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German Drugmaker Flirts With Russian Market, Backs Off

By The Moscow Times

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LONDON — German generic drugmaker Stada, under pressure to curb its reliance on a weakening home market, embarked on two takeover attempts in Russia over the last two years but failed both times following months of exclusive talks.

After deciding against a merger with Russia's largest drugmaker Pharmstandard in 2010, the German company opted out of acquiring unlisted firm Valenta a year ago, several people familiar with the matter said.

The misadventures, which have not been made public until now, suggest that Stada may be left behind in a global generics industry that is racing to achieve economies of scale. They also raise questions as to whether its management is too cautious in pursuing opportunities in emerging markets.

While the first deal would have eased its strained finances at the expense of handing some control to Russian partners, the second deal, worth about $400 million according to one source, would have helped widen its operating margin.

Stada, based in Bad Vilbel near Frankfurt, declined to comment. Officials at Pharmstandard, which has a market value of about 68 billion rubles ($2.3 billion), were not available for comment.

Stada's home market has been a headache after changes to the German government's drug reimbursement rules in 2008 upended Stada's strategy there, which had been focused on doctors and pharmacies.

Following the changes in policy, German health insurers were allowed to put bulk purchases out to tender among generic drugmakers, triggering a price war for big contracts.

The switch came at a bad time for Stada.

Formerly a procurement cooperative for German pharmacies that had relied on third-party producers, the company was investing heavily to develop its own production capabilities to emulate more nimble rivals Ratiopharm and Hexal.

As a result, Stada's finances are strained. Its debt burden of 2.6 times core earnings compares with multiples of just 1.2 for industry leader Teva and 0.9 times for U.S. peer Watson, according to Thomson Reuters StarMine data.

Expanding in burgeoning Russia could help resolve Stada's predicament. The country is already Stada's second-largest national market with annual sales of about 260 million euros ($340 million) after two successful acquisitions in 2005 and 2007.

The Russian generics market is forecast to grow at an annual rate of 13 percent through 2014, according to Stada. In addition, it is driven by patients who have to buy most prescription drugs themselves, preserving consumer loyalty to higher-margin generic medicines sold under a company brand.

That prompted Stada to enter talks with the country's biggest drugs player Pharmstandard in 2010, according to two people involved in the matter.

Russian oligarch Viktor Kharitonin, the mastermind behind Pharmstandard and its majority shareholder, contacted Stada's management with a merger proposal that would have given the German firm access to Pharmstandard's Russian plants and staff, and would have bolstered its footprint in a fast-growing market.

In turn Stada's know-how could have helped elevate Pharmstandard's manufacturing practices to Western levels, potentially jump-starting the group's exports and easing its complete dependence on former Soviet states.

The mooted deal drew support from the Russian government. Eager to improve the nation's health-care sector, it pledged to underwrite a capital increase to shore up the combined group.

Even though Stada shareholders would have had the upper hand in the new entity, the deal was eventually struck down by the German group's supervisory board, which feared a loss of power to their Russian partners.

Generics makers have been in an M&A frenzy for years because Western governments are putting pressure on the industry to provide drugs at the lowest possible price, which favors large players who can produce at low costs.

Israel's Teva has emerged as the undisputed leader, with $10 billion in takeover deals under its belt over the last 10 years. Runners-up Novartis, Mylan and Watson have spent billions each on deals, taking a firm lead over Stada.

The German group's largest takeover by far has been that of Serbia's Hemopharm for less than 500 million euros in 2006. The deal helped form the nucleus of Stada's manufacturing network.

Stada's chief executive Hartmut Retzlaff, aged 58 and in charge since 1994, appears to have shunned M&A that has been the key to success for many generics rivals but has undone a few.

The finances of Iceland's deal-hungry Actavis imploded in the 2008-09 financial crisis, leaving the group effectively under the control of its largest lender, Deutsche Bank.

Retzlaff is known for keeping a tight rein on the company with an unorthodox management style and for relying on his instincts rather than an army of advisers.

Encouraged by Stada's past success in Russia, Retzlaff trained his sights on peer Valenta, when its owners put it up for sale later in 2010.

The Valenta auction, organized by investment bank Jefferies, ended without yielding the owners' asking price, but Stada was exclusively invited back to the table several weeks later.

Stada then proposed acquiring only Valenta's marketing network and intellectual property and excluding the production facilities, which it regarded as too risky.

Two sources said Stada eventually secured the green light from key ministers in Prime Minister Vladimir Putin's Cabinet. At that stage, Stada and Valenta's owners were only about 10 percent apart on a dollar price, with the euro's strength at the time playing into Stada's hands.

But the deal collapsed in March 2011.

"We had intended to conclude a very complex deal. Agreeing its parameters required a great effort from both sides, everyone was tired and the deal did not take shape," Valenta's chief executive Alexander Itin said.

Itin said the complexity of the deal eventually overwhelmed both sides. "It was not a matter of disagreement over price."

Valenta said it made about 2 billion rubles in EBITDA last year on sales of 5 billion rubles.

Industry experts say Russia's attractive growth rates must be balanced against the risk of a falling ruble and of political upheaval. In addition, the industry has recently been subjected to a number of government restrictions on drug prices.

But that has not kept Stada from trying to thrash out deals in the country for years. Two sources said that at one point it was also looking into buying drugmaker Veropharm. Officials at Veropharm could not be reached for comment.

Meanwhile, Stada says in presentations to investors that "internationalization progresses," citing a proportion of sales from abroad of more than 71 percent, up from 63 percent in 2007.

But that is as much a result of deteriorating sales in its home market as it is of growth outside Germany.

Stada's need to act became apparent again at the start of the month, when it reported that its 2011 net income slumped by two-thirds, dragged lower by delayed payments from Serbian drugs distributors and as the margin squeeze in its home market continued.

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