CAZENOVE

26 February 2007

Actavis

STOCK RECOMMENDATION	SECTOR RECOMMENDATION	PRICE
OUTPERFORM	**NEUTRAL**	**Ikr69.30**

SECTOR
Pharmaceuticals & Biotechnology

REUTERS CODE	BLOOMBERG CODE
ACT.IC	**ACT IR**

12–MONTH RANGE	MARKET CAPITALISATION	PRINCIPAL LISTING
Ikr70.80 – 55.30	**Ikr234.2bn**	**ICX**

NEXT RESULTS DUE	LAST RESULTS	CHANGE IN STOCK / SECTOR RECOMMENDATION
28 February 2007 (FY)	**9 November 2006 (Q3)**	**n/a** / **No**

CHANGE IN EPS ESTIMATES
n/a

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Key points
Actavis, an Icelandic generics company, has been a key participant in both the growth of the generics market and the rapid consolidation of the generics industry.

Market growth is being driven by patent expiries, including several large blockbusters, ageing population and payers driving increased generic use.

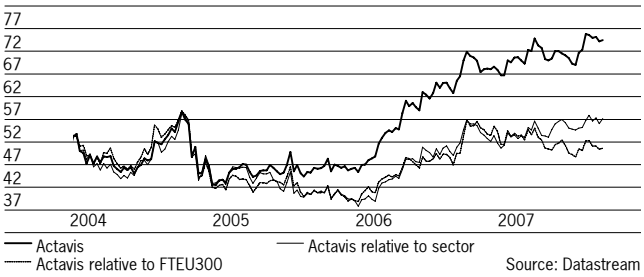
Consolidation is being driven by the need to acquire scale to offset the pricing pressure inherent in a commodity market.

Following a period of acquisitions, we expect Actavis to reap the rewards of post–integration cost cutting over the next few years, with EBITDA margins expected to increase by c. 400bp from 2006–2009. Revenue growth of 10% CAGR and the additional impact on EPS as a result of the financial leverage means the company is guiding to 20%+ EPS CAGR over the next three years as a standalone.

Valuation and share price catalyst
Actavis is trading at a 5% PER discount on our 2007E EPS forecasts on 17.1x but this expands to 17% next year as the growth accelerates and the PER falls to 12.3x. Our DCF also supports c. 20% upside to the shares.

In the near term, we believe investors will focus on the potential for Actavis to acquire Merck KGaA's generic business that is currently up for sale. This would be a transforming transaction, doubling the size of the business and bringing with it significant scale benefit. We see two likely outcomes: Actavis is successful at a price the market deems reasonable, accretion of over 30% by 2009 leads to significant upgrades and the shares trading at a discount of nearly 50%. Secondly, Actavis could be outbid by private equity and the market moves to assuming Actavis is another logical PE target. With limited downside risk as either a standalone or from M&A, we initiate with an OUTPERFORM recommendation.

Share price performance



Source: Datastream

Share price (%)	–1 mth	–3 mth	–12 mth
Ordinary shares	+2.7	+9.4	+8.2
Relative to sector	+1.7	+8.4	+5.0
Relative to FTSE Eurofirst 300 index	–1.5	+4.4	–3.6
Average daily volume shares			8,715,200
FTSE Eurofirst 300 index			1543.7

Year end: December	2005A	2006E	2007E	2008E
Turnover (€m)	579.2	1,390.4	1,573.2	1,732.6
PBT (adjusted) (€m)	119.3	164.9	176.0	248.7
EBITDA (€m)	176.3	299.3	348.4	420.6
Tax (%)	8.8	24.0	22.0	22.0
EPS (adjusted) (€)	0.04	0.03	0.05	0.06
DPS (€)	0.0001	0.000	0.000	0.000
EV/EBITDA (x)	21.6	13.5	11.7	9.5
PER (x)	**23.0**	**25.3**	**17.1**	**12.3**
EBIT margin (%)	23.2	15.1	15.3	17.2
EV/sales (x)	6.6	2.9	2.6	2.3
ROE (%)	10.8	11.1	10.8	13.2
ROCE (%)	6.9	10.2	11.0	12.5
Interest cover (x)	10.0	4.8	3.8	6.2
Net debt/equity (%)	115.6	123.3	114.0	96.6

Source: Company; Cazenove

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1.0
Executive summary

The generics industry is experiencing a period of rapid growth driven by:

- Patent expiries on a significant number of products, including several large selling blockbusters.
- Ageing populations that use significantly greater prescription drugs.
- Payers driving increased use of generics as they try to keep a cap on ever increasing healthcare costs.

However, generic products by their very nature are only differentiated on by price ie they are effectively commodity products, and pricing through 2006 continued to be under pressure.

In a commodity market, we argue that scale is critical to drive the economies required to compete on price and maintain adequate returns. It is this dynamic that has driven, and we expect to continue to drive, significant consolidation in the industry.

Actavis has been at the forefront of this consolidation, acquiring and integrating more than 20 companies since 1999, driving revenues from €57m in 1999 to around €1.4bn in 2006E. This successful acquisition spree has also helped drive the shares – up c. 370% in the last four years and 30% in 2006.

We believe management continues to underplay the leverage effect it gains on the acquisitions it has made to date and we believe EPS growth as a standalone could come in ahead of guidance of 20%+ CAGR over the next three years. We see c. 20% upside for Actavis standalone from the current level on both relative and DCF valuation.

In the immediate future, we believe investors are likely to focus on the potential for Actavis to bid for Merck KGaA's generics business that is currently up for sale. This would be a transforming transaction for Actavis, doubling its current sales and catapulting it to the number three generics player globally. Given the significant apparent interest from both industry and private equity buyers, we believe investors may be concerned on the potential for Actavis to overpay. We see two possible outcomes:

- Actavis is successful in acquiring Merck Generics at a price the market deems reasonable. The earnings accretion is likely to be significant and would lead to the shares trading on a single digit PER multiple by 2009 – a 46% discount to its peers.
- The price tension created by the auction process pushes up the price to a point where Actavis walks away. Investors will have a very comparable (high) multiple to apply to Actavis. In the case of a private equity purchaser of the business, we believe the market will rapidly switch to applying these multiples to Actavis given they would be the next logical target and easiest way to extract cost savings.

We believe this situation is very similar to the Smith & Nephew/Biomet situation late last year. Although S&N was ultimately unsuccessful in its acquisition of Biomet, the shares are up 27% since the PE acquisition of Biomet was announced in December.

We believe the valuation on both relative and discounted cashflow as a standalone is attractive enough to warrant an overweight position – 18% PER discount in 2009E. This, coupled with the apparent significant upside potential and limited downside risk from the Merck situation leads us to initiate coverage with an OUTPERFORM recommendation.

2.0
The generics industry – growing demand, but price is key differentiating factor

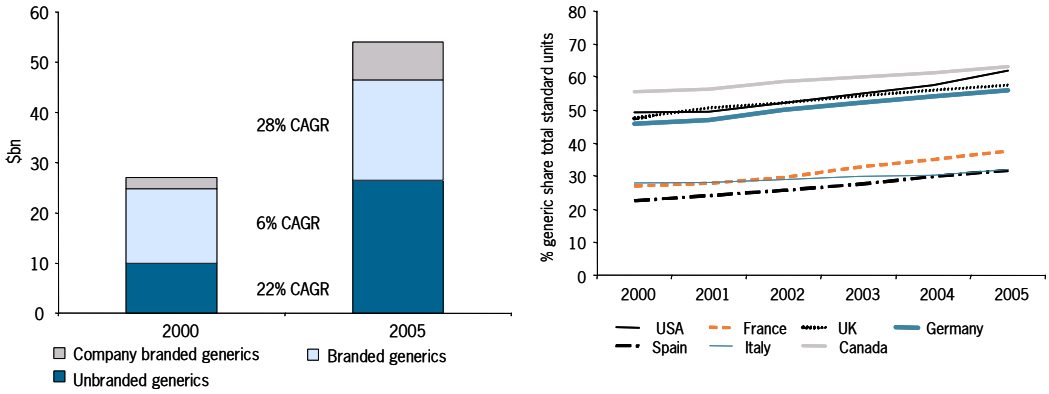
2.1 What are generics?

Generic drugs are the chemical equivalent of a drug that is no longer covered by patents or other exclusivity (such as Hatch–Waxman). When a brand name drug's patent expires, other companies can produce the same active chemical compound and sell the drug under its generic name.

Generics are usually priced at a (significant) discount to the original branded therapies. Their use has increased significantly in recent years as more branded therapies have gone off–patent and payers have become more adept at switching patients to cheaper generic products.

Sales of generic products doubled from $27bn to $54bn between 2000 and 2005 in the largest eight geographic markets (figure 2.1). Generic penetration by volume differs by country (figure 2.2), but has been increasing in all geographies.

Fig 2.1 Generic sales in top eight markets ($bn) **Fig 2.2** Generic penetration by units in top seven markets



Source: IMS

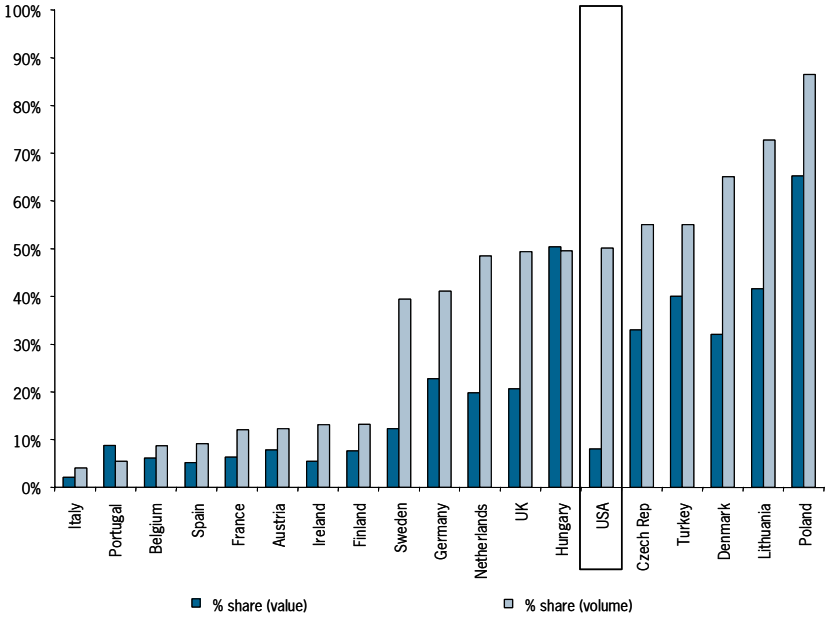
Generic penetration differs widely across Europe and also by whether one looks at penetration rates by value or volume (see figure 2.3). We highlight the following points:

- The difference in US penetration by volume (50.1%) vs value (8.0%) is much higher than any market in Europe and illustrates firstly the higher prices paid for branded therapies in the US, but also the lower prices paid for generics compared to Europe (in general). We believe the better pricing achieved in many European countries for generics results from market inefficiencies. In the longer term, we believe the risk is that generic pricing in Europe trends towards US pricing.

- Generic penetration in many Eastern European countries is high, and the discount of generic drugs is relatively low. We believe investors may therefore be concerned on outlook for further growth in these markets. However, we believe further economic development in these countries leaves significant potential for increasing absolute prices of branded and generic pharmaceuticals.

- Generic penetration in several key Western European markets (France, Spain, Italy) remains very low. While this apparently offers significant upside for growth, we believe there are significant structural blocks to increasing generic penetration, such as the ways in which pharmacists and physicians are remunerated. We note that some European governments (notably France and Germany) made moves in 2006 to increase the use of generics.

Fig 2.3 Generic penetration by volume and value



Source: European Generic Association

2.2 Increasing drug demand, particularly for generics

Demand for generics is likely to increase further in the near to medium term, driven by:

- Demographics – ageing populations use more drugs, and typically those therapies with high generic penetration (either already or expected in the near term) eg hypertension (high blood pressure), hypercholesterolemia (high cholesterol) etc. In particular, we note that figure 2.4 indicates that 65–79 year age group has more than three times as many prescriptions filled annually than the 35–49 year age group.
- More branded products reaching the end of their protected lives.

Fig 2.4 Prescription trends by age group

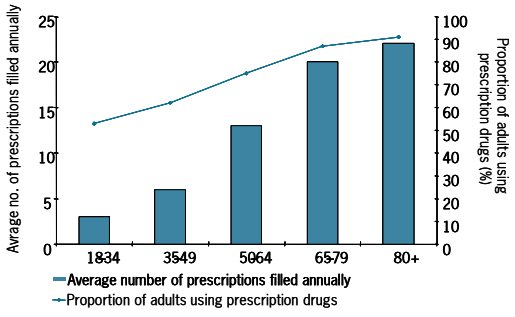
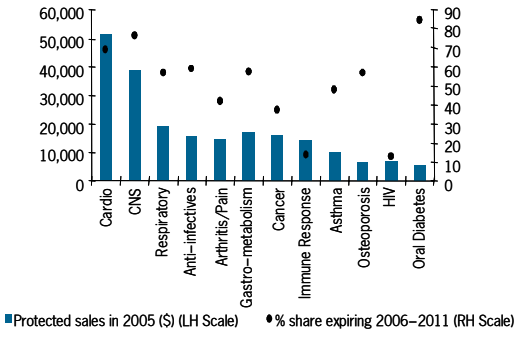


Fig 2.5 Generic exposure by therapeutic class 2006–11



Source: Center on an Ageing Society, US Census Bureau, International Data Base, IMS

- Payers driving increased use of generics vs branded therapies through formularies (preferred drug lists), co–payments. The launch of generic Zocor (a cholesterol lowering statin) in the US has illustrated that insurers are now trying to drive therapeutic substitution – ie attempting to switch patients from one branded therapy to a different (soon–to–be) generic therapy.

Payers are the strongest advocate of the use of generics because of the significant cost savings that can be made. With many healthcare budgets in the developed world under significant strain as a result of the ageing population, increasing generic usage is a relatively easy cost containment measure eg compared with cutting medics' salaries.

US prescription drug costs 1.9% of GDP…

…and total healthcare costs reached 16% in 2004

As set out in figure 2.6 below, every major economy has experienced an increase in the percentage of GDP spent on healthcare in the last decade. Furthermore, Japan has been the only country that has been able to reduce the percentage of pharmaceutical spend, albeit from very high levels (figure 2.7). We also note that while the percentage of pharmaceutical spend in the US remains low on a relative basis, this is merely an aberration of high other healthcare costs – as a percentage of GDP, US prescription drug costs increased by 70% from 1.1% to 1.9% over the period.

Fig 2.6 Total healthcare spend as % of GDP in 1993 and 2003

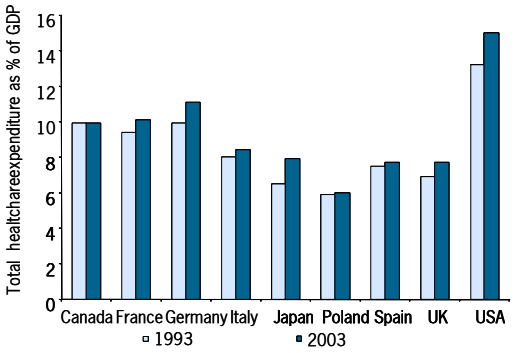
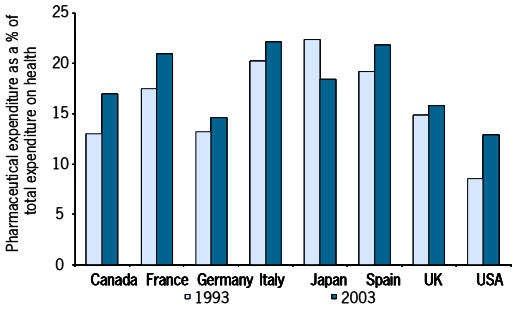


Fig 2.7 Pharma expenditure as % of healthcare expenditure



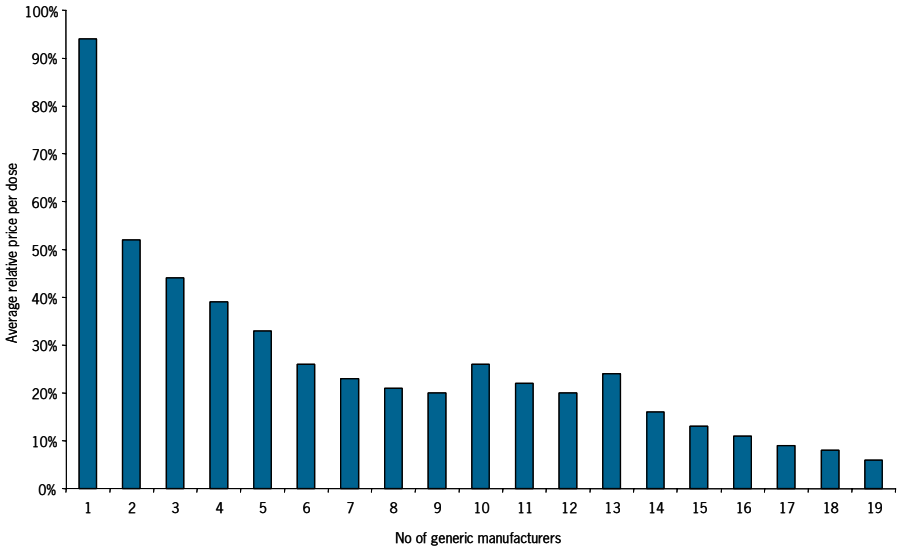
Source: OECD

Given the double demand increase for generics from the ageing population (volume) and payers (mix) we believe the demand outlook for the generics industry is positive.

2.3 Low barriers to supply – price is key differentiator

However, generics have no patent protection and their only differentiating feature is therefore price. With such low barriers to entry, the price of a generic product inevitably falls with increasing numbers of competitors.

Fig 2.8 Average relative price per dose with increasing numbers of generic manufacturers



Source: FDA analysis of IMS data 1999–2004

We believe investors therefore face a slightly odd prospect of an industry with an excellent demand profile, but with supply largely unlimited, the outlook for pricing and hence sustainability of margins is less certain. Price erosion for previously launched generics in the US in 2006 was around 7–8%, and is expected to be at similar levels in 2007.

2.4 Lowest cost will win – the need for scale

We believe it is the need to compete aggressively on price that has been the key driver of recent significant consolidation within the sector – in commodity markets (which is effectively what generic businesses are), price is key and consolidation should bring economies of scale. The lowest–cost producer will have the biggest competitive advantage. Our concern for the US/European generic companies is that they will find it difficult to compete on cost with the Indian producers – although acquiring or building Indian manufacturing capacity is feasible.

While we can see the need for scale, we are concerned that multiples paid in some recent transactions in the industry will not provide positive returns for shareholders. Inevitably the answer to this relies on the medium–long term outlook for pricing and the level of synergies.

Fig 2.9 M&A transactions in the generic sector

Date	Acquirer	Target	Amount paid ($m)	EV/sales (x)	EV/EBITDA (x)	Comment
2006						
November	Actavis	Abrika	110–235#	4.1	10.1	Abrika was established in 2002 to develop controlled release generics. EBITDA margins of c. 40%
October	Barr	Pliva	2500	2.1	9.8	Actavis initially bid for Pliva, with Barr counter–bidding and ultimately winning.
March	Actavis	Sindan	160	2.0	7.7	Romanian manufacturer of oncology products with good growth and margins (EBITDA margin in 2006 expected to be 22%.
March	Ranbaxy	Terapia	324	4.2	N/A	Entry into Romanian market
February	Dr Reddy's	Betapharm	480	2.9	N/A	Fourth largest generics company in Germany
2005						
October	Actavis	Alpharma generics business	683	1.1*	8.2*	Significantly increased Actavis' exposure to the US market.
September	Zentiva	Sicomed	213	3.5	16.7	No 1 Romanian generics producer
July	Teva	Ivax	8,516	4.2	26.2	Expected to be accretive in the first year
February	Novartis	Hexal	5,673	3.4	11.3	$200m of cost synergies expected within 3 years. Expected to be earnings accretive within 12 months
February	Novartis	Eon Labs	2,492	5.8	13.6	
2004						
December	STADA	OAO Nizhpharm	108	2.1	N/A	4th largest Russian pharma company
August	Teva	Dorom	86	N/A	N/A	Acquisition of Italian business from Pfizer
August	Merck KGaA	NM Pharma	65	N/A	N/A	Swedish generic manufacturer acquired from Pfizer
April	IVAX	Kutnowskie Zaklady	150	3.5	13.3	Offer for 75% IVAX didn't already hold of Polish manufacturer
March	3i	Betapharm	372	3.1	N/A	Fourth largest generics company in Germany

* Based on annualised H1 2005

Dependent on earn out payments

Source: Cazenove, Bloomberg, Companies

smaller players are likely to be less competitive, but more likely to be acquired

In such a rapidly consolidating market, we believe investors face an uneasy investment choice with smaller players likely to be sub–scale and finding it difficult to compete against their larger competitors. However, it is these small players that are most likely to be acquired by the larger players as they seek to consolidate their scale advantage.

2.5 Commodity business – impact on margins

We argue that the generic sector is a commodity business given price is the only differentiator. We believe that intrinsically such businesses should be relatively low margin, and that margins are likely to be under permanent downward pressure.

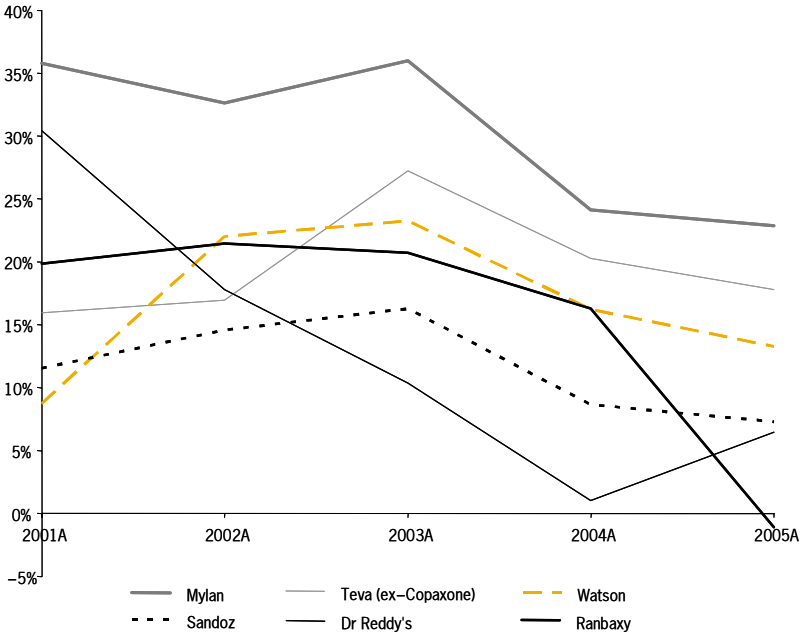
consolidation driving synergies, but margins are not improving…

…are underlying margins under significant pressure?

Given price is the only differentiator, one might expect downward pressure on margins. Clearly one way to explore this would be to look at how margins have developed over time. The key barrier to this investigation, however, is the significant level of consolidation over the last 2–3 years prevents getting 'clean numbers'. However, we believe this in itself should raise questions about the sustainability of margins ie there has been significant consolidation over the last 2–3 years which has allowed significant cost synergies. However, this has not been reflected in significantly improving margins. Our concern is that the consolidation is hiding significantly deteriorating underlying margins and when the consolidation slows down this will become more apparent.

Figure 2.10 illustrates the downward trend in margins and in particular shows the very thin margins of the Indian players.

Fig 2.10 Operating margins for selected generic companies over the last five years

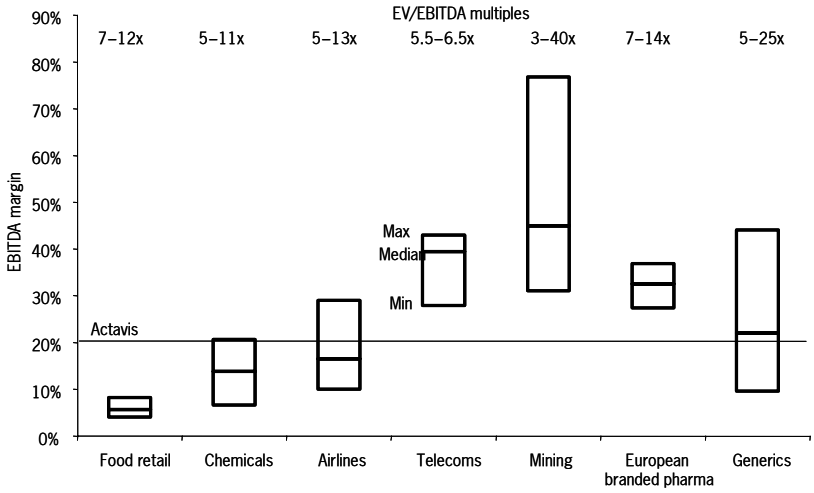


Source: Cazenove, Company reports

We have also explored other commodity sectors (figure 2.11) to try and gain a feel as to where margins in the generics industry might end up in the medium to long term. We make the following points:

- EBITDA margins differ significantly between different commodity sectors; but
- EBITDA variation is typically less between companies within the same sector (Ryanair is a notable outlier in Airlines).
- The variation in generic margins largely reflects the slightly differing models in our view – with those companies with a branded or specialty pharma arm achieving higher margins (Barr, Mylan and Teva).

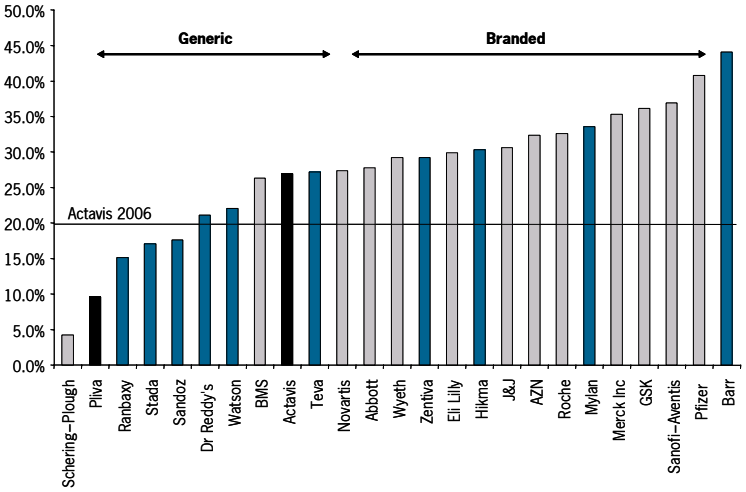
Fig 2.11 EBITDA margins in commodity sectors (and branded pharma)



Source: Cazenove

We set out in figure 2.12 2005 EBITDA margins for selected generic and branded pharma companies. Unsurprisingly generic margins are lower, despite spending much less on R&D and SG&A. The clear exceptions are Barr, Mylan and to a lesser extent Teva, which have above average margins compared to their generic peers, reflecting a portion of non–generic business.

Fig 2.12 Generic and branded pharma EBITDA margins



Source: Cazenove, Company reports

2.6 Big pharma fights back

Big pharma has always vigorously defended its patents against generic challenge, as well as using other protective measure such as switching to other line extensions. However, we believe several more worrying trends for the generic industry have emerged relatively recently in the US and indicate the branded companies are taking an even more aggressive approach:

- Use of Citizen's Petition's to delay generic approval post–patent expiry eg Concerta.
- Settling patent disputes with generic companies.
- Launch of an authorised generic.
- Aggressive price cutting of the branded product on launch of generics e.g. Zocor (Merck Inc.).

The last two of these has a clear impact on the incentives for generics to challenge patents under Hatch–Waxman legislation – six months of exclusivity for the first generic to file. This first six months with no other generic competition means the discount is substantially less and is a key profit driver for the generics companies. The last two developments above reduce the profitability of this period.

In our view Merck's decision to significantly discount branded Zocor sets a dangerous precedent for the generics industry. Merck announced it reached agreement with the two largest HMO's (UnitedHealth and Wellpoint) to supply branded Zocor at a discount to Teva's generic. Branded Zocor will therefore be in Tier 1 on the formularies and generic Zocor in Tier 3 ie with bigger co–pays for patients. UnitedHealth's clients will have a co–pay of $10 for branded Zocor, but a $50 co–pay for generic Zocor. The impact of the announcement on Teva (the generic company with first to file status) was significant – the shares traded down 12–13%.

An immediate response to this might be that it is anti–competitive, and certainly Senator Charles Schumer has raised the issue with the FTC. However, in its purest interpretation, we believe it will be difficult to persuade the FTC that action, which results in lower prices for consumers, is anti–competitive. What is less clear, however, is the FTC's view on the longer–term implications for competition – if such action becomes widespread in the industry, some generics companies are likely to be forced into bankruptcy (or more likely into defensive M&A), which would reduce the number of generic players and hence competition.

The provisions of Hatch–Waxman that aim to stimulate generic competition appear to be stalling in the face of such tactics from the branded pharma industry. In the long term we believe that lobbying by the generic industry coupled with political pressure is likely to push through some resolution to ensure sufficient incentives are in place for the generic industry, although the precise method remains unclear.

These issues continue to remain of interest to politicians and the FTC alike, with Jon Leibowitz (Commissioner of the FTC) recently testifying to the Senate's Special Committee on Ageing on Barriers to Generic Entry (www.ftc.gov/os/2006/07/P052103BarrierstoGenericEntryTestimonySenate07202006.pdf).

More recently, the FTC also presented before the Committee on the Judiciary of the United States Senate on settlements between the branded and generic pharmaceutical companies. (http://www.ftc.gov/speeches/leibowitz/070117anticompetitivepatentsettlements_senate.pdf). Having lost in the Supreme court on the validity of reverse payments (i.e. branded effectively paying the generic company not to launch), the FTC has asked for a legislative remedy ie a change in law.

2.7 Key to success is scale, ex–US exposure, differentiation

We believe there are several ways (other than lowest price through scale) that a generics company can make above average returns:

- Have non–generic exposure eg a branded/specialty pharmaceutical area eg Barr (female healthcare), Teva (Copaxone).
- Focus on more difficult preparations e.g. Mylan (Transdermal), Hikma (Injectables).
- Greater ex–US exposure eg Zentiva, Hikma.

We believe that these will continue to be areas of differentiation.

One further area that is likely to offer higher margins in the future is generic (or at least biosimilar) biologics and this is an area of focus for several groups. In our view, scale will be important in this area given the significant investment required in both manufacturing and clinical trials. We are cautious on the near–term opportunity, but believe that in the medium (Europe) and longer term (US), the regulatory pathway to biosimilars will be mapped out.

3.0
Actavis – Icelandic roots, global ambitions

Actavis was founded in 1956 and is headquartered in Iceland. A series of more than 20 acquisitions over the last six years has grown the company into the third (currently 6th) largest generic company globally by sales.

We believe Actavis' acquisition strategy has been driven by the key issues set out above, namely:

- To gain critical mass (hedging regulatory risk, cost efficiencies).
- Geographic expansion.

3.1 Acquisition led strategy

We believe such an acquisition–led strategy is dependent on three critical factors:

- Ability to identify targets and acquire them at a reasonable price.
- Access to finance.
- Quality of execution.

3.2 Consolidation gaining pace

Consolidation in the generics sector has been frenetic over the last few years. We set out in figure 3.1 a comprehensive list. Actavis has been at the forefront of this, executing a range of small to large transactions.

Fig 3.1 Actavis – M&A transactions

Date	Target	Amount paid (€m)	EV/sales (x)	EV/EBITDA (x)	Comment
2007					
February	Samnar	N/A	N/A	N/A	FDA approved facility to develop and manufacture APIs in India, allowing backward integration
2006					
December	Grandix	N/A	N/A	N/A	Increased low cost Indian manufacturing
November	Abrika	110–235#	4.1	10.1#	Abrika was established in 2002 to develop controlled release generics. EBITDA margins of c. 40%.
March	Sindan	148	1.8	8.4	Romanian manufacturer of oncology products with good growth and margins (EBITDA margin in 2006 expected to be 22%.
2005					
October	Alpharma generics business	683	1.1*	8.2*	Significantly increased Actavis' exposure to the US market.
September	Keri pharma	N/A	N/A	N/A	First step into Hungarian market through acquisition of local generic company.
September	Higia	N/A	N/A	N/A	One of the largest pharmaceutical distributors in Bulgaria, giving access to 2000 pharmacies. Expected to add €90m–100m in sales in 2006. Margins below Actavis margins.
May	Amide	398	4.7	9.4	First significant entry into US market through purchase of this private company. Transaction expected to be 30–35% EPS accretive in first full year.
March	Pharma Avalanche	N/A	N/A	N/A	Provided a direct sales and marketing presence in the Czech and Slovak Republic markets.
February	Lotus	20	N/A	N/A	Indian CRO.
2004					
December	Biovena	N/A	N/A	N/A	Provides a direct sales and marketing presence in the Polish market.
February	Pliva Pharma Nordic	N/A	N/A	N/A	Acquisition of Pliva's sales and marketing organisation in Finland/Norway to build local presence.
2003					
December	FAKO	112	1.4	6.9	90% stake acquired in Turkey's 7th largest pharma company, giving sales and marketing presence in a country with significant generic usage/penetration.

Dependent on earn out payments. Source: Actavis, Bloomberg, Companies

Actavis' strategy to date has been to target underperforming assets, which has been possible at more reasonable prices than other deals. It has then shown that it is able to quickly turn round the profitability of these assets.

3.3 Merck – transforming transaction?

Actavis has recently announced its interest in Merck KGaA's generic business, which was recently put up for sale. Merck Generics is the world's third largest generics business, with around €1.8bn in sales in 2006 ie it is around 25–30% larger than Actavis.

We believe Merck is looking to sell the business in order to:

- Reduce debt following the acquisition of Serono.
- Focus on higher margin business.
- Take advantage of attractive prices being paid for generics businesses.

We believe the overlap of Actavis and Merck is attractive. In particular, Merck would bring a significant presence in Southern European markets (notably France, Spain and Italy) where Actavis is currently absent or sub–scale. We also believe a deal would bring Actavis expertise in respiratory medicine (inhalers) that has been cited by management as a key goal.

Several other parties have expressed an interest in the Merck business, including Ranbaxy (in concert with an unnamed private equity group) and several other private equity houses (Blackstone and KKR according to The Times). We also believe that Teva and Sandoz (Novartis) are also likely to show an interest. This press speculation has hinted the business might carry a price tag of c. €4bn, which we believe is at the low end given the quality of Merck's business.

Given the significant level of interest, we believe investors may be concerned that Actavis becomes involved in a bidding war and ultimately overpays. We believe, however, that the management team has previously demonstrated that it will not overpay for assets (most recently in PLIVA).

We believe investors may also be concerned at the level of dilution they might be exposed to in any financing. However, in line with previous transactions, Actavis has announced that it would be able to finance the transaction on very favourable terms with debt. We understand it has up to €6bn in additional facilities in place. We note the company recently received shareholder approval for a 36% increase in equity (c. €1m) which we believe gives the board further flexibility.

We set out below our initial analysis of how a potential acquisition of Merck may look. We note that given the limited availability of information on Merck Generics given it is part of a larger group (notably its depreciation and amortization charges), and no disclosure on the size of potential cost savings, this is very much a 'first cut'. Our key assumptions are:

- Merck purchase price of €4.5bn. This would be equivalent to EV/2007E sales of c. 2.4x and EV/EBITDA of c. 11.7x. For reference this is in line with the 11.7x Barr paid for Pliva and slightly below the 13.8x EBITDA a private equity consortium paid for Biomet, although we believe Biomet had substantially better growth prospects.
- Cost synergies of c. €80m of the combined group's sales by 2009. This is around 2% of combined sales and is substantially lower than the €100m of synergies (by year 2) indicated would be possible in the proposed acquisition of Pliva. We believe this reflects the lower level of overlap of Actavis/Merck, but could be on the conservative side, particularly given the larger scale of the potential transaction and the comparatively high level of R&D spend at Merck.
- We have assumed Merck's EBITDA margin is 20%, slightly lower than Actavis' (2007E 22%). We assume 16% for 2007E given the impact of generic DuoNeb.
- We have assumed depreciation and amortisation rates of 7% of group sales.
- We have assumed no revenue synergies.

- We have assumed no pay down of the total debt in the next three years and an interest rate of 5%, reflecting very competitive rates negotiated by Actavis.

Fig 3.2 Proforma P&L for Actavis acquiring Merck's generic business

Proforma group	2007E	2008E	2009E
Sales – Merck	1,833	1,971	2,207
Combined sales	3,406	3,704	4,116
Merck EBITDA	293	394	441
Combined EBITDA	642	815	925
Cost savings	20	50	82
Proforma EBITDA	662	865	1,007
Interest	(295)	(295)	(295)
D&A (7% combined sales)	(238)	(259)	(288)
PBT	128	310	424
Tax @ 22%	(28)	(68)	(93)
PAT	100	242	331
MI	(3.0)	(3.0)	(3.0)
Net income	97	239	328
Accretion (%)	–28%	25	37
Combined group			
EV sales	2.5	2.3	2.1
EV EBITDA	12.9	9.9	8.5
PER	27.2	11.0	8.0
EBITDA/Interest	2.2	2.9	3.4
Debt:EBITDA	9.2	7.2	6.4
EBITDA margin (%)	19.4%	23.4	24.5
ROIC (incl. cost savings)			
Merck EBITDA		394	441
Cost savings	293	50	82
D&A	20	(99)	(110)
PBT	(92)	346	413
Tax @ 22%	222	(76)	(91)
NOPAT	(49)	270	322
ROIC (%)	173	6.0	7.2
WACC (%)	3.8%	6.5	6.5

Source: Cazenove

We make the following points:

- Interest cover remains within serviceable limits, with cover over 3x by 2009E, and debt:EBITDA falling to around 6.3x.
- With the full cost savings achieved by 2009, the multiples for the larger group begin to look increasingly attractive, particularly on a PER basis where the leverage impact from a fully debt–financed acquisition begins to show through.
- ROIC exceeds WACC on our three–year forecasts.
- If we flex the cost savings to €100m, this would result in a 2009E PER of 9.4x.

We see two most likely outcomes:

- Actavis is successful in acquiring Merck Generics at a price the market deems reasonable (particularly when taking into account the cost savings).
- Actavis is unsuccessful because Merck is sold at a high price/multiple to a third–party, be that an industrial or private equity bidder. We believe the market would then move to applying such multiples to Actavis.

In either event, we see little downside risk to Actavis' shares at the current levels. We note this is very similar to the recent situation with Smith & Nephew/Biomet and we believe investors will be interested to note the outcome with respect to the near–term impact in S&N's shares (+c. 20% despite losing out on the bid).

We understand that Actavis is unlikely to make a formal bid before it has received access to more detailed numbers which is expected late February/early March.

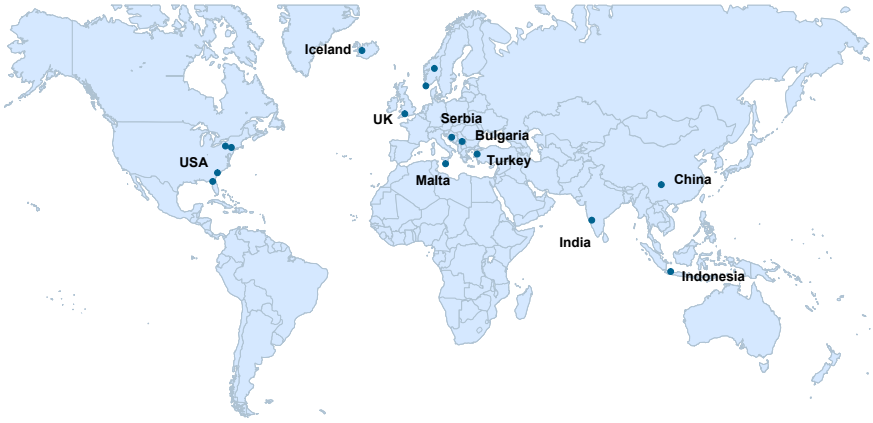
3.4 Manufacturing

Actavis has 20 manufacturing sites in 10 countries, four of which are FDA approved. Following the significant acquisition spree, we understand there is significant spare capacity:

- 55% utilisation of capacity in tablets and capsules.
- 30% utilisation of capacity in creams and liquids.

While there is clearly scope to reduce this capacity, we believe the company will also look to utilise some of it in the medium term.

Fig 3.3 Actavis manufacturing footprint



Source: Company

The recent acquisitions of both Grandix and Samnar significantly increases the group's low–cost Indian manufacturing capacity. We understand that following a plant upgrade, Samnar is expected to have a capacity of 4bn tablets and capsules p.a. and will become Actavis' largest manufacturing site.

3.5 Product development

The favourable patent environment in Iceland, Malta and Turkey enables Actavis to develop, manufacture and stockpile new products before patents have expired. While this preferential situation is expected to remain in the near term, we believe EU accession for these countries is likely to remove this competitive advantage in the medium term.

Visibility on the product portfolio and timing of launches is poor on a near– medium– and long–term view. This is due to the competitive nature of launches and the uncertainty of the patent litigation. However, we believe Actavis' portfolio is broad enough to give some reassurance to investors (given the clear underlying positive fundamental demand drivers).

3.6 Finance – well supported

Actavis' M&A activity to date has largely been funded through debt. This was initially provided by Icelandic institutions, but as the company has grown it has tapped a more international list of lenders.

The financing put in place for the 2006 acquisitions of Amide and then Alpharma was slightly more complex, perhaps unsurprising given the size of these deals. The Alpharma deal in particular used a placing of preferred shares to part finance the transaction. The preference shares carry slightly unusual terms:

Fig 3.4 Preference shares

Number	100
Amount raised €m	356
Company has right to redeem at any time until May 2011	
Initial premium on redemption (%)	+11
Annual increase in premium (%)	+1
If not converted by May 2011, shareholders can exchange for 39% of share capital, or c. 64% of additional share capital	

Source: Actavis annual report

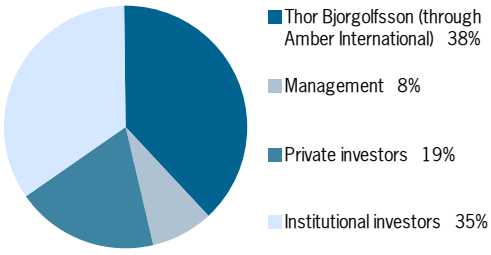
Our working assumption is that the company redeems these shares just prior to May 2011, refinancing them with additional debt. We have therefore included these preference shares as debt in our valuation assumptions. For completeness, we also include an analysis of the fully diluted EPS figures.

3.7 Shareholder structure

Given the current financing structure and limited liquidity in the Icelandic listed shares, the company has expressed an aim to list on a more international market (either New York or London).

We believe that the company could use the liquidity event of a listing to either raise further funds (for further acquisitions or to pay down debt). We also believe the current shareholders could look to sell a proportion of their shares in order to facilitate liquidity.

Fig 3.5 Actavis shareholders



Legend: segments listed clockwise from top

Source: Company accounts

One aspect that we believe international investors are likely to focus on is corporate governance. In particular, we note that:

- The company has made a €2.7m loan to the CEO.
- At 9 January 2006, an investment company owned by the CEO acquired shares in the company. This investment company entered a forward contract to buy 64.8m shares as well as a put option to sell 25.6m shares, dated 1 June 2008.
- The company has no non–executive directors.
- Three of the five members of the board have a significant personal holding in the company (1.3bn, 111m and 12.5m shares).

Finally, we note that the Icelandic Stock Exchange was recently acquired by OMX. We also understand the Actavis is exploring the possibility of a euro–denominated listing when it is quoted on OMX which will remove the Icelandic Krona forex risk for international investors and should further help liquidity.

4.0
Financial analysis

We set out below the recent financial performance of the group. This has clearly been heavily impacted by the significant acquisition strategy to date.

Fig 4.1 Actavis revenue

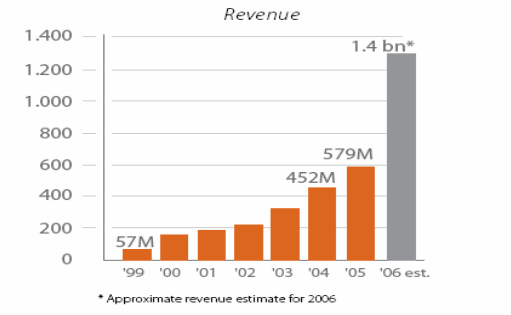
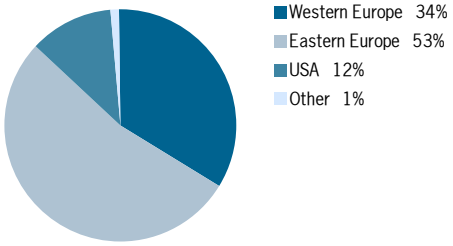


Fig 4.2 2005 reported sales by geography



Legend: segments listed clockwise from top

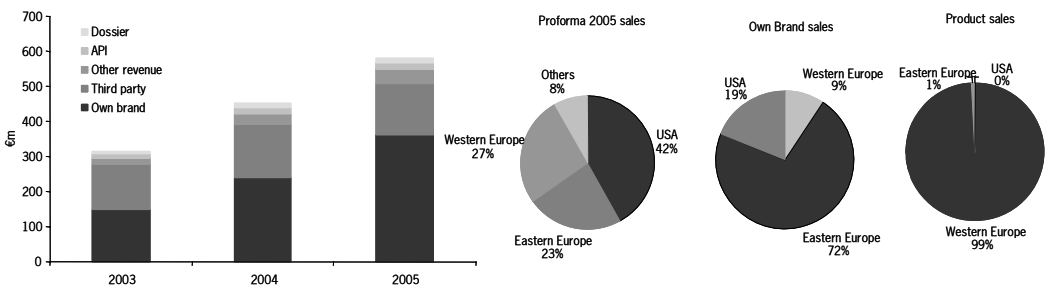
Source: Actavis

We also note that to date the company has a fairly limited exposure to the US market, although figure 4.2 above only includes around six months of the Amide acquisition and 12 days of sales from the Alpharma acquisition. On a proforma basis US sales would have been 42% of group 2005 sales.

The company has two key revenue drivers: Own Brand and Product Sales. It also generates sales from APIs (Active Pharmaceutical Ingredients) and Dossiers.

Fig 4.3 Actavis divisions

	Actavis				
	Own Brand	Product sales	API	Dossier	Other
Description	Actavis branded products	Finished products and IP sold to 3rd party generic companies	Active pharmaceutical ingredients i.e. bulk	Dossier	Other
Geography	Eastern Europe and USA	Vast majority to Western Europe (Germany)	Eastern Europe	Western Europe	Mix
Comment	65% of 2005 sales. Reported 2005 sales up 51% on 2004	25% of 2005 sales. Reported 2005 sales down 9% on 2004	3% of 2005 sales. Reported 2005 sales down 7% on 2004	2% of 2005 sales. Reported 2005 sales down 9% on 2004	Broadly flat overall



Source: Actavis

4.1
Limited sales visibility

Given the competitive nature of new generic launches, we believe that sales visibility in the short, medium and long term is relatively poor. Furthermore, the revenue base is actually relatively concentrated – the top 10 products accounted for 23.2% of revenues in the first nine months of 2006.

However, at a recent Capital Market's day the company set out detailed guidance for both revenues and costs (see section 6).

Price erosion was a dominant theme across the generic industry in 2006, and Actavis expects this to continue into 2007, with overall price erosion expected to be 7–8%. Despite this, the company is guiding to revenue growth of 13% on an underlying basis, with a further 2pp of positive forex impact giving 15% reported growth. This growth is expected to be driven by the launch of new products and in new markets.

Fig 4.4 Actavis underlying revenue growth guidance (%)

Revenue guidance at 26/1/07	2006E	2007E	2008E	2009E
USA	+12	+0–2	+8–10	+8–10
West Europe	–3	+15–18	+8–10	+8–10
CEEA	+18	+19–21	+10–15	+10–15
Total	+10	+13	+10	+10

Source: Actavis

5.0
Valuation

We have valued Actavis using both relative and DCF techniques. Furthermore, given the uncertainty of the Merck transaction, we have run the valuations on two scenarios – one assumes Actavis is not successful in its bid for Merck ('Actavis standalone') and the other does and achieves our estimated synergies. We assume a winning bid of €4.5bn and that the company raises new debt to finance the deal.

5.1
Relative valuation

Fig 5.1 Actavis relative valuation

	EV/sales			EV/EBITDA			PER		
Company	**2006E**	**2007E**	**2008E**	**2006E**	**2007E**	**2008E**	**2006E**	**2007E**	**2008E**
Barr Pharmaceuticals Inc	3.7	2.9	2.2	8.5	6.9	5.8	17.0	15.3	12.9
Mylan Laboratories Inc	3.1	2.7	2.5	9.9	7.9	6.6	17.7	16.1	15.0
Watson	1.5	1.0	0.9	8.0	5.3	4.6	22.8	17.7	14.3
Teva	4.0	3.6	3.1	12.4	12.2	10.1	16.4	17.0	14.9
Zentiva NV	3.6	3.1	2.7	12.5	10.5	8.9	22.8	18.4	15.5
Stada Arzneimittel AG	2.6	2.1	1.9	14.7	11.4	10.1	28.3	20.5	16.8
Ranbaxy	2.7	2.3	N/A	20.3	16.8	N/A	31.4	23.3	N/A
Dr Reddy's	4.1	3.3	N/A	35.5	24.9	N/A	43.3	26.4	N/A
Average	3.2	2.6	2.2	15.2	12.0	7.7	25.0	19.3	14.9
Median	3.3	2.8	2.3	12.5	11.0	7.8	22.8	18.1	14.9
Actavis standalone	2.9	2.6	2.3	13.5	11.7	9.5	25.1	17.0	12.3
Actavis + Merck		2.5	2.3		12.9	9.9		11.1	8.1
Actavis standalone									
Premium/(discount) to median (%)	(13)	(7)	0	8	7	22	10	(6)	(18)
Actavis + Merck									
Premium/(discount) to median (%)		(10)	0		19	29		52	(26)

Source: Cazenove, Bloomberg

We make the following observations:

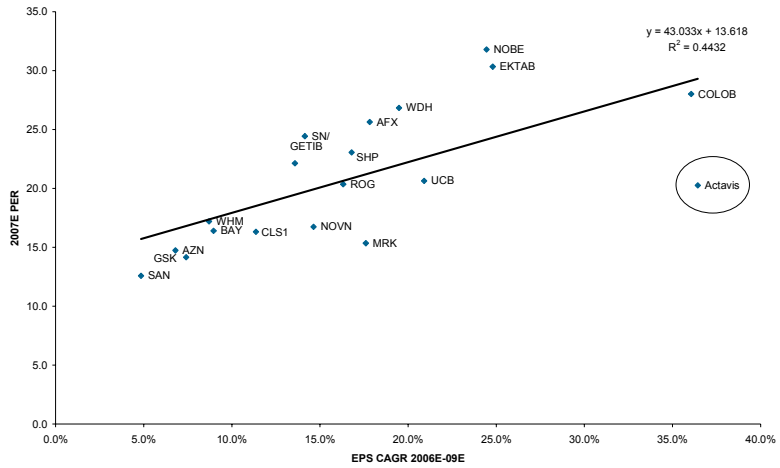
- Actavis standalone looks relatively expensive on EV multiples as these capture all the debt of the transactions, but very little of the costs savings. It also fails to take into account the low tax rate enjoyed by the group (22%). This latter point is captured in the PER multiple, which is more in line with its peers, and at a significant discount by 2008E when the cost savings start to come through.

- Actavis + Merck would trade at a significant discount (which would be even bigger in 2009 given there would be further likely cost savings.

- We note that company guidance is for EPS CAGR of 20%+ CAGR 2007–2009. We are forecasting 25–30%. We believe that a 2007E PER of 17.0x does not adequately capture this growth profile (PEG <1.0).

We set out below the PEG chart for our entire profitable healthcare coverage universe and note that this further illustrates Actavis' discount rating given its medium–term growth prospects.

Fig 5.2 2007E PER vs EPS CAGR 2006E–09E



Source: Cazenove, Bloomberg, NB Merck KGaA's growth 2007E–10E

5.2 DCF valuation

We set out our standalone DCF valuations below. We assume a base case WACC of 6.5% which reflects the high proportion of (cheap) debt funding.

Fig 5.3 Actavis DCF valuation

DCF	2007E	2008E	2009E	2010E	2011E
Operating profit	241.1	298.0	353.0	369.7	385.3
Depreciation & amortisation	107.3	122.6	130.4	124.5	128.0
EBITDA	**348.4**	**420.6**	**483.4**	**494.2**	**513.3**
Taxation	(38.7)	(54.7)	(68.6)	(74.7)	(80.5)
Operating post tax cashflow	309.7	365.9	414.8	419.5	432.8
Capital expenditure net of disposals	(268.0)	(195.0)	(137.0)	(160.0)	(160.0)
Decrease/(Increase) in working capital	(24.5)	(29.1)	(13.2)	(5.5)	(37.2)
Free cashflow	**17.2**	**141.9**	**264.6**	**254.0**	**235.6**
OP FCF margins	1.1%	8.2%	13.9%	12.3%	10.5%
Discount rate	0.94	0.88	0.83	0.78	0.73
Discounted FCF	**16.1**	**125.0**	**218.8**	**197.2**	**171.7**

Terminal value calculation

Cash flow in 2011	236	2011 EBITDA	513
Terminal growth rate	**2.5%**	Multiple	10.0
Discount rate	4.0%	TV	5,133
TV	5,839	PV of TV	3,740
PV of TV	4,533		
Average terminal value	**4,137**		

DCF calculation	
Cashflows	729
Terminal value	4,137
	4,866
Debt	(1,397)
Market cap €	**3,469**
ISK:EUR	87.47
Value per share (ISK)	**91**

Source: Cazenove

We set out below the sensitivity of both scenarios to both the WACC and long–term growth rate

Fig 5.4 DCF valuation (Ikr per share) – sensitivity to WACC and terminal growth rate

		WACC				
		5.5%	**6.0%**	**6.5%**	**7.0%**	**7.5%**
	1.00%	90	82	75	70	64
	1.50%	97	88	80	73	67
TGR	**2.00%**	106	95	85	78	71
	2.50%	118	103	92	83	75
	3.00%	135	115	101	89	80

Source: Cazenove

6.0
Actavis forecasts

The company recently held a Capital Markets Day where it presented detailed guidance out to 2009:

Fig 6.1 Actavis guidance

Guidance at 26/1/07	2007E	2008E	2009E
Revenues €bn	1.6	1.76	1.94
Gross margin (%)	40	41	43
EBITDA %	21–22	23	25
U/L growth (CER) (%)	+13	+10	+10
Overall growth (AER) (%)	+15		
Capex			
SG&A (%)	25	25	25
R&D expensed	63	70	77
R&D capitalised	104	96	85
D&A	100–110	120–130	130–140
Interest	60–65	45–50	40–45
Tax (% PBT)	22	22	22
EPS growth (%)	*20+*	*20+*	*20+*

Source: Actavis

We set out below our detailed forecasts. We note that our revenue forecasts are slightly below company forecasts and our EBITDA margin is broadly in line with company guidance.

Despite this, we note that we are forecasting EPS CAGR for 2007–2009 of c. 30% – we note that company guidance is for 20%+ growth.

6.1 Profit & loss account

Fig 6.2 Profit and loss forecasts (€m)

Year end: December	2005	2006E	2007E	2008E	2009E	2010E
Forex (%)			2.0			
Gross sales	579.2	1,390.4	1,573.2	1,732.6	1,908.6	2,069.8
Net sales	551.1	1,351.2	1,506.7	1,661.7	1,824.8	1,966.1
Cost of sales	(276.5)	(797.1)	(906.5)	(955.3)	(1,025.6)	(1,122.7)
Gross profit	302.7	593.3	666.7	777.4	883.0	947.1
Other operating income	27.9	27.9	27.9	27.9	27.9	27.9
Sales and marketing	(81.4)	(195.4)	(222.7)	(245.0)	(269.5)	(293.7)
R&D	(54.3)	(70.6)	(63.5)	(69.9)	(76.9)	(83.0)
G&A	(60.6)	(145.4)	(167.3)	(192.3)	(211.6)	(228.5)
Impairment	0.0	0.0	0.0	0.0	0.0	0.0
Other operating costs	(168.4)	(383.5)	(425.6)	(479.3)	(530.0)	(577.4)
Profit from operations	134.3	209.9	241.1	298.0	353.0	369.7
Loss from associates	(1.8)	(1.8)	(1.8)	(1.8)	(1.8)	(1.8)
Financial income/(expense)	(13.2)	(43.2)	(63.3)	(47.6)	(39.5)	(28.5)
Profit before tax	119.3	164.9	176.0	248.7	311.6	339.5
Income tax	(10.5)	(39.6)	(38.7)	(54.7)	(68.6)	(74.7)
Net profit	108.8	125.3	137.3	194.0	243.1	264.8
Minority interest	(3.0)	(3.0)	(3.0)	(3.0)	(3.0)	(3.0)
Attributable profit	105.8	122.3	134.3	191.0	240.1	261.8
Dividend paid	(3.6)	0.0	0.0	0.0	0.0	0.0
Basic EPS	0.03	0.025	0.039	0.056	0.071	0.078
Diluted EPS	0.03	0.025	0.039	0.056	0.071	0.077
Adjusted EPS – strip out purchased intangible amortization						
Basic EPS	0.038	0.031	0.047	0.064	0.080	0.087
Diluted EPS	0.038	0.031	0.047	0.064	0.080	0.087

Source: Cazenove

6.2 Cash flow statement

Fig 6.3 Cash flow forecasts (€m)

Year end: December	2005	2006E	2007E	2008E	2009E	2010E
Net earnings	108.8	125.3	137.3	194.0	243.1	264.8
Depreciation and impairment of fixed assets	21.2	34.6	47.0	55.0	60.0	52.6
Amortisation	20.8	54.8	60.3	67.6	70.4	71.9
Working capital provided by operating activities	136.9	214.7	244.6	316.6	373.5	389.2
Changes in operating assets and liabilities						
Inventories	(13.6)	(7.7)	(23.8)	(4.6)	(9.4)	(15.0)
Receivables	6.0	(39.0)	(28.1)	(36.7)	(21.4)	(14.8)
Short term liabilities	1.5	(160.6)	27.4	12.2	17.6	24.3
	(6.1)	(207.4)	(24.5)	(29.1)	(13.2)	(5.5)
Net cash used in operating activities	130.8	7.4	220.1	287.5	360.3	383.8
Net cash used in investing activities	(961.2)	(200.0)	(268.0)	(195.0)	(137.0)	(160.0)
Net cash generated from financing activities	937.8	0.0	0.0	0.0	0.0	0.0
Net change in cash and cash equivalents	107.4	(192.6)	(47.9)	92.5	223.3	223.8

Source: Cazenove

6.3 Balance sheet

Fig 6.4 Balance sheet forecasts (€m)

Year end: December	2005	2006E	2007E	2008E	2009E	2010E
Non–current assets						
Goodwill	784.6	784.6	784.6	784.6	784.6	784.6
Other intangible assets	548.0	603.2	675.9	704.3	718.9	727.0
Property, Plant & Equipment	346.3	401.7	489.7	533.7	525.7	553.1
Investments in associates	0.3	0.3	0.3	0.3	0.3	0.3
Other investments	0.7	0.7	0.7	0.7	0.7	0.7
Deferred tax assets	54.4	54.4	54.4	54.4	54.4	54.4
Total	1,734.3	1,844.9	2,005.6	2,078.0	2,084.5	2,120.1
Current assets						
Inventories	231.4	239.1	262.9	267.5	276.9	291.9
Fair value derivatives	9.2	9.2	9.2	9.2	9.2	9.2
Trade and other receivables	294.7	333.7	361.8	398.5	419.9	434.7
Cash and cash equivalents	99.3	(93.3)	(141.2)	(48.7)	174.5	398.3
Total	634.6	488.7	492.7	626.5	880.5	1,134.1
Non–current liabilities						
Interest–bearing loans	(868.4)	(868.4)	(868.4)	(868.4)	(868.4)	(868.4)
Retirement benefit obligation	(11.6)	(11.6)	(11.6)	(11.6)	(11.6)	(11.6)
Obligations under finance leases	(15.5)	(15.5)	(15.5)	(15.5)	(15.5)	(15.5)
Deferred income tax liabilities	(78.5)	(78.5)	(78.5)	(78.5)	(78.5)	(78.5)
Total	(974.0)	(974.0)	(974.0)	(974.0)	(974.0)	(974.0)
Current liabilities						
Interest–bearing loans	(22.4)	(22.4)	(22.4)	(22.4)	(22.4)	(22.4)
A/cs payable and other liabilities	(359.9)	(199.3)	(226.6)	(238.8)	(256.4)	(280.7)
Obligations under finance leases	(2.1)	(2.1)	(2.1)	(2.1)	(2.1)	(2.1)
Provisions	(2.5)	(2.5)	(2.5)	(2.5)	(2.5)	(2.5)
Total	(386.9)	(226.3)	(253.6)	(265.8)	(283.4)	(307.7)
Equity						
Issued capital	(53.0)	(53.0)	(53.0)	(53.0)	(53.0)	(53.0)
Share premium	(687.7)	(687.7)	(687.7)	(687.7)	(687.7)	(687.7)
Other reserves	(10.0)	(10.0)	(10.0)	(10.0)	(10.0)	(10.0)
Retained earnings	(246.6)	(371.9)	(509.2)	(703.2)	(946.3)	(1,211.1)
Minority interest	(10.7)	(10.7)	(10.7)	(10.7)	(10.7)	(10.7)
Total	(1,008.0)	(1,133.3)	(1,270.6)	(1,464.6)	(1,707.7)	(1,972.5)

Source: Cazenove

APPENDIX

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David Adlington and Martin Brunninger.

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