An undervalued pharmaceutical company available without a prescription

This investment idea is an unusual one for me to recommend.

It’s a company in an industry that I would normally not invest in because it’s too difficult to get an idea of how successful their future products will be.

You may be thinking that this is true of all companies, and you would be correct. But because developing new products in this industry costs hundreds of millions it means it is different from normal companies.

I am of course talking about the pharmaceutical industry.

But this company is different.

It produces and sells so-called over-the-counter (OTC) pharmaceutical products. That means even though their products are mainly sold through pharmacies customers do not need a doctor’s prescription to buy their products.

The company is called Omega Pharma SA (Omega), and is a €760 million market value company located in Belgium.

**Company Description**

<table>
<thead>
<tr>
<th>Company Snapshot (in Euro)</th>
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<tbody>
<tr>
<td>Location</td>
</tr>
<tr>
<td>Security No. (ISIN)</td>
</tr>
<tr>
<td>Share price</td>
</tr>
<tr>
<td>(Closing price on 19.10.2010 Brussels Stock Exchange)</td>
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<tr>
<td>Market Capitalisation</td>
</tr>
<tr>
<td>Shares outstanding</td>
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<tr>
<td>Debt to Equity (30.06.2010)</td>
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<tr>
<td>Revenues</td>
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<tr>
<td>Net Income after tax</td>
</tr>
<tr>
<td>Price to Earnings ratio</td>
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<tr>
<td>(trailing 12 months)</td>
</tr>
<tr>
<td>Dividend Yield</td>
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<tr>
<td>(trailing 12 months)</td>
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<tr>
<td>Year End</td>
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</tbody>
</table>

**Further Reading**
- Omega - Company website
- Omega – Investor Relations
- Omega – Financial Reports
- Omega – Financial Times summary

Source: Annual report, Bloomberg, Financial Times 18 October 2010 ([www.ft.com](http://www.ft.com)) and company website
Omega Pharma SA was founded in 1987 with €7,500 in starting capital by two pharmacists, one of which was Marc Coucke, the current CEO.

The idea was to build a consumer health company in which the relationship with pharmacists played a central role. Omega’s business model is thus based on its extensive relationship with pharmacists.

In 1998, Omega was listed on the Euronext exchange in Brussels and currently has around 2,000 employees and is active in 35 countries.

The company has grown mainly through acquisitions of OTC products from other companies, as well as the acquisition of complete companies.

In 2007 Omega became a 100% OTC consumer healthcare company when it listed and sold off its professional healthcare activities, in a company called Arseus. Omega sold its remaining 24% stake in Arseus in 2009.

Omega is structured around four regional divisions:

- Western Europe (41% of group sales).
- Belgium (27% of group sales).
- Emerging Markets (12% of group sales).
- France (20% of group sales).

Source: last 2 year average from company annual report

Information on the company's brands can be found on Omega’s website (www.omega-pharma.be) as there is too much information to mention here.

**The Idea**

Omega’s competitive advantage lies with its extensive network and impressive track record of marketing to pharmacists that has been built up since 1987, and its ability to market newly developed and acquired products through this 35 country network.

This means when they buy country- or regional-specific products, Omega is able to quickly and effectively sell the products in other countries, increasing the sales and profitability of the acquisition almost immediately. For example, about 800 Omega sales representatives visit approximately five to 10 pharmacists a day to ensure strong visibility of Omega’s products and to introduce additional products.

As with any investment there are also negative points. Here is the main one:

Of the directors and management of Omega, only the founder and chief executive officer (CEO) Marc Coucke, owns a substantial amount of shares in the company. Marc owns 30.01% of the company, worth more than €224 million, thorough a company called Couckinvest NV.
A further negative is that Couckinvest NV, with this minority stake, effectively controls the company because it controls the board of directors. Omega’s articles of association determine that when shareholders appoint directors to the board, half of the directors plus one should be appointed from candidates exclusively nominated by Couckinvest NV.

Even though the CEO has to date done good work at Omega. I view any measures to control a company while owning a minority stake as unfavourable.

**Valuation**

At the current share price of €30.92 Omega is valued as follows:

<table>
<thead>
<tr>
<th>Valuation Metric</th>
<th>December 2009</th>
<th>Five year average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price to Earnings</td>
<td>9,4</td>
<td>9,0</td>
</tr>
<tr>
<td>Dividend yield</td>
<td>2,6%</td>
<td>1,7%</td>
</tr>
<tr>
<td>Price to Book</td>
<td>1,1</td>
<td>1,3</td>
</tr>
<tr>
<td>Price to free cash flow</td>
<td>5,9</td>
<td>9,7</td>
</tr>
<tr>
<td>EBIT(^1) to Assets</td>
<td>104,5%</td>
<td>100,3%</td>
</tr>
<tr>
<td>EBIT to Enterprise value(^2)</td>
<td>10,9%</td>
<td>10,5%</td>
</tr>
<tr>
<td>Price to sales</td>
<td>0,9</td>
<td>1,1</td>
</tr>
</tbody>
</table>

Source: Annual report, Bloomberg, Financial Times ([www.ft.com](http://www.ft.com)) and company website

\(^1\) EBIT – Earnings before interest and taxes

\(^2\) Enterprise value = Market capitalisation + debt – cash

I identified Omega using the magic formula developed by the very successful hedge fund manager, Joel Greenblatt. You can read all about the formula in Joel's excellent book, “The Little Book that Beats the Market”.

The magic formula identifies companies that earn a high return on physical assets - which means it is a good business - and companies that are undervalued. It then combines these two rankings to give you a list of good, undervalued businesses to research further.

And that is exactly the case with Omega - it's a good business that generates high returns on physical assets. And it is currently available at an attractive price. This makes sense because most of Omega’s real value lies in its products, requiring it to invest little in physical assets; only investments in sales, research and development and advertising.

If you look at the above valuation table, you will see that the company is undervalued, based on nearly all valuation measures.

It trades slightly over book value, on a price to earnings ratio of under 10, and more importantly, on a price to free cash flow of under six times.

One of the reasons that Omega may be so undervalued is that it has had a negative sales growth of 15.2% from 2005 to 2009. So at first glance it looks bad, but you must remember that in 2007 it listed and sold off its professional healthcare activities, in a company called Arseus. If you remove the impact of the Arseus sale, Omega grew sales by 8% in 2007, 2.8% in 2008 and 0.3% in 2009. Granted, these are not mind blowing numbers but the last two years of sales growth is not bad in the current economic environment.

If Omega could grow sales in 2008 and 2009, even by a small percentage, imagine how much
better they will do once the world economy recovers?

Thus, not only is Omega a very profitable company it is also in excellent financial shape because it has used a large part of its substantial cash flow to pay back debt. Since 2005 total debt has decreased by €174.5 million, decreasing from 98% of equity to 42% in 2009.

With debt decreasing so much the company has the ability to substantially increase its dividend payments should it not decide to make any more acquisitions.

Even though it is something I do not consider when evaluating a company, because it’s not something you can assign any likelihood to, Omega may be an attractive takeover candidate for one of the large pharmaceutical companies should they want to broaden their OTC activities.

Since 2004, 11 OTC acquisitions have taken place at between 2.4 to 4.8 times enterprise value to sales. At the moment Omega is valued at only 1.24 times. Should it be acquired at 2.4 times enterprise value to sales (the lowest multiple), it will be at a share price 125% higher than what it is today.
Source: Company presentation

But as I said, it is not something I think will happen, but as with every undervalued company it’s a nice possibility to have.

Recent developments

On 26 August 2010 Omega reported half year results. In spite of sales increasing 3% to €423.5 million, net profit after tax decreased 14% to €33.6 million. The decline in profitability was caused by higher expenditure in product development and marketing to support the product roll outs planned for the second half of this year.

Because of the new products to be launched in the second half of the year, lower interest costs and cost reductions, management left their sales and profit expectations of 4% sales growth and significant earnings per share growth for the year unchanged.

Positive was that the company said that they are seeing signs that the recession may be coming to an end as orders from pharmacists increased for the first time in years.

Negative arguments:

- Even though Omega’s products are sold through pharmacies its sales are still linked to the health of the general economy. Should European economic growth decline or fall into recession the sales and profitability of Omega will be impacted.
- Omega has a number of very large and financially strong competitors, mainly the divisions of large pharmaceutical companies. Market share losses to these competitors will severely impact Omega’s profitability.
- Even though Omega is not active in the prescription pharmaceutical market the company would still be liable should its products not perform as expected. The company has insurance that covers product liability but it still has the risk that a substantial claim may lower its profitability and weaken its strong financial condition.
Positive arguments:

• With a number of new product launches planned for the remainder of 2010 and a number of existing products that can still be introduced in new countries Omega is in a position to substantially increase its sales and profitability in the years to come.
• Omega is in a strong financial condition with low net debt on its balance sheet and a business that generates a lot of cash to either pay out to shareholders or invest in the business.
• Omega is a pure consumer health company without the risk of a pharmaceutical company product development and related product liability.
• Omega is an attractive takeover candidate that is currently trading substantially below the valuation other similar transactions took place at.

Summary and Conclusion

My arguments for recommending are simple.

Omega operates in a structurally attractive industry with high margins. The company is well positioned to use its sales network in 35 countries to market the country and regional products they have developed or acquired, which should result in a profitable sales growth in future.

But most important is that you are not paying much to invest in a good business. At a price to earnings ratio of less than 10, and less than six times free cash flow, Omega is definitely undervalued.

Even though the dividend is not high at 2.6%, it is more than you can get on a bank deposit. This at least gives you an adequate return while you wait for the share price to increase.

Disclosure

I currently have an investment in Omega with a 3% portfolio weighting.

Tim du Toit
Analyst