

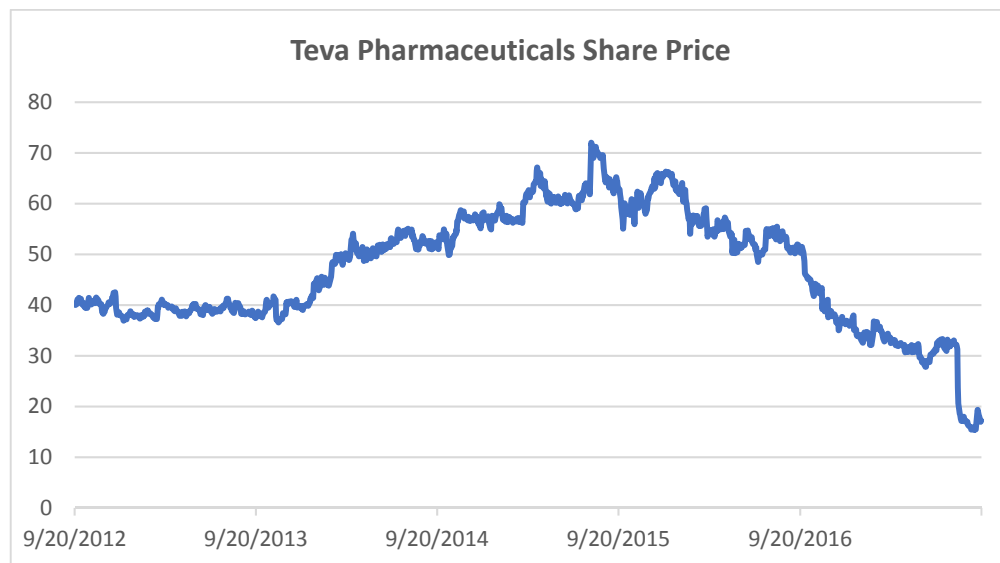
יועצי השקעות ישראל | Israel Investment Advisors

Teva's Collapse Masked Underlying Strength in the Israeli Stock Market

Brian J. Friedman, CFA
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For two decades Teva Pharmaceutical Industries, Ltd. (Teva) was Israel's most valuable company with a market capitalization of \$59 billion in 2015. From its peak in 2015, the share price of Teva declined by a dramatic 76% (chart 1). Prior to its collapse, Teva comprised 29% of the Tel-Aviv 125 Index (Chart 2). Now at a market value of just \$17 billion, its TA-125 Index weighting hovers around 8%. More than any other company, Teva accounts for the poor performance of the Israeli stock market indexes. Underlying strength in the remainder of the Israeli stock market has been masked by Teva's share price implosion.

Chart 1



Source: Bloomberg, L.P.

Chart 2

Teva % of Index					
	8.30.17	8.30.16	8.30.15	8.30.14	8.30.13
TA-100/125	8.64%	23.71%	29.00%	24.62%	22.96%
Bluestar Israel (BLS)	7.84%	11.49%	14.25%	12.82%	12.68%
MSCI Israel Cap (EIS)	15.84%	20.97%	25.97%	25.24%	24.55%

* As of 8.30.17, TEVA is no longer the largest holding in any of the above indices.

Source: Bloomberg, L.P.

Teva is the World's Largest Generic Drug Manufacturer

Teva's rise and fall is the story of the global generic drug boom and a single blockbuster treatment for Multiple Sclerosis called Copaxone. In the 1990s and 2000s, Teva evolved into the world's largest generic drug company. When a drug loses patent protection, prices plummet as competitors jump into the market. Teva leveraged its scale in this cutthroat competitive environment to become the low-cost producer for hundreds of generic products.

Teva built the core of its business around generic drugs, but they spotted an opportunity in the late 1980s. Researchers at Israel's Weizmann Institute of Science discovered and patented a novel treatment for Multiple Sclerosis. Unlike today, very few foreign companies were interested in Israeli science or technology back then. Using their home field advantage, executives at Teva swooped in to acquire Copaxone from the Weizmann Institute in 1987.

Teva Launched the Blockbuster MS Drug Copaxone in 1996

The FDA approved Copaxone in 1996, and over time it became one of the most prescribed MS treatments. In 1996 Teva was a company with nearly \$1 billion in revenues and \$130 million in operating profit. By 2014 – when Copaxone's patents started to expire - Teva's revenue exceeded \$20 billion with revenues from Copaxone alone accounting for \$4 billion. Since Copaxone's profit margins were much fatter than Teva's generic products, analysts estimated that Copaxone contributed 50% of Teva's total net income.

Mega Mergers for Generics as Copaxone Patents Expired

Copaxone's patents expired in 2014 and 2015. To blunt the impact of looming competition, Teva embarked on a series of mega-mergers. These deals, and most particularly its acquisition of the Actavis Generics business from Allergan in 2016, left Teva saddled with \$33 billion in long-term debt.

Teva bulked up on its generics business just as a major unexpected shift occurred in generic drug pricing. Pharmacy chains consolidated, giving them greater negotiating power against generic drug manufacturers. Teva's "solution" to its Copaxone problem turned out to be an even bigger problem given the debt involved.

In 2014 Teva Pharmaceuticals produced more than \$5 billion in cash flow, but \$1.5 billion to \$2.0 billion could disappear over the next several years if generic competition mounts. Meanwhile interest expense skyrocketed by \$1 billion from 2014 to 2016.

It was a stunning fall for Israel's premier multinational company, but can Teva survive? Teva Pharmaceuticals is still the largest and most efficient generic drug company in the world. Even if Copaxone cash flows plummet, Teva should be able to cover regular principal and interest payments. Bankruptcy is a possibility, however, since much of Teva's debt must be refinanced over the next three years. Teva brought in a new CEO over the past several weeks to lead a turnaround. Part of the plan is to sell assets and pay down debt. Teva can probably skirt bankruptcy, but the turnaround will be slow.

Teva's Collapse Concealed Underlying Strength in the Israeli Stock Market

Stock indexes such as the Tel-Aviv 125 or the MSCI Israel Index are market value weighted. Teva's large presence in these indexes was always a major risk factor for funds linked to them. An 8% weighting is still quite large, particularly for a heavily indebted company threatened with potential insolvency. Our analysis indicates Teva has a fighting chance for survival, and its stock is most likely undervalued, but the indexes remain overexposed.

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