

Equities

25 March 2011 | 9 pages

Eastern Japan earthquake/pharmaceutical sector

Alert: How to overcome the disaster, power outages?

- **Direct damages and planned power outages** — Two weeks have elapsed since the eastern Japan earthquake and companies are reporting on damages they have suffered. We believe damages sufficient to impact on production have occurred at Shionogi (Kanegasaki, Iwate), Daiichi Sankyo (Onahama, Fukushima), and Astellas Pharma (Takahagi, Ibaraki). In addition, it looks as though the impact on production at all plants in the TEPCO service area from rolling blackouts has been greater than anticipated. Terumo has already revised down, reflecting the impact of the power outages. We think companies that have been hit by either direct damage or the outages are likely to announce extraordinary losses for FY3/11 or weak sales forecasts for FY3/12. Investors should keep in mind possible near-term impact.
- **Just temporary?** — While recovery from the direct damage is the highest priority, firms seem to be wringing their hands most about reduced productivity due to the rolling blackouts. We also cannot rule out the possibility that restrictions will be imposed on business activities in the vicinity of the Fukushima nuclear plant. Although there are normally several months' supply of pharmaceuticals in inventory, if production is idled at the plants in question for a prolonged period supply shortages will occur. The focus is on whether alternative facilities can be found. If they cannot be found internally, firms may turn to outsourcers. If that also proves to be impossible, market share may shift to generics or similar products offered by other companies.
- **Who has been unaffected?** — We believe there has been no impact on the production front at Takeda Pharmaceutical, Dainippon Sumitomo, and Santen Pharmaceutical, so they face little risk of downward revisions. The market however may be underestimating the damage and the impact on earnings from rolling blackouts. So in the two months until May, when FY3/12 earnings are being priced in, we think companies where there is little risk of downward revisions due to the disaster could benefit. We feel that with disaster-afflicted companies, assessing the impact is the prudent first step.

Takeda Pharmaceutical (4502.T; ¥3,905; 2M), Dainippon Sumitomo Pharma (4506.T; ¥699; 1M), Santen Pharmaceutical (4536.OS; ¥3,090; 1M)

- Industry Overview
- The Japan Earthquake

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Takeda Pharmaceutical

Valuation

We use a DCF model with earnings forecasts for seven years to derive our target prices for the companies in our coverage. For all companies, we assume a 3% risk-free rate, a 5% equity-risk premium, and a terminal growth rate of zero after seven years. We use betas derived by our Data Service Group for each company; the average beta for our universe is around 0.7. We calculate a WACC based on the tax rates used in our forecasts for each company. For Takeda, we assume a beta of 0.9 and a WACC of 7.49% (based on a tax rate of 38%).

Our target price of ¥4,300 equates to a PER of 13x our FY3/11 EPS forecast. This is below the sector average of 17x, although the PER increases to 16x, in line with the average, if projected per-share surplus funds of ¥1,120 are included.

Risks

We see the following potential risks to our target price: 1) investors' valuation assumptions differing from ours; 2) unexpected developments concerning drug candidates. If these factors manifest themselves differently than we have anticipated, the share price may vary from our target price.

We rate the shares Medium Risk (M) based on their three-year historical volatility, which places them in the sixth through ninth deciles in terms of share price risk compared with our coverage universe.

Dainippon Sumitomo Pharma

Valuation

We reference theoretical share prices derived from a seven-year DCF model in setting target prices for the pharmaceutical companies in our coverage. Our assumptions for all of our coverage are a risk-free rate of 3%, an equity premium of 5%, and a terminal growth rate after seven years of 0%. We use the betas calculated by our data services team, with the average for our coverage at about 0.7. We also forecast tax rates for each company and calculate WACC (average capital cost after taxes). For Dainippon Sumitomo, we estimate WACC at 5.16% based on a beta of 0.8 and a tax rate of 35%.

Our target price of ¥1,100 corresponds to a FY3/11E PER of 38x, just over 2x the sector average of 17x, and a FY3/15E PER of 24x, just under 2x the sector average of 13x.

Risks

We believe risks to the shares deviating from our target price include the following: 1) investors may apply different assumptions in their valuation models from those we have and 2) US sales of schizophrenia treatment Latuda, which has been approved, could fall far short of our expectations. If these factors manifest themselves differently than we have anticipated, the share price could diverge from our target price.

We rate the shares Medium Risk (M) based on their three-year historical volatility, which places them in the sixth through ninth deciles in terms of share price risk compared with our coverage universe.

Santen Pharmaceutical

Valuation

We use a DCF model with earnings forecasts for seven years to derive our target prices for the companies in our coverage. For all companies, we assume a 3% risk-free rate, a 5% equity-risk premium, and a terminal growth rate of zero after seven years. We use betas derived by our Data Services Group for each company; the average beta for our universe is around 0.7. We calculate a WACC based on the tax rates used in our forecasts for each company. For Santen, we assume a beta of 0.7 and a WACC of 6.49% (based on a tax rate of 37%) in our DCF model.

Our target price of ¥4,100 is equivalent to about 21x our FY3/11 EPS forecast, above the sector-average PER of 17x.

Risks

Target price risks include the following: 1) the application of assumptions by investors that differ from those we use in our valuation model; 2) the extent of profit contributions from business development in China and northern Europe; and 3) the success or failure of drug candidates. If these factors manifest themselves in a way other than that we have anticipated, the share price may diverge from our target price.

We rate the shares Medium Risk (M) based on their three-year historical volatility, which places them in the sixth through ninth deciles in terms of share price risk compared with our coverage universe.

Appendix A-1

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Takeda Pharmaceutical (4502)

Ratings and Target Price History Fundamental Research

Analyst: Hidemaru Yamaguchi

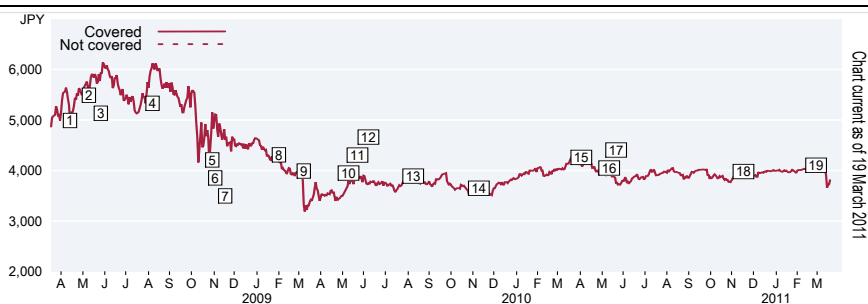


Chart current as of 19 March 2011

	Date	Rating	Target Price	Closing Price
1	14-Apr-08	1M	*6,500	4,990
2	9-May-08	1M	*6,800	5,490
3	27-May-08	1M	*7,300	5,930
4	7-Aug-08	1M	*7,100	6,120
5	30-Oct-08	1M	*6,500	5,150
6	4-Nov-08	1M	*5,900	5,110
7	18-Nov-08	1M	*5,600	4,610

* Indicates change

	Date	Rating	Target Price	Closing Price
8	1-Feb-09	1M	*6,000	4,250
9	8-Mar-09	1M	*5,300	3,820
10	11-May-09	*2M	*4,000	3,800
11	22-May-09	2M	*4,100	3,860
12	8-Jun-09	2M	*3,900	3,750
13	10-Aug-09	*3M	*3,500	3,890
14	10-Nov-09	3M	*3,300	3,580

	Date	Rating	Target Price	Closing Price
15	2-Apr-10	3M	*3,700	4,110
16	12-May-10	3M	*3,600	3,990
17	21-May-10	*2M	*4,000	3,740
18	17-Nov-10	2M	*4,200	3,870
19	28-Feb-11	2M	*4,300	4,065

Rating/target price changes above reflect Eastern Standard Time

Takeda Pharmaceutical (4502)

Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Hidemaru Yamaguchi

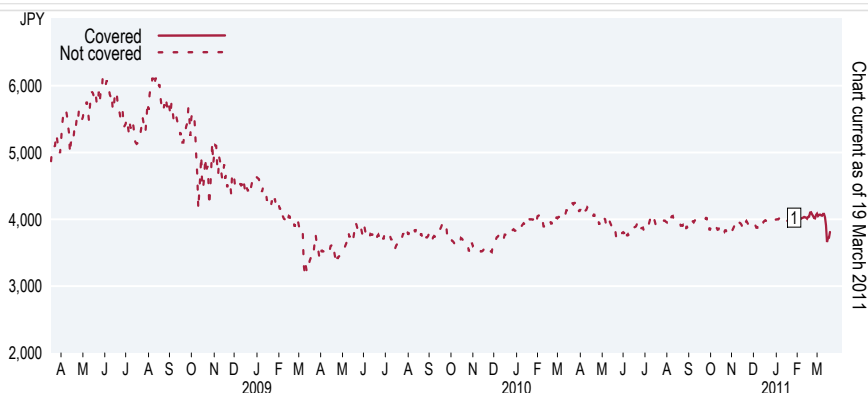


Chart current as of 19 March 2011

	Date	Rating	Target Price	Closing Price
1	27-Jan-11	*ADD LP	-	3,990

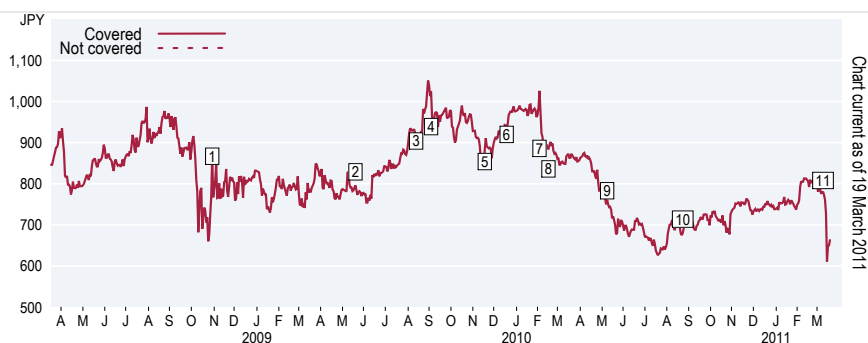
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Dainippon Sumitomo Pharma (4506)

Ratings and Target Price History Fundamental Research

Analyst: Hidemaru Yamaguchi



	Date	Rating	Target Price	Closing Price
1	30-Oct-08	*2M	*800	867
2	20-May-09	2M	*820	796
3	13-Aug-09	*3M	*840	921
4	3-Sep-09	3M	*800	1,025

* Indicates change

	Date	Rating	Target Price	Closing Price
5	18-Nov-09	*2M	*890	883
6	18-Dec-09	2M	*1,000	938
7	3-Feb-10	*3M	*900	1,026
8	16-Feb-10	*2M	900	885

	Date	Rating	Target Price	Closing Price
9	10-May-10	2M	*800	761
10	24-Aug-10	*1M	*1,000	680
11	9-Mar-11	1M	*1,100	781

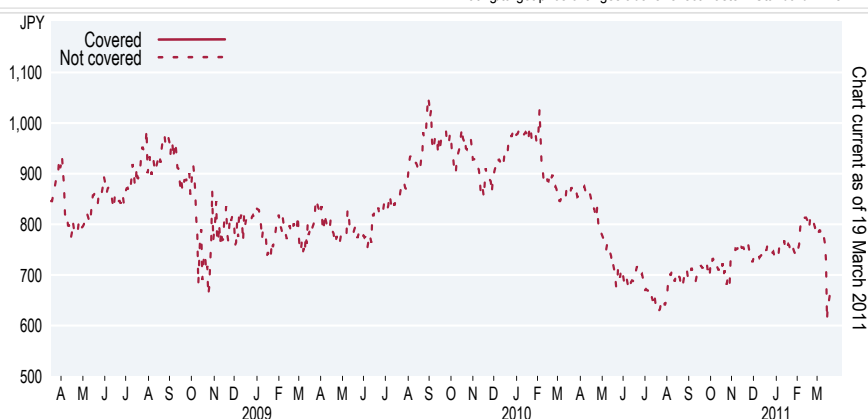
Rating/target price changes above reflect Eastern Standard Time

Dainippon Sumitomo Pharma (4506)

Ratings and Target Price History

Best Ideas Research Relative Call (3 Month)

Analyst: Hidemaru Yamaguchi



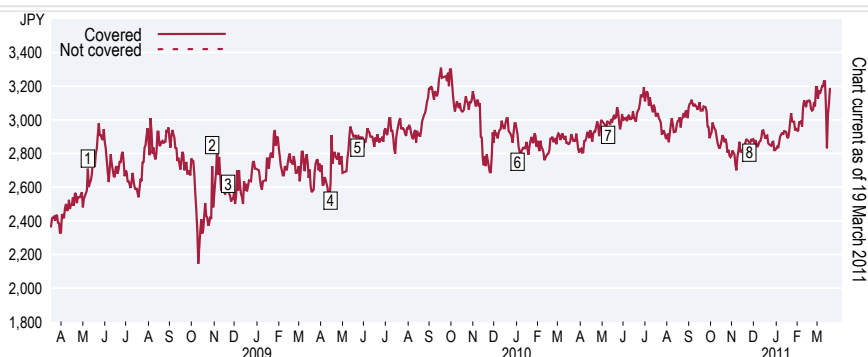
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Santen Pharmaceutical (4536)

Ratings and Target Price History Fundamental Research

Analyst: Hidemaru Yamaguchi



	Date	Rating	Target Price	Closing Price
1	8-May-08	1M	*3,400	2,710
2	30-Oct-08	1M	*3,300	2,725
3	21-Nov-08	1M	*3,400	2,575

* Indicates change

	Date	Rating	Target Price	Closing Price
4	15-Apr-09	1M	*3,500	2,620
5	22-May-09	1M	*3,800	2,900
6	4-Jan-10	1M	*3,500	2,912

	Date	Rating	Target Price	Closing Price
7	11-May-10	1M	*4,000	2,985
8	25-Nov-10	1M	*4,100	2,865

Rating/target price changes above reflect Eastern Standard Time

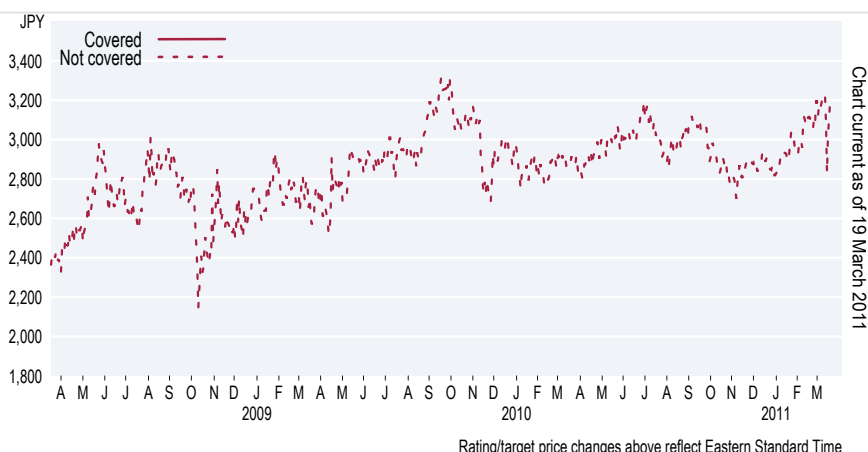
Santen Pharmaceutical (4536)

Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Hidemaru Yamaguchi



* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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12 Month Rating			Relative Rating		
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45%	44%	40%	0%	44%	0%

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