Short Cambrex Corporation
NYSE:CBM

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Introduction

Investment Thesis

1. Cambrex is a smaller player in the highly competitive, fragmented, and commodity-like world of small molecule Active Pharmaceutical Ingredient (API) contract manufacturing.

2. More than a third of its revenue, and likely more than half of its operating earnings come from Gilead’s declining HCV franchise.

3. The hard catalyst of the loss of Gilead’s high margin business (which management already acknowledges) should lead to sales declines, lower capacity utilization, and operating deleverage, and substantial margin compression.

4. In addition to reduced earnings, its multiple should compress away from its peers.

Snapshot

**Capitalization**

- Share Price: $55.05
- Market Cap: 1,891
- Net Debt: (183)
- Enterprise Value: 1,708

**Financials**

- 2018E Revenue: 536
- 2018E Sales Growth: 0.1%
- 2018E EBITDA: 157
- 2018E FCF Yield: 3.1%

**Valuation**

- P/2018E E: 19.0x
- P/2019E E: 17.8x
- EV/2018E EBITDA: 10.4x
- EV/2019E EBITDA: 10.0x

*Figures in millions*

Source: FactSet
Company Overview

- Founded in December 1981 and based in East Rutherford, NJ
- Pure-Play Small Molecule API Contract Manufacturer Organization (CMO)
- An API is the ingredient in the pill that does the beneficial work
- Niche focus on drugs with <$5 million in sales—the Gilead business excepted
- Major producer of APIs for Gilead’s hepatitis C virus (HCV) franchise
- Gilead makes up 35.1% of Cambrex’s revenue

Cambrex’s Charles City, IA Plant
Contract Manufacturing is a Bad Business

- “Contract manufacturing is a difficult, competitive, low-margin business.” – Industry Week (2013)

- “Regardless of efforts to consolidate the sector, the landscape of the CMO industry remains fragmented. The major players in the sector only command a 2-4% market share each.” – Results Healthcare (2017)

- Cambrex commands just under 2% of the market

Source: Cambrex Presentation
Small Molecule: A True Commodity Business

<table>
<thead>
<tr>
<th></th>
<th>Small Molecule</th>
<th>Large Molecule/Biologic</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Size</strong></td>
<td>- Small (single molecule)</td>
<td>- Large (mixture of related molecules)</td>
</tr>
<tr>
<td></td>
<td>- Low molecular weight</td>
<td>High molecular weight</td>
</tr>
<tr>
<td><strong>Structure</strong></td>
<td>Simple, well defined, independent of manufacturing process</td>
<td>Complex (heterogeneous), defined by the exact manufacturing process</td>
</tr>
<tr>
<td><strong>Manufacturing</strong></td>
<td>- Produced by chemical synthesis</td>
<td>- Produced in living cell culture</td>
</tr>
<tr>
<td></td>
<td>- Predictable chemical process</td>
<td>- Difficult to control from starting material to final</td>
</tr>
<tr>
<td></td>
<td>- Identical copy can be made</td>
<td>- Impossible to ensure identical copy</td>
</tr>
<tr>
<td><strong>FDA Approval Process</strong></td>
<td>None beyond initial drug approval</td>
<td>New, lengthy process with each new manufacturer</td>
</tr>
</tbody>
</table>

- Because small molecule manufacturing involves a simple, predictable chemical process that identically replicates the molecule in question, no additional FDA approval is required.

- For these reasons, small molecule API manufacturing is a **commodity business**.

- Barriers to entry are very low, hence the fierce competition in the space.

- Sufficient capital is the only substantive requirement for new entrants in the industry.
Why Small Molecule Manufacturing is a Commodity-like Business

Easy to Make: Aspirin, a small molecule

Hard to Make: Insulin, a large biologic
The West is Losing Share to the East

- China and India have won share due to their fundamentally lower cost structure for manufacturing, labor, equipment, and materials combined with access to a large talent pool of chemical engineers and scientists.

- This uniquely disadvantages Cambrex which manufactures solely in the US and Europe.

Source: Dr. Reddy's informEx Presentation, Clarivate.com
How then has Cambrex been so successful thus far?

Cambrex in the Time of Gilead

- Gilead’s HCV franchise has “the fastest growth out of the gate of any pharmaceutical ever.” – Forbes

- Since getting Gilead’s HCV business, Cambrex’s EBITDA margins have nearly doubled from **18.3% in 2011** (pre-Gilead) to **32.7% in 2017**, which is about **1000 basis points higher** than their larger peers

- In addition to process knowledge, Gilead’s business has allowed Cambrex to experience high capacity utilization, allowing them to leverage fixed costs (production facilities and equipment) more effectively

Top Drug Launches in History

One of Gilead’s HCV drugs, manufactured by Cambrex

Source: Forbes
What Gilead Giveth, Gilead can Taketh Away

Cambrex’s 2017 Financials

Revenue

- Gilead made up more than a third (35.1%) of Cambrex’s 2017 Revenue
- Assuming an ex-Gilead operating margin of 21.0% (which is better than its pre-Gilead margins of 18.3%), its Gilead operating margin is 54.4%
- This implies that Gilead made up more than half (58.4% using conservative estimates, though it is likely higher) of Cambrex’s 2017 operating profits

EBITDA

Source: Cambrex SEC Filings
Gilead’s HCV Franchise is in Freefall

Gilead’s HCV Sales in 2018 are expected to drop **41.4% year-over-year**, with a **72.0% drop from its peak** in 2015.
With its simple 12-week pill regimens, Gilead’s products cure people of HCV, with Epclusa curing all 6 major strains.

- Patient starts have dropped 36.3% since the 2015 peak.
- With every cure, Gilead’s total addressable market shrinks.
While companies like Merck, Roche, and Bristol-Myers Squibb have HCV drugs, the most prominent competition is AbbVie’s new drug Mavyret.

- **Mavyret** cures all 6 types of HCV at ~1/3 or less the cost of Gilead’s products.

- As of **September 2017**, Mavyret had already “grabbed 7% of total new subscriptions” in the HCV space.
Cambrex hasn’t Felt Gilead’s Pain—Yet

Cambrex’s Gilead Sales have leveled off, but they’ve still grown, even as Gilead’s HCV Sales have declined. How is this?

Source: Cambrex SEC Filings
Gilead has several HCV API suppliers, which is a common practice implemented to mitigate production risk. It has cut production at secondary manufacturers but left primary manufacturers like Cambrex untouched—so far.

In this example, unit production drops 20% year-over-year

While all of the other suppliers have experienced unit reductions, Cambrex’s unit volumes remain unchanged

To maintain several suppliers, future supply reductions will have to occur across the board

Cambrex will be next on the chopping block
Steven M. Klosk, Cambrex Corporation CEO

Gilead HCV API Agreement

“We have a firm commitment for significantly reduced volumes of this product for 2018, which is in line with our expectations. We have a 5-year supply agreement ending in December 2020 that now includes a defined minimum volume for 2019, which represents a further significant decline compared to the volumes we expect to ship in 2018. There is no minimum volume stipulated in the agreement for 2020.” – Q4 2017 Earnings Call

Source: Cambrex Q4 2017 Earnings Call
Oh, and Then There’s That Whole Take-Or-Pay Thing

**Take-Or-Pay Payments**

- It is what it sounds like

- In contracts with these provisions, a company must either take the product from its supplier or pay a penalty to the supplier

- In general, take-or-pay payments pale in comparison to the revenue that would have been generated by actually selling the product

**Cambrex’s Take-Or-Pay**

- Cambrex booked a $6.2 million take-or-pay payment in Q4 of 2017, which is the first time since 2003 that “take-or-pay” has been mentioned in their filings

- Why it’s likely Gilead: Since the majority of APIs Cambrex produces are for drugs with annual market sales less than $5 million, Gilead’s HCV franchise is the only one with large enough sales to justify a payment this size
“Is there no balm in Gilead, no healer there?” – Jeremiah 8:22

The precipitous decline of Cambrex’s high-margin Gilead business will be a large blow to its topline, will lead to heavy operating margin compression due, at least in part, to operating deleverage caused by lower capacity utilization rates, and will also lead to multiple compression away from its peers.
Nobody Knows the Troubles Cambrex has

- No bulge bracket coverage, in spite of being a member of the S&P 600 and Russell 2000 indices, among several others
- Cambrex is net cash, and so is not active in debt markets
- This is why Cambrex only has 10.3% short interest, despite having a nearly $2 billion market capitalization and a clear short catalyst

Cambrex’s Sell-Side Coverage

[Lists of sell-side coverage firms]
Sell-Side Expectations are Wildly Inflated

Keanu Reeves, Actor and Philosopher

- Assuming ex-Gilead EBITDA margin = 21% (higher than pre-Gilead business but in line with larger peers), Gilead Sales = (20%), and Gilead EBITDA margin = 50%, ex-Gilead Sales must grow 10.8% to hit the midpoint of guidance

- 10.8% is 330 bps higher than its 2014-2017 ex-Gilead Sales CAGR

- It’s also 380 bps higher than the 2017-2027 forecasted market size CAGR of 7%

- On top of this, as Cambrex’s Gilead Sales disappear, the street is growing EBITDA in 2019 ($164 million) and 2020 ($170 million)

Source: FactSet, Future Market Insights
More Realistic (But Still Very Conservative) Estimates

<table>
<thead>
<tr>
<th>Assumptions</th>
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<tbody>
<tr>
<td>Ex-Gilead EBITDA Margin</td>
<td>19.0%</td>
</tr>
<tr>
<td>Gilead EBITDA Margin</td>
<td>46.2%</td>
</tr>
<tr>
<td>Ex-Gilead Sales Growth</td>
<td>10.8%</td>
</tr>
<tr>
<td>EBITDA Relative to Estimates</td>
<td>(9.8%)</td>
</tr>
</tbody>
</table>

- Using an ex-Gilead EBITDA margin of 19.0% (where it was pre-Gilead), a Gilead EBITDA margin of 46.2% (where it was in 2015 at a similar level of Gilead Sales), and ex-Gilead Sales growth of 10.8% (this is the company’s guidance), operating earnings should be ~10% below sell-side estimates.

- This estimate gives the company credit for ex-Gilead Sales growth, and still assumes high margins.

Source: Cambrex SEC Filings, FactSet
Management has been/is Selling Cambrex Stock

- The only 2 purchases were by board members in 2014 (accompanied by a sale of the same number of shares at the same price) and 2016 (valued at the time at $30,075)

- Since the start of 2016, COO Shawn Cavanagh has sold $4.5 million in Cambrex stock

- Over the same period, former CFO Gregory Sargen (though still part of Cambrex’s C-Suite) has sold $4.4 million in Cambrex stock
What About The CEO?

The Current Value of Cambrex CEO Steven Klosk’s Cambrex Holdings

$4.57 million
What About The CEO?

The Value of Cambrex CEO Steven Klosk’s Cambrex Stock Sales Since the Beginning of 2016

$11.98 million
Cambrex Is Exceedingly Overvalued

<table>
<thead>
<tr>
<th></th>
<th>2018E</th>
<th>2019E</th>
<th>2020E</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gilead Sales</td>
<td>150,228</td>
<td>120,182</td>
<td>84,128</td>
</tr>
<tr>
<td>Gilead Sales Growth %</td>
<td>(20.0%)</td>
<td>(20.0%)</td>
<td>(30.0%)</td>
</tr>
<tr>
<td>Ex-Gilead Sales</td>
<td>374,072</td>
<td>393,632</td>
<td>419,410</td>
</tr>
<tr>
<td>Ex-Gilead Sales Growth %</td>
<td>7.7%</td>
<td>5.2%</td>
<td>6.5%</td>
</tr>
<tr>
<td>Total Sales</td>
<td>524,300</td>
<td>513,814</td>
<td>503,538</td>
</tr>
<tr>
<td>Total Sales Growth %</td>
<td>(2.0%)</td>
<td>(2.0%)</td>
<td>(2.0%)</td>
</tr>
<tr>
<td>EBITDA</td>
<td>140,479</td>
<td>130,314</td>
<td>118,555</td>
</tr>
<tr>
<td>EBITDA Margin %</td>
<td>26.8%</td>
<td>25.4%</td>
<td>23.5%</td>
</tr>
<tr>
<td>EBIT</td>
<td>115,208</td>
<td>105,548</td>
<td>94,284</td>
</tr>
<tr>
<td>EBIT Margin %</td>
<td>22.0%</td>
<td>20.5%</td>
<td>18.7%</td>
</tr>
<tr>
<td>Net Income</td>
<td>87,558</td>
<td>80,217</td>
<td>71,656</td>
</tr>
<tr>
<td>Net Income Margin %</td>
<td>16.7%</td>
<td>15.6%</td>
<td>14.2%</td>
</tr>
<tr>
<td>Assumed P/E Multiple</td>
<td>15.0x</td>
<td>15.0x</td>
<td>15.0x</td>
</tr>
<tr>
<td>Implied Stock Price</td>
<td>$37.93</td>
<td>$34.41</td>
<td>$30.43</td>
</tr>
<tr>
<td>Implied Return of Short Position</td>
<td>31.1%</td>
<td>37.5%</td>
<td>44.7%</td>
</tr>
</tbody>
</table>

Model Assumptions

- Cambrex trades in line with peers at 19.0x Forward P/E, but as topline and margins decline, the model applies a 15.0x multiple
- Assumes topline within management’s guidance, and grows ex-Gilead sales at slightly above the market rate in year 1
- Implies 12-month short return of 31.1%
1. **Cambrex Replaces Gilead HCV Franchise with a Similarly Remarkable Product:** Given that Gilead’s HCV franchise is the most successful drug launch ever, the likelihood Cambrex lands another golden goose like this is low.

2. **Gilead’s Decline Allows Cambrex to Focus on Other Opportunities:** While likely true given that it won’t have to cater to Gilead anymore, Cambrex’s replacements will take time to fill Gilead’s void, and will likely do it with much lower margin business.

3. **Cambrex is Acquired for a Hefty Premium:** Given that it is trading at a market multiple on peak margins and earnings, the prospect of an acquirer doesn’t make sense.