Sample Hedge Fund Stock Pitch: Mylan [MYL]

In this sample stock pitch outline, we'll make a **LONG** ("Buy") recommendation for Mylan [MYL] based on the results of our market and valuation analysis.

We'll explain the reasons for this recommendation, the additional information we would need to create a comprehensive pitch, and then conclude with a stock pitch outline that you can immediately apply to Mylan, or any other company you're pitching.

NOTES AND DISCLAIMERS:

First, please do not construe this as "investment advice." We are **NOT** recommending that you invest in any of the companies covered here. This is a tutorial about how to *research* and *pitch* companies that you think are interesting, and how to use what we've learned so far to support your arguments.

Also, keep in mind that the tips covered here **move you in the *right direction*, but are NOT sufficient** for an entire case study or stock pitch.

Stock Pitch – LONG Recommendation for Mylan [MYL]

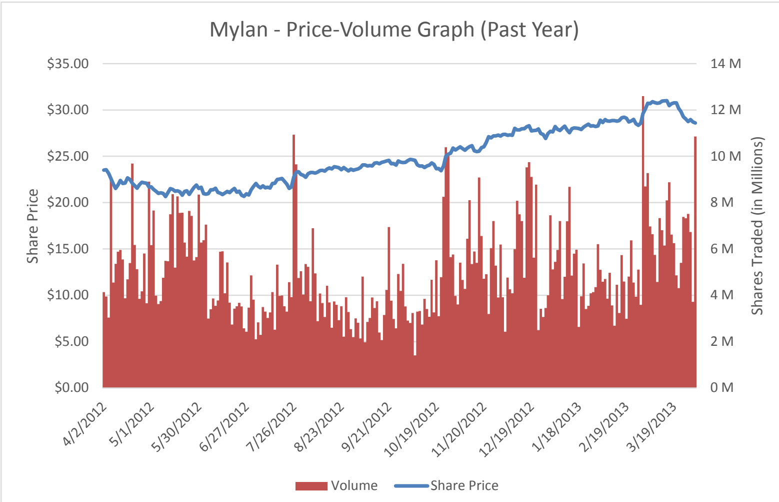
Recommendation

I recommend longing Mylan [MYL], a generics pharmaceuticals company, which currently trades at $28.60 per share, because it is undervalued by 10-20%, the market has incorrectly overemphasized price competition in its EpiPen product line, and there is significantly more upside to its recently announced Agila acquisition than the market has given it credit for. Additionally, even if growth in its generics segment declines at faster-than-expected rates, there is still at least 10% potential upside in the stock.

Catalysts to increase its share price in the next 6-12 months include the close of its recently announced $1.6 billion Agila acquisition (expected in Q4), the company's first earnings announcement post-acquisition, and the launch of Xeloda, an oral cancer drug, in the middle of the year.

Key investment risks include the Agila acquisition failing to close, integration being more challenging than expected (resulting in lower revenue growth and/or margins), and the company's new product launches for the year, such as Xeloda, generating lower-than-expected revenue. We could mitigate those risks via protective put options or covered calls, or by longing the stock of peer companies that have invested more heavily in other geographies or in competitive products.

Company Background



Mylan is a global pharmaceuticals company that operates in 2 segments: generics and specialty pharmaceuticals (primarily EpiPen). Total revenue in FY 2012 was $6.8 billion, with EBITDA of $1.7 billion (24% margin), and the company has grown revenue at 10-12% for the past 2 years, mostly through acquisitions of generics and specialty businesses from other companies.

Its generics segment accounted for 88% of total revenue and 85% of operating income in FY 2012, but its percentage of total revenue has declined slightly from over 90% 3 years ago.

Mylan currently trades at trailing multiples of 2.3x EV / Revenue and 9.3x EV / EBITDA. Forward multiples in our "base case" revenue and margin assumptions are 2.1x EV / Revenue and 9.0x EV / EBITDA in FY 2013, excluding the impact of the Agila acquisition (which is set to close in Q4 of FY 2013).

Investment Thesis

Currently, the market views Mylan as a fairly standard generics pharmaceuticals company in "the middle of the range" of its peer companies in the industry. As a result, it also trades at valuation multiple squarely in the middle of that range, and its multiples are close to those of Actavis, its closest peer (excluding the impact of acquisitions).

However, the stock is priced imperfectly for the following reasons:

1. There is significantly **more** upside to the Agila acquisition than the market has priced in – as demonstrated by channel checks we performed in emerging markets such as Brazil, which comprises 27% of Agila's revenue. Factoring in higher-than-projected growth rates, our analysis implies a valuation of at least $31.00 – $32.00 per share vs. Mylan's current price of $28.60.
2. There is significantly **less** downside in the decline of its specialty segment than the market has attributed to it. Even with more conservative estimates, the specific decline rate of this segment only accounts for approximately $0.75 – $1.00 of Mylan's implied per share value. In most reasonable scenarios, a faster-than-expected decline rate would push down Mylan's valuation by *at most* $0.50 per share.

3. While some have expressed concern over growth in its core generics segment, even with lower assumed growth rates over the next 5 years, there is still potential upside of at least 10% over the next 12 months; furthermore, the launch of key new products such as Xeloda in the middle of this year reduces the risk of lower-than-expected revenue growth.

Each of these reasons ties in directly to the company's valuation and will make a substantial impact (in the case of reasons #1 and #3 above), or will make far less of an impact than what the market currently expects, even in a downside scenario (for reason #2).

Even if some of these reasons turn out to be incorrect, any one of the factors above represents a significant difference from the current market view of the stock and could result in substantial upside.

If all of the factors above turn out to be incorrect, then Mylan is valued appropriately at its current stock price and an investment would represent minimal downside risk, even if there's no room for share price appreciation.

Catalysts

Catalysts in the next 6-12 months include:

- The close of the recently announced $1.6 billion Agila acquisition (expected in Q4 FY 2013);
- The company's first earnings announcement post-acquisition; and
- The Xeloda launch in the middle of the year.

Catalysts #1 and #2 are interrelated and are the most significant in terms of valuation. Specifically, the acquisition of Agila may result in $450+ million in additional revenue in FY 2014 and over $120 million in EBITDA, with revenue growing to over $900 million and EBITDA growing to $300+ million in FY 2017.

This makes a difference of over $7.00 per share in the base case assumptions in our DCF analysis (discount rate of 6.7%, terminal FCF growth rate of 1.0%, and generics revenue growth at 7% initially, falling to 4% by FY 2017):

WITHOUT Agila, Mylan's implied share price is in the $20.00 - $30.00 range:

Mylan, Inc. - Net Present Value Sensitivity - Terminal Growth Rates

		Discount Rate								
		5.0%	5.5%	6.0%	6.5%	**7.0%**	7.5%	8.0%	8.5%	9.0%
Terminal Growth Rate	2.5%	$ 72.63	$ 57.89	$ 47.36	$ 39.46	**$ 33.32**	$ 28.40	$ 24.37	$ 21.02	$ 18.18
	2.0%	59.26	48.52	40.47	34.20	**29.18**	25.08	21.66	18.76	16.25
	1.5%	49.70	41.49	35.10	29.99	**25.80**	22.31	19.36	16.81	14.56
	1.0%	**42.54**	**36.02**	**30.81**	**26.54**	**22.98**	**19.97**	**17.39**	**15.09**	**13.09**
	0.5%	36.97	31.65	27.30	23.67	**20.60**	17.96	15.64	13.59	11.79
	0.0%	32.51	28.07	24.37	21.24	**18.55**	16.19	14.11	12.27	10.63

Its implied share price is exactly $25.12 without the acquisition, but it jumps to $32.00+ per share with the acquisition included in future years (the highlighted area below shows more of a "downside" case; 30-40%+ revenue growth is likely based on our channel checks):

Mylan, Inc. - Net Present Value Sensitivity - Initial Agila Revenue Growth vs. Decline in Revenue Growth Rates in Subsequent Years										
		Initial Agila Revenue Growth								
		15.0%	20.0%	25.0%	30.0%	**35.0%**	40.0%	45.0%	50.0%	55.0%
Agila - Annual Decline in Revenue Growth Rate	(1.0%)	$ 28.80	$ 29.71	$ 30.79	$ 32.04	**$ 33.51**	$ 35.20	$ 37.16	$ 39.39	$ 41.95
	(1.8%)	28.56	29.43	30.45	31.65	**33.05**	34.68	36.55	38.70	41.16
	(2.5%)	**28.34**	**29.16**	**30.13**	**31.28**	**32.61**	**34.17**	**35.96**	**38.03**	**40.39**
	(3.3%)	28.12	28.90	29.83	30.92	**32.19**	33.68	35.40	37.38	39.65
	(4.0%)	27.91	28.65	29.53	30.57	**31.79**	33.21	34.85	36.75	38.93
	(4.8%)	27.71	28.42	29.25	30.24	**31.40**	32.76	34.33	36.15	38.24

As shown in the table, even if Agila's revenue declines at faster-than-expected rates (the bottom several rows), there is still upside and a $28.00+ per share price is plausible with the Agila contribution.

Consensus estimates currently peg Agila's revenue growth at 25% in FY 2014, falling to 10% by FY 2017, but we have assumed a premium to these numbers because of the following factors:

- Via channel checks, we spoke with several healthcare professionals in emerging markets and they all agreed that Agila's market position in Brazil (which currently represents 27% of its revenue) is highly desirable and very difficult to replicate given government regulations there and the requirement to manufacture locally. Effectively, it has close to a monopoly in this fast-growing market and will maintain that for the next several years.
- Furthermore, several customers in Brazil mentioned that they expect demand for injectables will be higher than expected and that the growth rate in Brazil will be even higher than overall injectables growth in emerging markets as a whole.

As a result, we believe that 35%+ growth initially followed by a slower-than-expected decline is reasonable, which in turn will boost Mylan's share price once the market gains knowledge of this and prices it in appropriately.

The second catalyst, the company's first earnings announcement post-acquisition, is significant because this event may make the market realize the pricing imperfection in Mylan's stock once the company provides higher-than-expected guidance for FY 2014 as a result of the acquisition.

It is possible that the acquisition may not close, or may not be approved by government authorities, or may not work as well as expected, but we address these risks below in the section on Investment Risks.

Finally, catalyst #3, the launch of the Xeloda brand, is significant because it is a $700+ million brand with the potential to boost Mylan's total over revenue over the next 5 years by anywhere between 2% and 5% depending on the revenue contribution each year.

This sensitivity table shows the impact of Mylan's generics segment revenue growth and its overall operating margin over the next 5 years on its implied share price:

Mylan, Inc. - Net Present Value Sensitivity - Generics Revenue Growth vs. Operating Margin (Excl. Acquisition)									
	Initial Generics Revenue Growth (Annual change of (0.8%))								
Mylan, Inc. Standalone Operating Margin	3.0%	4.0%	5.0%	6.0%	**7.0%**	8.0%	9.0%	10.0%	11.0%
17.5%	$ 29.24	$ 30.49	$ 31.78	$ 33.13	**$ 34.52**	$ 35.96	$ 37.46	$ 39.01	$ 40.62
17.0%	28.31	29.52	30.78	32.08	**33.43**	34.82	36.27	37.78	39.33
16.5%	**27.38**	**28.55**	**29.77**	**31.03**	**32.33**	**33.68**	**35.09**	**36.54**	**38.05**
16.0%	26.46	27.59	28.76	29.98	**31.24**	32.55	33.90	35.31	36.76
15.5%	25.53	26.62	27.75	28.93	**30.14**	31.41	32.71	34.07	35.47
15.0%	24.60	25.65	26.74	27.88	**29.05**	30.27	31.53	32.83	34.19

While this table does not *directly* show the impact of <u>cumulative</u> revenue and revenue growth over 5 years, you can see the impact of even a 1% change in initial revenue growth in FY 2013: approximately 1% in extra revenue growth translates into around $1.25 in extra per share value.

With Xeloda and other new products, we believe at least 6-7% revenue growth, falling by 0.5%-1.0% per year, is reasonable, which would imply valuations of at least $29.00 - $30.00 per share, and potentially over $32.00 per share.

All of the above represent catalysts that could boost Mylan's share price to our targeted range of $32.00 - $34.00 per share in the next 12 months; if they all come true and work as expected, the price may be near the upper end of that range, and if one or more is false, there is still potential upside in the stock but it would be reduced to the lower end of that range, or slightly below it.

Valuation

We have valued Mylan using public comps, precedent transactions, and the DCF analysis.

To select comparable public companies and precedent transactions, we have used the following criteria: **[You would explain the criteria here in a real stock pitch – we are skipping it here in the interest of time and wanting to focus more on the DCF analysis.]**

Here are the implied valuation ranges from these methodologies: **[You would display the ranges from this analysis in a real stock pitch and explain what the valuation ranges tell you about the company – might it be undervalued? Overvalued? Valued appropriately?]**

The discounted cash flow analysis uses the following "base case" assumptions:

- Initial Generics Segment revenue growth of 7.0%, declining by 0.75% per year (based on Mylan's product pipeline, expected launch dates, and consensus estimates, which we have seen no reason to deviate from)

- Initial Specialty Segment revenue growth of 10.0%, which then reverses into a 20.0% annual decline each year starting in the second year – most analysts project this segment to grow for 2 years before declining, but we are being extra conservative with the base assumptions here
- Operating Margin of 16.5% and Tax Rate of 35.0%, in-line with historical levels
- $1.6 billion in debt raised for the Agila acquisition in FY 2013, with a $125 million cash earnout in FY 2014; Agila's revenue grows from $454 million in FY 2014 to $908 million in FY 2017, with Operating Income rising from $121 million to $283 million – these numbers exceed consensus estimates due to our channel checks and additional research
- 6.7% discount rate (based on public comps and WACC), 1.0% terminal FCF growth rate, and standard discount periods

Here's the DCF down to the NOPAT line so that you can see the revenue and operating income contributions from different segments and the Agila acquisition:

Mylan, Inc.- Free Cash Flow Projections								
		Historical				Projected		
Fiscal Year Ends December 31,	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
Generics & Other Revenue:	$ 5,028	$ 5,583	$ 5,996	**$ 6,416**	**$ 6,817**	**$ 7,192**	**$ 7,533**	**$ 7,835**
Generics Revenue Growth Rate:	*N/A*	*11.0%*	*7.4%*	*7.0%*	*6.3%*	*5.5%*	*4.8%*	*4.0%*
Specialty (EpiPen) Revenue:	423	547	800	**880**	**704**	**563**	**451**	**360**
Specialty Revenue Growth Rate:	*N/A*	*29.3%*	*46.3%*	*10.0%*	*(20.0%)*	*(20.0%)*	*(20.0%)*	*(20.0%)*
Total Revenue:	**$ 5,451**	**$ 6,130**	**$ 6,796**	**$ 7,296**	**$ 7,521**	**$ 7,755**	**$ 7,984**	**$ 8,195**
Overall Revenue Growth Rate:	*N/A*	*12.4%*	*10.9%*	*7.4%*	*3.1%*	*3.1%*	*3.0%*	*2.6%*
Operating Income:	722	1,005	1,109	**1,204**	**1,241**	**1,280**	**1,317**	**1,352**
Operating Margin:	*13.2%*	*16.4%*	*16.3%*	*16.5%*	*16.5%*	*16.5%*	*16.5%*	*16.5%*
Less: Taxes, Excluding Effect of Interest:				(421)	(434)	(448)	(461)	(473)
Net Operating Profit After Tax (NOPAT):				**782**	**807**	**832**	**856**	**879**
Contribution from Agila:								
Revenue:	129	193	255	344	454	586	739	908
Revenue Growth Rate:	*84.3%*	*49.6%*	*32.1%*	*35.0%*	*32.0%*	*29.0%*	*26.0%*	*23.0%*
Operating Income:	32	49	66	91	121	169	223	283
Operating Margin:	*24.7%*	*25.4%*	*25.9%*	*26.3%*	*26.6%*	*28.8%*	*30.2%*	*31.2%*
NOPAT:				68	91	126	168	212
Tax Rate:				*25.0%*	*25.0%*	*25.0%*	*25.0%*	*25.0%*
Combined Company Revenue:				**7,296**	**7,975**	**8,341**	**8,722**	**9,103**
Combined Company Operating Income:				**1,204**	**1,362**	**1,448**	**1,541**	**1,635**
Combined Company NOPAT:				**782**	**897**	**958**	**1,024**	**1,091**

Here are the most relevant sensitivity tables based on key variables in this analysis, such as the discount rate, terminal growth rate, and revenue growth and margins:

Mylan, Inc. - Net Present Value Sensitivity - Terminal Growth Rates										
		Discount Rate								
		5.0%	5.5%	6.0%	6.5%	**7.0%**	7.5%	8.0%	8.5%	9.0%
Terminal Growth Rate	2.5%	$ 89.51	$ 71.77	$ 59.10	$ 49.60	**$ 42.21**	$ 36.30	$ 31.47	$ 27.44	$ 24.03
	2.0%	73.40	60.48	50.80	43.26	**37.24**	32.31	28.20	24.72	21.74
	1.5%	61.90	52.02	44.34	38.19	**33.16**	28.97	25.43	22.39	19.76
	1.0%	**53.27**	**45.43**	**39.17**	**34.04**	**29.77**	**26.16**	**23.06**	**20.37**	**18.03**
	0.5%	46.56	40.17	34.94	30.58	**26.90**	23.74	21.00	18.61	16.47
	0.0%	41.19	35.86	31.41	27.66	**24.44**	21.64	19.20	17.04	15.08

Key Takeaways: The analysis is highly sensitive to both of these assumptions – however, these terminal growth rates are also quite conservative and even in the case of 0.5% growth, the company would only be valued at *slightly* less than its current stock price. The bigger question is the **discount rate** – is 6.5% or 7.0% more appropriate? Our estimated rate is right in the middle of the range. This one will require some additional research.

Here's another table for the initial revenue growth in Mylan's generics segment (with the revenue growth rate falling by 0.75% each year, i.e. the second year would be 6.3%), along with the company's overall operating margin:

Mylan, Inc. - Net Present Value Sensitivity - Generics Revenue Growth vs. Operating Margin (Excl. Acquisition)										
		Initial Generics Revenue Growth (Annual change of (0.8%))								
		3.0%	4.0%	5.0%	6.0%	**7.0%**	8.0%	9.0%	10.0%	11.0%
Mylan, Inc. Standalone Operating Margin	17.5%	$ 29.24	$ 30.49	$ 31.78	$ 33.13	**$ 34.52**	$ 35.96	$ 37.46	$ 39.01	$ 40.62
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	15.5%	25.53	26.62	27.75	28.93	**30.14**	31.41	32.71	34.07	35.47
	15.0%	24.60	25.65	26.74	27.88	**29.05**	30.27	31.53	32.83	34.19

Key Takeaways: If you look at the highlighted area, you'll see that *even in downside scenarios*, the valuation implies, at worst, approximately a 15% discount to Mylan's current share price, and each 0.5% in margin contributes about $1.00 per share, with each additional 1.0% of revenue growth adding $1.25.

The more optimistic scenarios and implied values over $35.00 per share are less likely, but from this table it certainly seems like the potential upside exceeds the potential downside.

We have already shown the analysis of Agila's initial revenue growth and decline rate in the Catalyst section and given estimates for the impact of the Specialty segment decline rate; the key takeaways are that the Specialty decline rate is almost irrelevant, and that additional upside from Agila contributes substantially to implied valuation, at around $1.25+ per share for each 5% of initial Year 1 revenue growth.

Based on our research and channel checks, we believe there is a high likelihood that actual revenue growth will meet or exceed these numbers due to Agila's favorable geographical split and strong competitive advantage in emerging markets.

Investment Risks

The top risk factors include:

1) The Agila acquisition failing to close;
2) Integration being more challenging than expected (resulting in lower revenue growth and/or margins); and
3) The company's new product launches for the coming year, such as Xeloda, generating lower-than-expected revenue.

We'll address each of those risk factors in turn and explain how to mitigate them:

Agila Acquisition Fails to Close

If the Agila acquisition does not close or is held up by regulatory approval or by other factors, the company might be worth closer to the $25.00 – $30.00 per share range (see the tables in the Catalysts section above).

While that is not dramatically different from its current price of $28.60, there is a chance that the market may overreact and send the stock price down, or that the stock price could fall as the company guides to lower revenue and EPS in FY 2014 as a result of the delay.

To hedge against this risk, we could buy protective put options on Mylan's stock at a strike price of $27.17 (or something close to that) to limit our losses to 5%; this is not an investment with massive upside, so we don't see a reason to accept greater than 5% losses if the potential gain is only 10-15%.

Integration is More Challenging than Expected / Emerging Markets Grow More Slowly

As shown in the tables above, this investment thesis is heavily dependent on growth in emerging markets exceeding estimates and the Agila acquisition making a substantial contribution to revenue and operating income from FY 2014 through FY 2017.

If that does **not** happen, the company's implied per share value would be closer to $25.00 – $30.00 per share in the case where initial revenue growth from Agila is between 15% and 30% and the annual revenue growth decline rate is 3.0% – 5.0% rather than the 3.0% we've assumed in the base case.

That doesn't represent a massive potential loss, but we could hedge against this outcome by longing a competitor with less exposure to emerging markets (e.g. Actavis), or even a much larger pharmaceuticals company with a more diversified pipeline, such as Pfizer or Merck.

New Product Launches (Xeloda) Generating Lower-than-Expected Revenue

As shown above, the analysis here is dependent on solid revenue growth in Mylan's generics segment going into FY 2013 and beyond – if the initial revenue growth is in the 3.0% – 6.0% range rather than the

7.0% in our base case, and the operating margin falls from 16.5% to closer to 15.0%, the company's implied value per share falls to the $23.00 – $27.00 range.

This is a sizable discount to the company's current $28.60 share price, so we could hedge against this risk via protective put options (purchased at $26.00 – $27.00 strike prices), or by longing the stock of a competitor that is focused on other segments of the pharmaceuticals market, or one that offers products in the same segment (oral cancer drugs) but with more competitive pricing or other benefits.

This would require additional research on the market and peer companies to execute properly.

The Worst Case Scenario

Another risk is that we could be wrong about everything outlined above, from the revenue growth rates and margins to the acquisition, new product launches, and more.

A true "worst case scenario" might result in an implied share price of between $15.00 and $20.00 if you assume dramatically lower revenue growth, lower margins, a significantly higher discount rate, and a terminal FCF growth rate of less than 1.0%.

Assets minus Liabilities on Mylan's Balance Sheet is currently $3.4 billion, which equates to a stock price of $8.60.

If you subtract out Intangible Assets and Goodwill, however, the picture is **not** as favorable since *Tangible* Assets minus Liabilities is actually a negative number – as is often the case for pharmaceutical firms with IP-heavy portfolios.

So there is not much "Balance Sheet protection," but we could protect against these extreme downside scenarios via protective put options, longing the stock of peer companies such as Actavis, or investing in another company in the sector with a different geographical and/or product focus.

Additionally, there is another way to hedge against this extreme downside with Mylan: since it has acquired so many companies in recent years, it could sell off any divisions that have not already been fully integrated, or even ones that *have* been more fully integrated (and accept a discount to market value for them).

We would need to conduct additional research and do more valuation work on what these divisions might be worth, but the company has spent nearly $1 billion on these deals in the past several years – on the surface, that is also a low per-share value, but potentially they could be sold for significantly more than that $1 billion depending on how market values have changed over time.

Return to Top.

What Next?

Now that you've completed this case study and read through this stock pitch above, **what's next?**

What can you do to master these concepts and get more practice with all of this?

Here's what we recommend:

1. **Flesh Out the Missing Pieces Here** – For example, do your own channel checks and your own industry research and see if you can confirm / deny some of these assumptions, or at least make your own arguments for or against what we've laid out above.
2. **Practice with Your Own Company** – Use what you've learned here to generate your *own* investment ideas and stock pitches, in any industry you're interested in. The same structure always applies, but the model inputs, research, and valuation will be different.

And if you're looking for a more structured approach:

1. **Job Search Digest Webinars** – We're actually covering this very case study and including more on the technical parts in a case study on Tuesday next week (June 25th). If you sign up for the Job Search Digest newsletter, you'll receive an announcement about this webinar and instructions on how to join.
2. **Numi's Stock Pitch and Case Study Service** – I linked to this at the end of the previous articles, but he's your best source for personalized assistance with your stock pitches and hedge fund case studies and he's worked with dozens of clients over the years and helped them land offers in equity research, hedge funds, and more. You can visit his LinkedIn page here or email him at numi.advisory@gmail.com.
3. **BIWS Financial Modeling Courses** – This is a relatively recent addition, but we now include **bonus case studies** if you've signed up for the Fundamentals or Advanced courses (or any combination thereof). If you're already a member, click here to access them. These case studies cover valuation, merger models, LBO models, and more, and several of them also teach you how to make investment recommendations in PE and HF interviews.

Return to Top.