

**Summary:**

- Potential problems associated with deteriorating cash conversion cycle
  - Cash flow from operations likely to lag earnings as annual DSOs are up 15% and DOH are up 37%
  - Concerns about cash management systems and extended terms on receivables
  - Inventory turns less than twice a year
  - Potential premature revenue recognition
  - Weak operating cash flows may surprise investors as Taro does not provide quarterly cash flow information
- Gross margins inconsistent with peers
- Trades at a premium to peers yet underperforms on cash flows

## Taro Pharmaceuticals Industries (TARO)

**TARO:** \$59.43  
**Market Cap:** \$1.71B  
**52-Week High/Low:** 72.40 / 32.50  
**Shares Out:** 28.78 M  
**Float:** 25.30 M  
**% Float Short (3/8/04):** 4.05%  
**Revenue (LTM):** \$315.5 M  
**Net Income (LTM):** \$61.2 M  
**FYE:** December 31  
**Auditors:** Ernst & Young

**Company Description:** Taro Pharmaceutical Industries Ltd. is principally engaged in the production, research and development and marketing of pharmaceutical products. The Company is an Israeli corporation that operates in Israel and through Israeli, North American and European subsidiaries.

## Highlight

At Taro Pharmaceuticals (Taro), what you see may only be partially what you get. As a foreign-based company, Taro does not provide quarterly securities filings. Therefore, interim financial information from the Company is limited to consolidated income and balance sheet information provided in earnings press releases. Over 2003, the Company has posted impressive results, with year-over-year revenue and earnings growth of 49% and 37%, respectively. Reported cash balances were also up \$28 million over last year. Yet, our analysis of the Company's balance sheet indicates operating cash flows have not kept pace with earnings growth, as the Company has used a significant portion of its cash to fund extended receivable collections and inventory accumulation. As such, investors may be taken by surprise upon the filing of the Company's Form 20-F Annual Report, which is scheduled for release sometime in April. Over the longer term, the risks associated with poor cash management could impact liquidity and financing options. Also of note, the degree of gross margin improvement over recent quarters is puzzling, given the fact it is inconsistent with peers and is accompanied by significant growth in operating costs. Given TARO shares currently trade at a premium to comparable generic pharmaceutical companies, who appear to have much stronger operating cash flows than Taro, investors should be aware of the "sticker shock" risk associated with the Company's pending Form 20-F Annual Report and other longer-term risks noted in our report.

## Analysis

### *Deteriorating Cash Conversion Cycle*

The Company's inability to generate strong operating cash flows from this recent surge in sales growth and profitability indicates poor cash management capabilities, as depicted in the Company's deteriorating cash conversion cycle. The cash conversion cycle is an excellent measure in determining how effectively a company utilizes its liquid assets and working capital in managing its operations. The cash conversion cycle is defined as days sales outstanding (DSOs) plus days inventory on-hand (DOHs) less days payable outstanding (DPOs). This weakness in the Company's operations and cash flows may surprise investors, as the Company does not report quarterly cash flow information.

Table 1: Quarterly Cash Conversion Cycle – Taro vs. Peers

in days	2003					FYE 2003	Annual % Change	
	FYE 2002	1Q	2Q	3Q	4Q			
<b>TARO</b>								
Days Sales Outstanding (DSOs)	95	93	93	103	116	110	15.4%	
Days Inventory on Hand (DOHs)	164	172	207	223	262	226	37.7%	Significant year-end inventory build
Days Payable Outstanding (DPOs)	87	195	202	177	190	152	74.9%	
Cash Conversion Cycle	172	70	98	148	188	183	6.6%	
<b>Peer Group</b>								
Days Sales Outstanding (DSOs)	58	56	44	60	55	56	-3.1%	
Days Inventory on Hand (DOHs)	131	149	101	138	129	127	-2.9%	
Days Payable Outstanding (DPOs)	29	53	43	53	41	23	-20.8%	TARO better payable cycle - yet, considerably longer collection and inventory cycles
Cash Conversion Cycle	160	152	102	145	144	160	0.3%	

Source: Company Reports, GLC.

Note: Peers include ALO, BRL, MYL. Quarterly figures based on 91.5 day period. Taro A/P includes additional accrued expenses that may limit comparability.

Table 1 highlights the significant shift in Taro's cash conversion cycle in the later half of fiscal 2003. The significant build in receivables and inventories is a driving force behind this shift. Strong revenue growth explains a portion of the build in receivables, yet the Company's year-end 110 DSO significantly lags Taro's target collection period of 30 to 90 days.<sup>1</sup> For two quarters running, the Company has claimed DSO extension resulted from payment timing issues.<sup>2</sup> The fact DSOs remained above Company target collection ranges for every quarter in 2003 indicates a weakness in collection capabilities and / or changes in customer sales agreements and terms. Either change may pose greater risks concerning potential premature revenue recognition. The Company's allowance for doubtful accounts and product warranty accruals have historically been immaterial (doubtful accounts has been less than 1% of accounts receivable for last three fiscal years) and well below peer group averages (peer allowance for doubtful accounts has averaged approximately 2% of accounts receivable over last three fiscal years). The lack of provisioning by the Company in this area may result in forward earnings risk were the Company to face a collections or product quality issue. We note that, at fiscal year end 2003, Taro's gross accounts receivable equaled 38% of sales, well above the 20% levels of its peers at this same time period.<sup>3</sup>

DOH of 226 days at year-end 2003 is well above historic ranges and significantly lags peers. A portion of this inventory build may be explained by the launching of new products and bulk purchasing of active pharmaceutical ingredients (APIs) by the Company. However, the fact the Company is turning inventory less than twice a year poses risks regarding cash efficiency and inventory obsolescence. The Company's disclosures lack transparency as inventory obsolescence accruals are not provided. The devaluation of the dollar is likely to have some impact on inventory levels, yet this should not impact Taro's inventory any more than its peers as each of these companies has manufacturing facilities in foreign territories. As a positive, the Company has been able to extend its payables cycle over 2003, thereby providing some buffer against the significant growth in receivables and inventory. With DPOs at 152 days, or 6.5x better than its peers, further improvement is unlikely while relations with vendors may be negatively impacted if maintained at this level going forward.

<sup>1</sup> Form 20-F as of December, 2002, pg 37.

<sup>2</sup> Earnings conference call: 4Q 2003, CFO Kevin Connolly: "A significant payment made by one of our major customs was received in the first days of January, but obviously that skews our DSOs as of year-end." 3Q, 2003, CFO Connolly, "...one of our major customers paid us a few days into the fourth quarter, skewing the DSOs lightly as of September 30<sup>th</sup>."

<sup>3</sup> Taro states it obtains "credit insurance" to protect it against customer default (20-F, 2002, Note 2, F-17), yet no further details concerning the cost of such insurance or the level of coverage is provided.

Table 2: Taro Annual Cash Conversion Cycle

(\$ millions)	2001	2002	2003
Total cash, cash equivalents and short-term investments	153.1	134.5	164.5
Percentage of total assets	49.8%	35.4%	26.7%
Days sales outstanding (DSO)	98	95	110
Days of inventory on hand (DOH)	162	164	226
Days payable outstanding (DPO)	72	87	152
Cash conversion cycle	188	172	183
Cash provided by operating activities	27.4	29.6	N/A
Cash provided by (used in) investing activities	(20.8)	(49.9)	N/A
Cash used in financing activities	137.0	0.2	N/A
Net increase (decrease) in cash and cash equivalents	143.6	(20.0)	30.0

In 2003, added 15 days to receivables and 62 days to inventory  
- but -  
no cash flow statement until 20-F filed

Cash increase due to debt issuance

Source: Company Reports, GLC.

As indicated in Table 2, Taro's current annual cash conversion cycle is not far off from historic ranges. The difference, however, lies with the fact the Company has doubled its inventory levels while offsetting this build with an extension in payables. DSOs are currently at a three-year high and almost double that of the Company's peers.

Table 3 provides estimated quarterly cash sources and uses model to provide insight into the Company's cash generating capabilities. Because the Company does not provide quarterly cash flow information or file quarterly financials with the SEC, investors must rely on Form 20-F Annual Report filing for actual cash flow information. Our analysis in Table 3 is an attempt to reconstruct the Company's cash flow results over the last four quarters in lieu of an actual cash flow statement.

Table 3: Taro Estimated Operating Cash Flow Analysis

(\$ thousands, FYE 12/31)	FYE	2003				FYE
	2002	1Q	2Q	3Q	4Q	2003
<b>Change in Key Working Capital Items</b>						
Receivables (Trade Only)	(27,907)	(2,579)	(10,012)	(24,047)	(14,846)	(51,484)
Inventories	(13,358)	(8,324)	(10,865)	(6,775)	(16,083)	(42,047)
Payables	21,420	9,314	(4,527)	(2,309)	9,818	12,296
Net	(19,845)	(1,589)	(25,404)	(33,131)	(21,111)	(81,235)
<b>Change in Other Working Capital Items</b>						
Depreciation and amortization	8,263	<b>Cash Flow Statement Not Yet Available</b>				
Other accounts receivable & expenses	(4,250)					
Other accounts payable & expenses	3,142					
Tax Payables & Deferred Income Taxes	5,331					
Other	(7,554)					
Net	4,932					
<b>Other Financial Items</b>						
Net Income	44,555	13,989	14,818	15,736	16,613	61,155
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Cash Flow From Operations	29,642	<b>Cash Flow Statement Not Yet Available</b>				
Change in Debt	(117)	23,016	54,134	15,796	50,134	143,080
Change in PP&E	39,334	25,087	21,845	15,822	26,176	88,930
Change in Cash	(19,963)	(8,800)	32,807	(16,291)	22,239	29,955

Payable extension provide cash - yet - receivable and inventory use significant cash

Cash use in key working cap items exceeds net income

Debt used to finance PP&E additions and operating cash uses

Source: Company Reports, GLC.

Note: Changes in key working capital items for all periods are calculated based on balance sheet line items and are, therefore, estimates of actual operating cash flow. Actual FYE 2002 cash flow items differ from amounts shown above.

The Company's cash uses for both receivables and inventory, based on quarterly balance sheet items, are significant and far outweigh the sources of cash provided by the extension of payables. The result is a net \$81 million in cash use, which is consistent with the cash conversion metrics discussed previously. Furthermore, the use of cash to fund working capital needs exceeds reported annual net income of \$61 million by over \$20 million. It is therefore possible the Company used a significant portion of its cash to fund operations over the year; an indication of poor cash management capabilities and low quality of earnings.

Non-operating sources of cash were mainly in the form of debt issuance of approximately \$140 million. A significant portion of this cash was used by Taro to fund the construction of new manufacturing facilities. The remainder, however, appears to be used for operating cash purposes. As such, cash on the balance sheet at year-end 2003 actually increased by \$28 million, or 18%, year over year. Given the lack of quarterly cash flow information, investors may be caught off guard upon the filing of the Company's Form 20-F, which is likely to indicate operating cash flow significantly underperformed earnings generation.

### Gross Margins Inconsistent with Peers

We believe investors should closely monitor Taro's recent gross margin performance. Specifically, the degree of gross margin leverage achieved by Taro in recent quarters, while impressive, is suspect given that it is both inconsistent with peers and is accompanied by significant growth in operating costs. It is unclear to us how Taro is able to achieve such margin improvement given management's explanations and, therefore, suggest investors closely monitor the Company's cost of sales going forward.

Table 4: Annual Common Size Income Statement – Taro vs. Peers

FYE	TARO			Peer group average		
	2001	2002	2003	2001	2002	2003
Revenue	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
COGS	36.7%	37.6%	32.5%	60.6%	52.6%	51.3%
Gross margin	<b>63.3%</b>	<b>62.4%</b>	<b>67.5%</b>	<b>39.4%</b>	<b>47.4%</b>	<b>48.7%</b>
R&D	13.2%	12.5%	12.9%	6.5%	5.2%	6.2%
SG&A	28.2%	24.8%	31.0%	26.5%	22.9%	26.7%
Total operating costs	41.4%	37.3%	43.8%	35.3%	29.9%	27.8%
Operating income	<b>22.0%</b>	<b>25.2%</b>	<b>23.7%</b>	<b>4.1%</b>	<b>17.6%</b>	<b>20.9%</b>

TARO gross margins well above peers - while - TARO FYE 2003 operating margins only slightly better than peers

Source: Company Reports, GLC.

Note: Peers include: ALO, BRL, MYL. Peer group fiscal year ends not comparable.

Taro's gross margins have historically outperformed other generic pharmaceutical companies, as highlighted in Table 4. Consequently, recent improvement to gross margins is commendable yet puzzling. Taro's gross margin in 2003 improved an impressive 500 bps over fiscal 2002 levels. Cost of sales grew at a compounded rate of only 2.6% over the year, as compared to the 8.7% compounded growth rate in sales over the same time frame. In the final quarter of 2003, cost of sales was flat on 6.6% sequential revenue growth. We question how this type of gross margin expansion is possible. For instance, in first quarter 2003, Taro reported \$68.9 million in sales on \$24.5 million costs. In the fourth quarter of 2003, the Company reported \$88.6 million in sales on \$26.5 million in costs. How is it Taro is able to drive \$20 million in additional sales while only increasing costs \$2 million?

We note the Company introduced two proprietary products during the year that should carry higher margins. However, the Company attributed recent growth mainly to its existing generics products.<sup>4</sup> Taro's disclosure is again deficient, as the Company does not provide a sales breakdown between generics and proprietary products. We note gross margins at global pharmaceutical companies, such as Merck and Pfizer, approximate 80% while other generic providers gross margins average below 50%. Lower cost of APIs may have contributed to lower COGs, yet the degree of margin expansion when compared to peers looks, in our opinion, too good to be true. Finally, manufacturing improvements could drive some margin leverage, yet Taro is still in the process of upgrading its manufacturing capabilities. If anything, future margins may be come under pressure once these new manufacturing facilities come on-line (in the form of increased depreciation expense), should the Company not witness a subsequent rise in sales.

Table 5: Taro Quarterly Income Statement

(\$ millions)	2003				CAGR - Last 4 Qs
	1Q	2Q	3Q	4Q	
Revenues	\$ 68.97	\$ 74.75	\$ 83.12	\$ 88.62	8.7%
Quarter to Quarter Change	11.3%	8.4%	11.2%	6.6%	
Cost of Goods Sold	24.59	24.75	26.56	26.56	2.6%
Quarter to Quarter Change	4.9%	0.6%	7.3%	0.0%	
Gross Margin	64.3%	66.9%	68.0%	70.0%	8.2%
R&D expense	8.72	9.59	11.22	11.06	
Quarter to Quarter Change	17.9%	9.1%	10.0%	-1.4%	18.0%
SG&A expense	26.26	32.00	36.90	43.16	
Quarter to Quarter Change	14.1%	21.8%	15.3%	17.0%	

COGs relatively flat during significant revenue growth - yet - Significant growth in SGA costs

Source: Company Reports, GLC. Note: CAGR = compounded average growth rate.

<sup>4</sup> "In 2003, growth and profitability of Taro's generic business enabled the Company to achieve strong financial performance while establishing support for two new proprietary product divisions." Taro Earnings Press Release, dated 2/17/2004.

The improvement in gross margins is also suspect, in our opinion, given the accompanying rise in Taro's operating costs. Specifically, the 18% compounded growth rate in SG&A expense over the last four quarters is of concern, especially given the fact this growth rate is over two times the growth rate of sales during the same period. Obviously this trend cannot continue without impacting profitability over the long term. The Company attributes the increase in SG&A expense to the building of its direct sales channel for its new proprietary product lines. While this may be the case, there is a concern the Company may be allocating cost of sales to operating expense given the fact compounded growth in SG&A costs was seven times that of cost of sales over the last four quarters. We suggest investors closely analyze the MD&A discussion in Taro's pending Form 20-F concerning operating cost performance for an indication as to the specific drivers behind margin performance.

### *Other Noteworthy Items*

- **Foreign corporation** – Taro's foreign corporation status impacts the Company in several ways. Investors should note, however, the Company's customers, operations, and financial reporting (financials are prepared using U.S. generally accepted accounting principals) are not materially different than those of its peers. As such, the dearth of quarterly financial information presents challenges to investors attempting to understand operational performance. Additional deficiencies in disclosure include the fact the Company provides no details about the effects on revenue recognition as a result of return provisions, price protection, distributor discounts, volume discounts, rebates and shelf life adjustments.
- **Family ties and split stock structure** – Four of eleven directors are part of the Levitt family, which founded Taro in the 1960s. The Company has a split class stock structure that affords the Levitt family 49% voting control while directly owning only 14% of outstanding shares. Both facts result in a situation where insider interest may not be fully aligned with outside common shareholders.
- **Questionable independence of audit committee chair** – Myron Strober, CPA, serves as chairman of the audit committee and was elected to the board in 2002. However, Mr. Strober previously served as a financial consultant and served on the Company's advisory board from 1993 to the time he was appointed on the board. As such, investors should question the true independence and oversight of this critical board member, especially in light of our noted concerns.

## Valuation

Shares of TARO currently trade at a premium to peers with regards to both earnings and revenue. Cash flow information is currently not available, but our research indicates Taro's operating cash flows significantly lags peers. The Company's future earnings growth, according to Reuters' estimates, is below that of BRL and MYL, yet the Company carries a higher forward earnings multiple. The premium in the forward earnings multiple may reflect the Company's recent strong earnings growth and margin performance. As discussed previously, we believe investors should closely analyze the Company's reported margins because of inconsistencies with peers. Our concerns regarding the Company's weak operating cash flows and cash management capabilities during a period of strong revenue and earnings growth should also be considered by investors. We note cash flow from operations at Taro's peers over the last four quarters has been strong, averaging over 100% of net income. Finally, the Company's split class stock structure, along with a family controlling interest and relating party dealings, should translate into TARO shares being discounted to peers, in our opinion.

Table 6: Valuation

	TARO	Average - Comparables	Premium / (Discount)
Current Price	\$59.43		
<b>Valuation</b>			
Price / Net Income - FYE	28.8x	25.3x	13.9%
Price / Net Income - FYE +1	23.1x	21.4x	8.3%
Enterprise Value / Sales - LTM	5.5x	3.6x	51.8%
Enterprise Value / Op Cash Flow	N/A	18.3x	N/A
<b>Performance</b>			
52-Week High	\$72.40		
52-Week Low	\$32.50		
52-Week % change	45.1%	23.6%	

Source: Company Reports, GLC, Reuters.

Note: Peers include: ALO, BRL, MYL. N/A = not available.

## Conclusion

We recommend investors in Taro closely analyze the Company's pending Form 20-F Annual Report given the discoveries highlighted in this report. Reported strong results in the Company's earnings release appear to tell only a part of the story. Longer term, investors should monitor cash management capabilities and margin performance.

### **Disclosure Information**

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