Perrigo Paves the Way for Recovery with Margin Focus

Price $24.62 **Dividend Holding** **January 23, 2025**

- 4.6% Dividend Yield, 21 consecutive years of growth.
- Concluded quality assurance program in the infant formula segment, expects to ramp production and return to form by 2026.
- Entering cost saving program, through consolidation of the organization and headcount cuts expects to save $150 million by 2026.
- Creating new 'disruptive growth' team to identify new markets to enter.
- Refinanced debt on the balance sheet, with new maturities not starting until 2030. Expects meaningful deleveraging below 3.0x net debt to EBITDA by 2026.
- Entering into voluntary non-renewals of contracts that are margin dilutive.

Investment Thesis

Perrigo (PRGO) is a pure player in the OTC consumer healthcare market. Since our last coverage on PRGO, it has continued to slim down the business, focusing on expanding the bottom line through contract non-renewals and headcount cuts. Additionally, PRGO has new management, a new CEO as of July 2023 with experience from Bayer and Procter & Gamble.

PRGO has experienced headwinds from a weaker 2023-2024 cold-and-flu season and continued pressure from ramping production in the infant formula segment following a change of FDA rules. However, the infant formula headwinds are rolling off quickly, and we expect a full return to form by 2026. On the growth side, PRGO has created a 'disruptive growth' team to explore entry into new markets, and the Women's health area continues to show strong growth.

In our view, the short-term business pressures are more than priced into the stock and effectively discount its strong 4.6% dividend yield and long-standing retail relationships. PRGO is at a turning point, and thus we believe it is a good pick for dividend investors looking for the possibility of capital appreciation.

Estimated Fair Value

EFV (Estimated Fair Value) = EFY26 EPS (Earnings Per Share) times P/E (Price/EPS)

EFV = E26 EPS X P/E = $3.15 X 15.3 = $48.28

A P/E of 15.3x would return PRGO to its pre-2023 ratio, as well as price in potential growth from focusing on women's health and entering new segments. Our earnings estimate of $3.15 are above the average of $3.05 due to our confidence in new management and the focus on expanding margins.

	E2025	E2026	E2027
Price-to-Sales	0.8	0.7	0.7
Price-to-Earnings	7.9	7.1	6.7

Analyst consensus data from SeekingAlpha

Existing Operations

Across North America and Europe, PRGO manufactures OTC (over the counter) brands for a wide variety of uses such as women's health, skincare, and cold-and-flu relief. Primarily (60% of revenue), PRGO manufactures generics in private-label format with a growing component of its revenue (40%) coming from own-brands.

Global Category	% of Revenue	Growth (year over year)
Infant Formula	9.4%	-30.4%
Upper Respiratory	17.8%	-11.4%
Digestive Health	12.0%	-2.4%
Pain and Sleep-Aids	12.7%	-10.4%
Healthy Lifestyle	12.3%	-0.6%
Oral Care	8.6%	-10.0%
Skin Care	15.2%	1.9%
Women's Health	5.0%	30.5%
Vitamins	4.3%	-6.0%
Others	2.6%	-5.3%

First 9 months of 2024, combined global revenues.

Total sales dropped 7.5% year over year. The decline in sales was due to voluntary contract non-renewals, continued headwinds in the infant formula segment, and the 2023-2024 flu season was weaker than the previous year.

Throughout the year, PRGO has executed several voluntary non-renewals of contracts which management stated were margin dilutive. PRGO expects an overall mid-single digit sales decline for the full year 2024 due to these margin improvement actions.

PRGO is the third largest manufacturer of infant formula in North America, with a branded market share of 19.8% and a private-label share of 16.1% for the 13 weeks ending October 6th, 2024. Part of the headwinds we covered in our last article was new FDA guidance on infant formula. During the final quarter of 2023, PRGO's Wisconsin plant was shut down for noncompliance with the new regulations which prompted a program to bolster QA across the segment. By the quarter ending September 2024 PRGO stated that all its facilities have been brought into compliance and reported it hit 85% stock across its largest customers. PRGO expects to reach this level across all customers by the end of 2024. With the acquisition of part of Nestle's and Gerber's infant formula business in 2022, we are confident that PRGO will be able to regain its 2019 market share level to the 35.0% branded and 27.9% private-label area.

The highlight of current operations was the women's health category, which had 30.5% growth year over year for the 9 months ending September 2024. According to PRGO, this was driven by Opill. Opill was approved in July 2023, as the first OTC oral contraceptive available in the US. For women between 15-44 who use contraceptives, 24% reported that they use pills. Pills are most common among the youngest consumers, with 44% of 15-24 reporting oral contraceptive usage.

Divestitures and Expansion

PRGO continues to streamline the business, announcing the sale of HRA's rare disease business in July 2024, for approximately $200 million cash up front, and $85 million more provided milestones are met.

For the time being, it is unlikely in our view that PRGO will engage in acquisitions considering the debt load is high. During the quarter ending September 2024 earnings call, PRGO mentioned that some of the savings from its cost-cutting programs are going toward 'disruptive growth' categories. Additionally, it appointed former Bayer QA/Regulatory lead as chief scientific officer, moving the former chief scientific officer to head the disruptive growth team. While there is little information available on the new team, management stated that the team will focus on entering new markets while developing 'disruptive' products in existing ones.

An area that PRGO identified as a potential commercialization point is GLP-1 related side effect relief. According to JP Morgan more than 30 million Americans, about the same number as get the flu every year, could be on GLP-1 drugs like Ozempic by 2030. Around 50% of GLP-1 users experience side effects similar to the stomach flu. PRGO stated that its first marketing directly to GLP-1 users will begin in the final quarter of 2024, with a full rollout in 2025 depending on initial response.

Risk

While we are confident in management's ability to recover market share and grow the top line, the generic OTC market that represents around 60% of PRGO revenue lacks pricing power compared to name-brands. Additionally, there are low barriers for entry in the generic market which puts an effective ceiling on how much PRGO can charge private-label customers. However, the advantage to this is that it provides a relatively stable floor that remains through times of economic uncertainty as consumers substitute out higher-price name brands.

PRGO's debt remains a concern, with Fitch downgrading PRGO to BB in April 2024. The higher debt load is due to the $1.9 billion acquisition of HRA Pharma, reported to have a multiple of ~14x EBITDA at the time the transaction closed. While this is on the higher end of OTC product healthcare acquisitions, HRA has a history of prescription-to-OTC in the women's healthcare market, such as its ellaOne emergency contraceptive.

Financials

Geographically, the European business had revenues flat year over year, with skincare growth offsetting losses due to a weaker cold-and-flu season. In North America, revenues fell 12.1% year over year due to the weaker cold-and-flu season, mixed with continuing impacts from the infant nutrition business. For the 9 months ending September 2024, PRGO's gross margin was flat at 35.8%, with operating margin slipping into the negatives. Excluding unusual items like impairments and restructuring charges, operating margin expanded 50bps to 6.0%.

Excluding the impact of ramping the infant formula business, PRGO expects to end 2024 with a gross margin of 40%. The infant formula business required around $25 million in expenditures for QA actions during 2024, which have addressed all the FDA's issues. For 2025, we expect margins to continue to climb as PRGO re-gains sales capacity in infant formula and additional spend rolls off. As previously discussed, PRGO will be executing a program of voluntary non-renewals of contracts that are margin-dilutive and will remove production of some product variations that are also margin-dilutive.

Project Energize is a 3-year optimization program started in February 2024, with the end goal of $150 million in annual savings by 2026. The program started with 550 layoffs, around 6.1% of the workforce, and focuses on organizational consolidation. For the first 9 months of 2024, management stated the program has already saved $95 million and plans to reinvest $50 million of the final savings annually in the growth of the business.

Over the short-term it is possible that restructuring and impairment charges eat at the gains of the program, though as these roll off, we expect strong margin gains.

PRGO's debt load does remain a concern, expecting to end 2024 with a net debt to adjusted EBITDA (less restructuring and impairment) of 4.0x, tracking to 3.0x by the end of 2025. It has rolled over $1.1 billion in issuances to 2032, though the new interest rate is around 200bps higher. While the higher interest rate is worse on the bottom line, the rollover of issuances has increased the maturity to past 2030 which should alleviate short-term risk to the business.

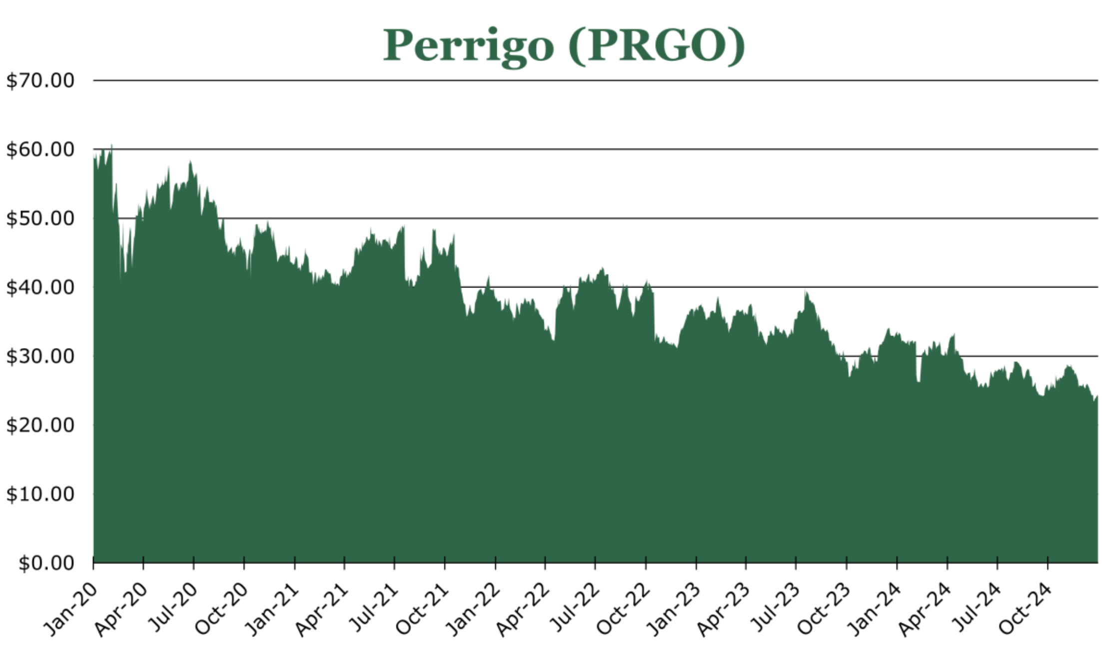
PRGO has 21 years of dividend growth, with a current yield of 4.6% or $1.1/share annually. Based on the post-dividend expected cash position of $525 million, we do not expect PRGO to have any trouble paying the dividend. However, we also do not expect more than token increases to the dividend over the short-term.

Conclusion

Despite alleviating headwinds and a strong dividend yield, PRGO has been hammered by the market, losing 27.43% over the trailing twelve months. As the infant formula business recovers and cold-and-flu season return to normal levels, we expect sales to return to low-single digit growth. With the addition of a 'disruptive growth' team to explore new markets for entry, it is possible that the long-term could see mid-single-digit growth. Over the short term we expect earnings to increase above revenue as PRGO enters several margin accretive programs. PRGO is a solid dividend stock that has a low valuation, with high prospects for recovery.

Peer Comparisons

	Perrigo (PRGO)	Organon (OGN)	Bausch Health (BHC)	Teva Pharmaceutical Industries (TEVA)	GSK (GSK)
Dividend Yield	4.59%	7.06%	-	-	4.66%
Price-to-Earnings	9.35	3.86	2.06	8.88	8.68
Price-to-Sales (TTM)	0.75	0.64	0.30	1.48	1.62
EV-to-EBITDA (FWD)	9.76	6.19	7.43	8.46	6.74
Net Income Margin	-3.63%	20.30%	-1.88%	-5.72%	8.02%
Price-to-Book (TTM)	0.72	8.29	NM	4.11	3.64



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