155	8.5%
Bioton	PLN	0.43	1.82	-76.4%	0.45	4.7%

Based on closing prices as of July 24, 2008; Source: Erste Group Research

- The persisting impact from unfavourable government measures in Hungary, combined with the appreciating forint, will only be partly offset by the reviving Russian market, sending target prices for **Richter and Egis** down to HUF 41,100 per share and HUF 21,000 per share, respectively. Nevertheless, after the downward move, both companies offer solid upside potential. Consequently, we stick to our **Buy recommendations for both Richter and Egis**.
- Warsaw Stock Exchange-listed **Bioton**'s share price fall was not only due to fundamental reasons; the stock was negatively hit by shattered investor confidence over another failure of the company to deliver on its earlier stated goals. Adjusting our 12-month target price to reflect the worse than anticipated results for the coming period (hampered by the negative impact from the strengthening zloty on the top line, as well as financial results) and incorporating an additional risk-reflecting discount yields a new target price of PLN 0.45 per share (down from PLN 1.03). Given the share price slump, we leave our **Hold recommendation unchanged**.
- The pending takeover story saved Prague-based **Zentiva** from the big sell-off. PPF's launch of a takeover offer at CZK 950 per share was trumped by Sanofi-Aventis' bid at CZK 1,050. We believe that Zentiva's improving business performance and more news on the possible takeover is set to keep Zentiva in the spotlight. Our revised target price of CZK 1,155 per share suggests that the current price fairly reflects its high growth prospects, but also temporary difficulties in certain markets and uncertainties related to the integration of its Turkish arm. Nevertheless, including a takeover premium comparable to previous transactions in the sector, we would arrive at a target value of around CZK 1,300 per share. Reflecting the vanishing probability of a bidding war after the PPF bid withdrawal, we **downgrade the stock to Hold**.

- Although the 1Q08 results were excellent and the recently published 1H08 sales highlights point to the ongoing strong progress, neither these factors nor its low foreign share ownership saved Krka from the storm on equity markets. We expect that Krka's 1H08 results (due on July 30) will confirm the company's regional competitive edge. Our revised target price of EUR 125.0 per share points to the stock's untapped potential at the currently depressed levels. We **confirm Buy recommendation**.

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