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GRIFOLS CLASS B (GRF.P) - PHARMA / BIOTECH - 02/09/2020

EXECUTIVE SUMMARY

Grifols (GRF-P) offers an attractive investment opportunity with an appreciation potential of over 75%. GRF-P presents all the qualities that we like to find in a company: 1) Scalable business - growth potential in all its plasma proteins, 2) secular long-term growth trend - population aging, 3) attractive sector structure - oligopoly of four companies that control more than 80% of the market and 4) the lowest possible price - 16.5x our profit estimate to 2022e.

COMPANY DESCRIPTION.

Grifols (GRF) is a company that collects plasma proteins that manufactures and sells plasma-derived products globally.

Blood plasma represents 55% of human blood and is used to create therapies for the treatment of chronic and complicated diseases. Donating blood plasma takes between one hour and three hours and can be done twice a week. White blood, on the other hand, does not take more than 30 minutes, although it can only do once every eight weeks. Plasma used in the United States must come from American donors, creating a regulatory barrier to entry.

Plasma donation centers in the United States are an oligopoly made up of a few companies (including GRF) that control more than 80% of the market. Plasma business has grown at a compound annual rate (CAGR) of + 9% over the last eight years and expects to grow at a rate of +5%. In 2019, there were 805 plasma donation centers, of which GRF operated 300; therefore, it **has a market share of over 37%.**

WHY DO WE LIKE GRIFOLS?

In 2011, GRF made a crucial move with the acquisition of Talecris for \$3.7tn, and today together with Takeda and CSL, they control two-thirds of the global plasma market with similar Percentages.

GRF is the world leader in the immunoglobulin segment, treatment of primary immunodeficiencies, and rare neurological diseases. Also present in Albuminia, Factor VIII, and Alpha-1.

In the biotechnology sector and within the most consolidated group of companies where GRF found, competitive advantages are in the form of intangible assets and cost advantages. The collection and fractionation of plasma is a complex process, and as such, requires a high initial investment that acts as a barrier to entry to the competition. Investment in R&D is less than in traditional pharmaceutical companies, as these are rare diseases where there is little competition. Low competition is a critical factor in having pricing power and not having to invest heavily in commercial equipment. The regulation also acts as a barrier to entry, as increasing installed capacity requires regulatory approval and can take between five and seven years.

GRF is also a global leader in the US blood and plasma analysis business (Diagnostics division), primarily thanks to the acquisition of the VAT Technology platform in 2017.

WHY HAS THE GRIFOLS PRICE DROPPED?

Since the annual highs in February, the GRF stock price (class A) has fallen by -27%, and class B has fallen by -33%, extending the discount between the two.

There are mainly three reasons to justify the drop in price:

1) Plasma collection: Covid-19 and CARES ACT benefits to US taxpayers, has negatively affected the supply of plasma and blood in the US as a result of the mandatory quarantine of the population. Lower utilization rates of the plants have caused a drop in plasma volumes during the first half of the year of -10% and the operating margin to 16%. GRF management expects to be able to offset the effect during the second half. A high US unemployment rate and the finalization of CARES ACT benefits will cause the utilization rate to grow in all donation centers during the second half of the year, as told us last July Jim McCroy, PaySign's director of corporate strategy. It is important to remember that each donor receives 46USD per donation and can make two donations a week; therefore, you can earn about 350 USD per month. Finally, on July 20, GRF announced the purchase of a plasma fractionation plant in Montreal (Canada), which includes eleven plasma collection centers in the US. **With this operation, GRF will become the only large-scale commercial producer of plasma drugs in Canada**, with the capacity to fractionate 1.5 million liters of plasma per year.

2) Price pressure due to greater competition in Bioscience: There is some competition from companies like Argenx, Momenta, and Alexion in immunoglobulin. These are rare diseases in niche markets, so GRF's cost advantage acts as a barrier to entry. We believe that strong demand for immunoglobulin and the lack of substitute products, guarantee GRF's future growth and profitability. The price environment is stable, and orders from countries like the US, Canada, and some parts of Europe continue to perform well.

3) Debt on the rise: In the last six years, GRF has made two significant acquisitions, Novartis' plasma and diagnostics division for USD 1.7bn in 2014 and the purchase of its NAT technology division for transfusion diagnostics and implants from Hologic in 2017.

The significant investment effort and the emergence of Covid-19 have caused the Net Debt to Ebitda ratio to come dangerously close to the level of the covenant (5x). A high debt worries Many investors, but GRF demonstrated that it can deleverage its balance sheet in less than two years with organic free cash flow. **In November of last year, GRF refinanced its debt, take out the covenant, and ensured that it would not have any relevant maturity or amortization of debt until 2025.** At the end of the first half of this year, the total debt level is EUR 5,501 million. However, the following should be added items: 1) Amount of operating leases as a result of the accounting change of IAS 16 (750M EUR), 2) GC Pharma bought for \$460M and 3) the increase of revolving credit by \$500m to \$1.000m with maturity to 2025.

On July 28, GRF announced that it had delivered its first batches of hyperimmune anti-SARS-CoV-2 immunoglobulin for use in clinical trials. This drug specifically developed to treat SARS-CoV-2 infection provides passive immunization to patients, strengthening the immune system and could be used for both prevention and treatment of the disease. Last Sunday, Trump announced at a press conference the emergency authorization of the use of plasma with antibodies from patients with coronavirus Covid-19 as a treatment against the virus. It could increase its income from a more significant sale of hyperimmune immunoglobulin drugs.

Finally, we believe that Ambar may have a material impact on GRF's future turnover. After the completion of phase II and III, the results achieved have yet to present, so ASFA should include at some point. Ambar is crucial because it substantially increases TAM for GRF since Alzheimer's is a vast market opportunity versus the niche markets where GRF usually operates. There is no patent,

and the rest of GRF's competitors can also have access to this production process to treat Alzheimer's.

VALUATION

We detail our fundamental valuation based on our baseline scenario and, more importantly, our worst-case scenario.

1) Base scenario: Sales growth will be supported by strategic investments and efforts made in recent years, which are allowing greater availability of plasma and responding to the robust demand for the main plasma proteins. Demand for immunoglobulin continues to be strong across geographies (especially the US and Canada), and GRF continues to develop new formulations and indications such as Xembify subcutaneous immunoglobulin. In Albumin, China leads the sale of plasma protein and represents a significant future growth potential. **For Biociencia, we expect sales growth of + 8% by 2020 and a CAGR of 5.5% by 2022 as a result of more significant pressure on prices.**

In the diagnostic segment, we expect sales to be stable this year due to lower plasma donations (Covid-19) but to recover and increase in the future thanks to the entry of new products.

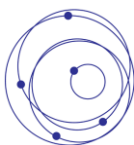
We expect the operating margin (Ebit) to fall to 18.5% this year and then recover to 22.5% in 2022.

Capex should reduce after the effort of the last years, and we estimate 5.5% of sales with +2% investment in growth.

At 22 times earnings and 17 times operating earnings, lower ratios than competitors such as CSL, we reached a target price of 25 EUR, more than 50% upside return.

2) Worst scenario: Reflects higher pressure on prices from the competition and non-recovery of plasma volumes during 2H20 as a result of Covid-19. Bioscience growth decreases to 1%-2%, and the diagnosis business remains flat until 2022 without recovery of margins. Investments must be maintained so as not to lose competitiveness. Still, the market would not be willing to pay the current multiple.

With a valuation multiple over profit and cash flow of 15x and Ebit of 12x, we reached a target price of 14,5 EUR, just 10% below the current price.



GRF/P:SM
Grifols SA

Soc.Bol SIBE

COMPANY INFO

13.92

EUR

-0.18 -1.28% ▼

1D

1M

6M

YTD

1Y

5Y

+ ADD TO WATCHLIST



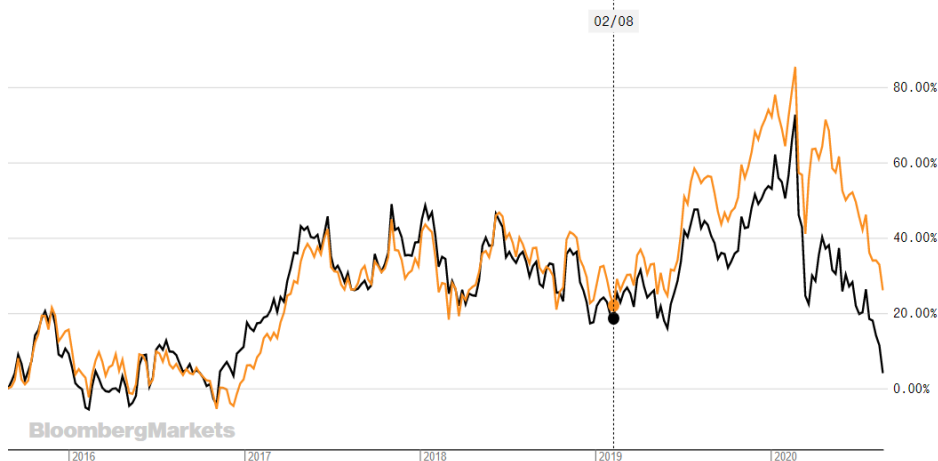
MARKET OPEN

AS OF 04:14 AM EDT 08/27/2020 EDT

grifols

● GRF/P:SM 18.58% ● GRF:SM 22.00%×

MINIMIZE CHART



Graph 1: Evolution of Class A and Class B Grifols prices - Source: Bloomberg

In short, we find GRF an attractive investment opportunity with exciting upside potential and an adequate margin of safety. GRF has all the qualities that we like to see in a company: 1) Scalable business model - Growth potential in all its plasma proteins, 2) long-term secular growth - population aging, 3) attractive sector structure - oligopoly of three companies that they control more than 80% of the market and 4) bought at the lowest possible price - potential upside of more than 50% with class B shares that trade at a substantial discount vs. history

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