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INVESTMENT IDEA: BAYER AG

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COMPANY OVERVIEW

Bayer AG is a life science company, founded in 1952 and incorporated in Germany. The Company operates in the following segments: Pharmaceuticals, Consumer Health, Crop Science. The Pharmaceuticals segment focuses on researching, developing and marketing prescription products and specialty therapeutics especially in the areas of cardiology, oncology, gynecology, hematology and ophthalmology, as well as radiopharmacology and others. The Consumer Health segment develops, produces and markets nonprescription over-the-counter products in the dermatology, dietary supplement, analgesic, gastrointestinal, cold, allergy, sinus and flu, foot care and sun protection categories, among others. The Crop Science segment researches, develops and markets crop protection solutions and seeds, and includes the subsidiary Monsanto.

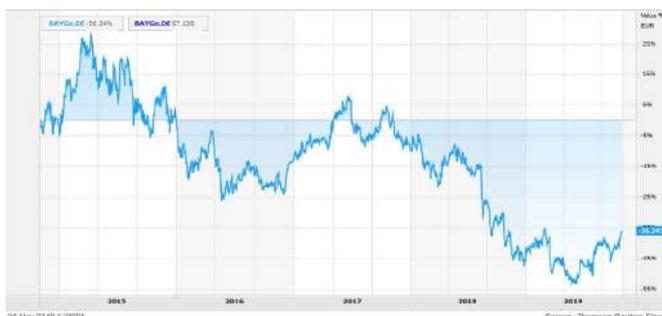


Figure 5 – Stock development of Bayer AG for the last 5 years

As of today (Oct 30th, 2019) the company has a market capitalization of €62.89Bn and revenues for €39.59Bn (2018), and its shares trade at €71.71 (Nov. 6th, 2019). The company currently (Oct 30th, 2019) employs 116,998 workers¹. Its ESG Score (Thomson Reuters ESG Combined Score) is C (2018).

The geographical breakdown of the company's revenues is as follows:

- EMEA: 36%
- North America: 29%
- Asia / Pacific: 20%
- Latin America: 15%

Revenues' contribution for each business is: €16.7Bn from Pharmaceuticals; €14.3Bn from Crop Science (but up to €19Bn on a pro-forma basis, i.e. with the incorporation of Monsanto); €5.5Bn from Consumer Health; €1.5Bn from Animal Health (the business has recently been divested); € 1.5Bn from other sources of income.

ANALYSIS OF THE BUSINESS AND BUSINESS OUTLOOK

The analysis of the industrial segments in which Bayer operates will be carried out individually.

- *Crop Science:* Following the acquisition of Monsanto Co. (final compensation of €63Bn), Bayer has become the main global player in this business. The rationale of this M&A operation was identified in the exploitation of relevant synergies, enabling the final conglomerate to offer products and services for all the phases of the agricultural production (from the seeds to the herbicides and to the digital services to monitor the harvest): unfortunately, the operation is experiencing severe complications and the effects of the synergies are being deferred (please refer to the next section for the complete analysis of the case). According to the 2019Q3 report, sales has grown by 4.8% (FX adjusted) with respect to 2018Q3 (on non-pro-forma basis), leading to substantial increase in earnings as well. The leadership of Bayer in this business is ensured (at least for the medium run) both by a broadly-acknowledged quality of its products and by its constant efforts in innovation (highly significant is the development of the Climate Fieldview™ platform, a system enabling farmers to plant the seeds and manage the harvest through big data analysis). Growth and stability drivers are represented by a steady demand and fast geographical penetration.
- *Pharmaceuticals:* Represents the historical business of the firm. Bayer produces some of the most widespread drugs, including Xarelto (the most broadly indicated anticoagulant) and Eylea (leader brand for retinal disease treatments) which together

¹ Bloomberg



account for almost 1/3 of the overall revenues for the segment. The patents for these two blockbuster drugs are going to expire respectively in 2023 and 2025, but the current pipeline (i.e. the list of the drugs under development and testing) and the number of partnerships that Bayer is carrying out with external partners seem to calm any concern. This business has historically proven to be anti-cyclical, although subject to shocks driven by successful research. The 2019Q3 report signals a surge in sales (+5.9% FX adjusted against 2018Q3), driven by a successful growth in China.

- *Consumer Health*: Under this segment are included some of the most renowned brands: Claritin, Aspirin, Canesten, Dr. Scholl's (recently divested). This is the segment which has suffered the most in the last period, due to drops in sales in the US and to temporary offer disruptions. The 2019Q3 report, however, signals an important enhancement of the performance in this business as well: +3,7% (FX adjusted) with respect to 2018Q3 mainly due to a record growth in Latin America.

THE GLYPHOSATE LITIGATION AND THE RESTRUCTURING PLAN

Following the acquisition of Monsanto Co., Bayer has undergone a severe legal attack which has been dealing with for more than one year. According to the last quarterly report (2019Q3), currently there are approximately 42,700 plaintiffs who have sued the company for having been exposed to glyphosate-based products manufactured by Bayer's subsidiary Monsanto and alleged to have caused severe diseases including non-Hodgkin lymphomas (NHL) and other forms of myeloma.

Starting from the first sentence, the conglomerate has lost around €30Bn of Equity Value: this discount can be broadly seen as the price of the liability that the market is expecting Bayer to be forced to pay in order to permanently settle the litigation. Is this a reasonable amount? According to our analysis, absolutely not.

A background checking carried out on similar litigations which took place over the last 15 years in

the pharmaceutical and chemical industry suggests us that often (not to say always) the market overreacts in front of such events. Particularly significant are the cases of Actos (Takeda), Baycol (Bayer), Vioxx (Merck), Avandia (GlaxoSmithKline), where the final settlement agreed between the companies and the plaintiffs have been significantly lower than what the market originally expected. According to a number of analysts, a reasonable settlement for the Monsanto litigation could be actually priced in the region of €5Bn - €15Bn.

Another point to stress is the substantial absence of scientific evidence able to support the alleged correlation between glyphosate-based products and NHL, which entails the lack of severe forms of restrictions or warnings from supranational health authorities.

Parallely, Bayer is performing a deep restructuring activity both on the financial side and on the business side (divesting some secondary segments and businesses such as Coppertone, Dr. Scholl's, the Animal Health business) which is improving the company configuration.

FINANCIAL AND RELATIVE ANALYSIS

The financial statements show a conglomerate substantially healthy and steady growing. Every business shows a positive contribution to the company result, with key growth drivers within each of them boosting the sales and sustaining the geographical expansions. The management has repeatedly proven to be precise and overall correct with its guidance, and the good forecasts for the incoming years seem reliable. Also, profitability is good, with all the segments of the company showing an EBITDA margin in the region of 21-34%.

The level of indebtedness has recently risen due to some important debt issuances made by the company in order to finance the acquisition of Monsanto, but its "flat" and well time-diversified wall of refinancing and the company's strong cash



generation ability calm down any arising concern on debt sustainability.

The following ratios summarize the company's situation with respect to its peers:

	EV/Revenue	EV/EBITDA	Price/EPS	Price/CF per share	Price/BV per share	Price/Revenue	Dividend per share yield
Bayer AG	2.32	8.33	9.92	6.28	1.44	1.48	4.1%
Merk KGaA	1.32	4.92	17.85	14.98	2.56	0.83	1.3%
Sandoz SA	3.30	10.58	13.25	12.52	1.71	2.77	4.0%
Roche Holding AG	4.18	10.49	14.47	11.85	6.00	4.01	3.2%
Novo Nordisk A/S	5.36	11.36	20.03	19.19	14.13	5.50	2.4%
BASF SE	1.31	9.02	15.70	8.54	1.64	1.03	4.6%
AstraZeneca PLC	5.23	16.93	22.52	18.63	8.53	4.67	3.0%
GlaxoSmithKline PLC	3.42	10.74	14.41	11.89	14.44	2.44	4.6%
Peer mean	3.45	10.58	16.89	13.94	7.00	3.03	3.3%

The particularly depressed price of the stock with respect to its fundamental values leads, as we could expect, to a substantial undervaluation of the company according to the most classical relative valuation metrics.

CONCLUSION

Our assessment of Bayer AG highlights a situation in which the market seems to have overreacted and overpriced the liability associated with the Monsanto litigation, leading to a severe depression of the stock price. Parallely, the businesses of the company seem to be stable and with valuable growth drivers, hence able to ensure low volatility in the financials for the incoming years. Also, the dividend paid by the stock should not be disregarded: Bayer currently pays a dividend yield of about 4.2%.

Therefore, we have decided to open a position on this stock and to allocate on it the 0.5% of our Discretionary Portfolio. Furthermore, the purchase has been split in two tranches in order to minimize the risk arising from unfavorable news in the quarterly report (released on October 30th):

- 0.3% invested on October 28th at EUR66.3749 (#4,520 shares, EUR300,014.55)
- 0.2% invested on October 30th at EUR67.1505 (#2,979 shares, EUR200,041.34)

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