KBC Securities

UCB

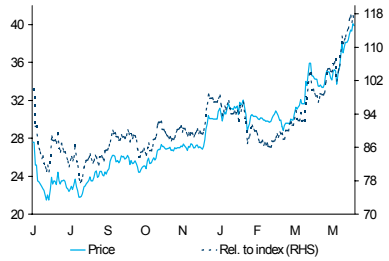
8 June 2004

Celltech, a sound strategic acquisition

Pharmaceuticals & Biotechnology

Belgium

Current price	€ 39.90	**Neutral**
Target price	€ 42.00	Rating unchanged



Source: Thomson Financial Datastream

FY/e 31.12	2003	2004E	2005E	2006E
Sales (€ m)	2,966	3,107	3,492	3,885
EBITDA (€ m)	647	672	810	948
Pre-Tax* (€ m)	485	453	486	621
Adj EPS* (€)	2.32	2.21	2.46	3.09
EPS (€)	2.32	1.83	1.70	2.32
DPS (€)	0.82	0.85	0.88	0.92
P/E* (x)	17.2	18.1	16.2	12.9
Yield (%)	2.1	2.1	2.2	2.3
EV/EBITDA (x)	9.2	12.1	10.1	8.7

Source: KBC Securities **Adjusted for goodwill and exceptionals*

Reuters UCBBt.BR
Bloomberg UCB BB
www.ucb-group.com

Market Cap € 5,823m
Shares outst. 145.9m
Volume (daily) € 10.6m
Free float 59%

Next corporate event

General Assembly FY03 on 8 June 2004

Performance over	1m	3m	12m
Absolute	14%	31%	45%
Rel. BEL20	11%	33%	16%
Rel. sector	16%	27%	32%
12-m Hi/Lo	€ 40.10/21.50		

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A Belgian company focused primarily on pharmaceuticals (allergies and epilepsy) with a presence also in chemicals and films.

UCB's share price hasn't stopped soaring since the acquisition of Celltech. Although we are positive about this strategic acquisition, we think that the upside potential is now virtually exhausted.

- From a strategic standpoint, Celltech's acquisition is an enormous step forward, reinforcing UCB's Pharma pipeline and management team. But the road to positive returns is still long and risky, so UCB still deserves a discount to average Pharma ratios.
- In technical terms, the merger should be positive as the acquisition is in cash, thereby avoiding any stock overhang. Die-hard Celltech investors have no reason not to re-invest their cash in UCB while new Pharma investors may be attracted by UCB's higher profile in Pharma.
- However, Celltech is yet to launch a 100% self-developed product and UCB's experience should prove useful for DP870, which is slated for launch in 2007-2008.
- Despite denials from the company, we are convinced that UCB will sell its Surface Specialties division. Without a disposal, UCB cannot meet its own target of a return to net cash in four years time. We estimate that Surface Specialties could be worth € 6 - € 8 per share.
- Both our peer group comparison and DCF valuation indicate that UCB is trading close to its fair value. Without new surprises, we expect a price range between € 38 and € 42 for the coming months. Our 12-month target price was increased to € 42, while our rating stays on Neutral.

Contents

The Celltech acquisition

£p 550 in cash

Last week, UCB reached an amicable agreement to acquire Celltech for £p 550 per share, equivalent to a 28% premium on the last closing price. According to management, the offer is 100% cash to avoid regulatory hurdles in the USA and because UCB considers that its stock was too cheap. A far more realistic explanation is that UCB simply wants to avoid share dilution.

Surface Specialties will be used to pay back the debt

Celltech will cost UCB € 2.25bn and the acquisition will be financed by bank lending. UCB expects to return to a net cash position in four years time. We feel this is quite an ambitious target. UCB's current free cash flow could grow to € 250m - € 300m in the coming years and Celltech has £ 155m in cash and no debts. Assuming that Celltech's cash flow and synergies (€ 100m/year) offset the financial costs of the acquisition, we would be surprised if UCB recovered more than € 1.5bn within four years. As far as we can see, the only way for UCB to reach the net cash target would be to sell the Surface Specialties division, although so far, the group is playing its cards close to its chest.

Similar commercial strategy

Both UCB and Celltech have a similar commercial strategy focused on specialty therapeutic areas. Celltech posted € 510m sales in 2003, made up of many small products often limited to a specific country. Royalty streams from sales of Rituxan and Remicade offset declining revenues from the antibody technology patents. Moderate but welcome synergies should flow from contact with UCB's smaller product portfolio.

Negative effect on short-term earnings

According to CFO Marc Wiers, the acquisition will enhance earnings by 2007 (i.e. after the second full year) after synergies and before amortisation of goodwill and other intangibles. Until then the impact will be slightly dilutive. The combined R&D budget will amount to € 400m a year. The broadening of the pipeline may require an increase in R&D spending, which is the main reason why the acquisition will be dilutive in the short-term. As no development partners will be sought, UCB will have to bear 100% of the costs. Profits come later. UCB expects sales and marketing expenses to decrease as a percentage of sales as potential blockbuster Keppra takes off, and this should free up additional resources for R&D without affecting the overall EBIT margin.

The € 100m synergy target does not seem overly aggressive since it corresponds to only 5% of combined Pharma sales. The company hopes to generate 65% of potential synergies in 2005 and 100% in 2006. It has also pointed to the growth potential of new products. We are a little sceptical here however; not only are product launches costly but we must wait until 2007 for the first launch of a major new product (CDP870). The acquisition will have a negative effect on cash flow because of the increased R&D expenses and the financing costs.

High-quality pipeline

The most important factor in the acquisition was the quality of Celltech's pipeline, where treatments for Immune and Inflammatory diseases and Cancer are currently under development. The furthest-advanced product is CDP870, currently in phase 3 for Crohn's disease and rheumatoid arthritis. For a detailed analysis of the combined pipeline we refer to the product description later in this report.

Filling the post-Zyrtec gap

The value of CDP870 lies not only in its future sales potential (although the launch is still four years away), but also in its capacity to step into the gap left when Zyrtec's US patent expires at end-2007. The launch will be too late to completely offset the negative impact of Zyrtec generics, but it does offer investors something positive to look forward – unlike the patent expiry of Keppra in 2009-2010.

No competing offers expected

To avoid competing offers from other companies, UCB and Celltech have also entered into a worldwide licensing agreement for CDP870 for all indications (except Crohn's disease) in North-America and major European countries. The unconditional agreement will not only deter potential counterbidders for Celltech. It also proves the commitment of Celltech's management to UCB – a crucial point, since UCB has little experience in biotech and cancer research.

Keeping the brains

UCB will therefore be keen to avoid brain drain in the experienced Celltech team. It has already announced that Celltech's R&D centre in Sloan, UK, will become UCB Pharma's R&D headquarters under the supervision of Dr. Melanie Lee (ex GlaxoWellcome). Thomas Beck, UCB's Global R&D Director, will report to Dr. Lee. More evidence of goodwill is the appointment of the Celltech CEO Göran Ando (ex Pharmacia) to the UCB Pharma board. Roch Doliveux (ex Schering-Plough), who joined UCB in October 2003, remains Director-General of the Pharma sector. We are therefore confident that UCB will not only succeed in keeping the know-how on board, but that both groups will learn a lot from each other.

Investors should be patient

Assuming that Surface Specialties is sold, UCB's new pure-pharma player status and the accompanying increase in pharma news flow should make it easier to capture the attention of pharma investors. But as with all long-term projects, there is risk involved: the investment is made today but the returns will not come before 2008, and are in any case, uncertain. Therefore, although we think a disposal makes good strategic sense, our enthusiasm is muted.

SWOT analysis

SWOT analysis	
Strengths	**Weaknesses**
• Blockbuster Zyrtec is a cash cow	• High dependence upon Zyrtec
• Keppra has long term growth potential	• Although stronger, the pipeline is at an early stage
• Reinforced management	• Variable track record of Surface Specialties
Opportunities	**Threats**
• Extended indications for Keppra	• Generic attack on the patents protecting Keppra
• Follow-up molecules of Keppra	• Possible failure of a product in development
• CDP870 for Crohn's disease and rheumatoid arthritis	

Source: KBC Securities

Shareholders

Poison pill exists

Financière d'Obourg is UCB's sole controlling shareholder, with a 40.33% stake. On 10 June 2003, UCB issued 30,000 bonds to Obourg for € 600,000. The bonds pay Euribor +0.25% and each bond has 1,000 warrants attached. The warrants can be exercised in case of a hostile take-over. This would increase Obourg's stake to 50.51%. The exercise price is the average price of the 30 trading days preceding the exercise date. Financière d'Obourg is 65% controlled by Financière de Tubize, which is controlled by the Janssen family.

News flow

11 June 2004	Payment of a gross dividend of € 0.82
28 July 2004	1H04 results
July 2004	Completion of the acquisition of Celltech
3Q04	• Results from Keppra in a non-epilepsy indication • News on the mechanism of action of Keppra • Decision about the launch of Xyzal or Efletirizine in the USA • Completion of monotherapy trial with CDP870 in RA
16-21 October 2004	American College of Rheumatology meeting with presentation of results of trial with CDP870 in combination with methotrexate.
4Q04	Filing of Keppra for children of 4 to 11 years old
17 December 2004	Announcement of R&D and investment programmes 2005

Valuation

Peer group comparison

Peer group comparison (closing prices 4 June 2004)	P/E 04	P/E 05	P/E 06	EV/EBITDA 04	EV/EBITDA 05	EV/EBITDA 06
LARGE PHARMA						
Aventis	17.1	15.7	13.8	9.7	9.0	7.8
Sanofi Synthelabo	15.9	14.2	12.2	9.4	8.1	7.0
GlaxoSmithKline Plc	14.7	13.8	12.9	9.7	9.2	8.6
AstraZeneca	22.4	19.1	16.4	12.7	11.0	9.4
Roche	24.1	21.1	18.2	12.1	10.5	9.2
Novartis	19.2	17.2	15.1	14.2	12.6	11.1
Pfizer	16.8	15.0	13.5	11.3	10.3	8.8
Merck & Co	15.4	14.4	14.8	8.8	8.3	8.1
Schering Plough	1,654.0	68.9	32.4	42.0	35.9	19.9
Bristol-Myers Squibb	16.6	16.8	17.7	9.4	8.9	10.4
Wyeth	13.7	12.6	11.5	10.2	8.9	7.7
Johnson & Johnson	18.8	17.2	15.9	11.4	9.5	
Abbott Laboratories	17.8	16.1	13.9	11.9	10.9	9.3
Lilly (Eli)	26.4	22.7	19.9	22.5	18.4	15.2
Merck KGAA	21.7	20.8	17.5	7.6	7.2	6.4
Median Large Pharma	**17.8**	**16.8**	**15.1**	**11.3**	**9.5**	**9.0**
BIOPHARMACEUTICALS						
Amgen	23.2	19.5	17.0	17.2	13.3	11.7
Genentech Inc	76.4	56.0	42.3	39.0	31.2	23.9
Biogen Idec Inc	43.0	35.2	28.7	10.6	9.6	5.5
Chiron Corp	24.1	20.1	16.7	14.3	8.7	6.7
Genzyme Corp	25.8	20.9	17.6	15.9	10.1	7.8
Medimmune	54.5	44.7	36.3	15.9	18.1	11.8
Cephalon Inc	27.0	19.9	16.7	15.9		
Altana AG	19.3	17.4	15.3	9.5	8.5	7.1
Lundbeck	18.3	19.4	15.7	9.5	9.8	8.0
Novo Nordisk	21.6	19.2	17.1	11.7	10.5	9.2
Schering AG	20.6	18.1	15.6	8.6	7.6	6.6
Serono	20.7	17.8	15.4	9.3	7.8	6.4
Median Biopharmaceuticals	**23.7**	**19.7**	**16.9**	**13.0**	**9.8**	**7.8**
UCB	18.2	16.3	13.0	11.9	10.0	8.6
Premium to Biopharmaceuticals	**-23%**	**-17%**	**-23%**	**-9%**	**2%**	**9%**
Premium to Large Pharma	**2%**	**-3%**	**-14%**	**5%**	**5%**	**-5%**

Sources: JCF Quant and KBC Securities

We try to avoid using ratios to value a share. As the previous table demonstrates, the apparent value of the stock can fluctuate sharply depending on the ratio used. To trade in line with the P/E ratios of the Biopharmaceutical group, one might conclude that UCB is still worth 25% more than current share price. But if we look at the EV/EBITDA, this conclusion no longer seems to hold.

Another observation is that ratios diverge considerably within a peer group. GSK has a P/E 2004 of less than 15, while that of Novartis exceeds 19. Amgen has an EV/EBITDA 2006 of almost 12, while Biogen IDEC doesn't reach 6. Obviously, these huge differences are due to specific characteristics of each company. Just using the average of a chosen ratio for a selection of companies is an often used, but too simplistic methodology.

UCB share is trading almost in line with its peers and we think that this is already very well. A premium wouldn't be justified. The main reason is that UCB's current value drivers Zyrtec and Keppra have to be replaced by the new molecules CDP870, UCB34714 and UCB35440 before 2010. Given the risky nature of drug development and the years of development still ahead, a drawback for one of these high-profile projects will have significant negative influences on valuation.

DCF valuation

DCF valuation

		2004	2005	2006	2007	2008	2009	2010
Risk free rate	5.0%							
Risk premium	4.0%							
LT growth	2.0%							
Beta	1.0							
NOPLAT		353.6	442.7	529.6	637.6	581.9	587.8	577.4
Depreciation		523.9	678.4	716.1	757.9	778.0	795.3	814.5
Investment		-2,820.2	-684.9	-729.4	-780.8	-792.2	-800.0	-802.7
Investment in working capital		10.7	-130.0	-128.9	-124.3	-33.7	-24.7	2.9
Free cash flow		**-1,932.0**	**306.1**	**387.3**	**490.4**	**533.9**	**558.4**	**592.1**
Discount factor		0.96	0.89	0.82	0.76	0.70	0.65	0.60
Present value of free cash flow		-1,846.4	271.3	318.3	373.3	375.9	362.6	354.3
Cumulative present value of FCF	2,845.9							
Present value of terminal value	2,986.2							
Entreprise value	**5,832.1**							
Value of debt	-19.3							
Provisions	250.6							
Minorities	11.4							
Value of peripheral assets	-1.9							
Theoretical value of equity	**5,587.6**							
Idem per share	**38.3**							

Source: KBC Securities

The conclusion of our valuation exercise is clear. UCB is trading slightly above its fair value and the fundamentals suggest little potential for outperformance. This can only change if positive results from clinical trials are shared with investors. But drug development is a high-risk business and nasty surprises can never be ruled out. New product launches and their timing are crucial to UCB's medium-term results and their success or failure can provoke sharp fluctuations in the share in either direction. Right now, we feel that the negative potential of bad news would probably outweigh the upside created by positive trial results.

Therefore, we feel comfortable with our Neutral rating with a 12-month target price of € 42.

Surface Specialties is worth € 1.0-1.2bn

The acquisition of Celltech and the company's target of returning to a net cash position in four years have convinced us that UCB will sell its Surface Specialties division, a business we value at between € 1.0bn and € 1.2bn. The lower price is twice what UCB paid for the Solutia activities. The higher price is obtained from applying a multiple of 6 on the 2007 EBITDA of the division and discounting it to today using a rate of 8% a year.

Company description

Pharma and Surface Specialties

UCB was created in 1928 from the merger of several chemical companies. Today, UCB is a hybrid company active in pharmaceuticals and specialty chemicals. In February 2003, UCB merged its Chemicals and Films businesses to create a new division called Surface Specialties. The company focuses on high added value products in markets where it has the potential to be a world leader.

83% of profits is Pharma

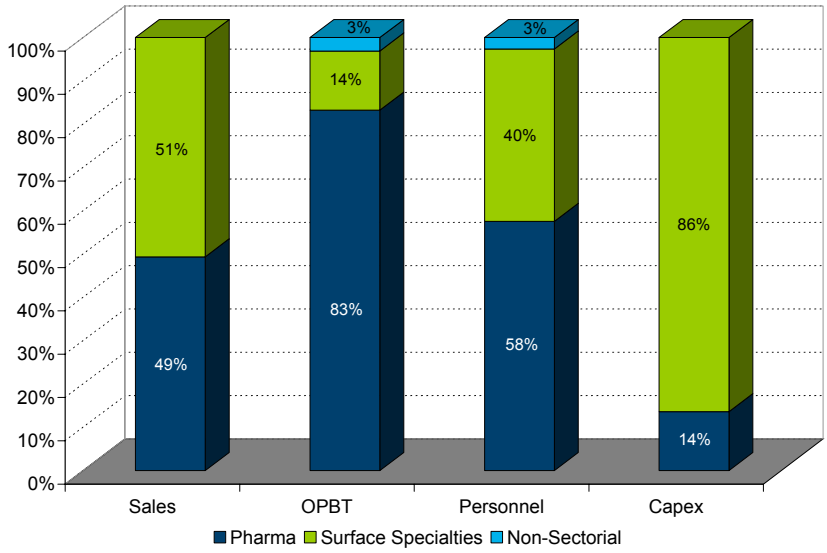
Today, the Pharma and Surface Specialties divisions each account for approximately 50% of consolidated sales. At the profit level however, the Pharma sector remains the most important with an 83% contribution to Operating Profit Before Taxation (OPBT). The Celltech acquisition enlarges the Pharma division's share of total sales, but should have a negative effect on its share of profits. This of course would no longer hold if, as we expect, UCB sells its Surface Specialties division.

60% of personnel is Pharma

UCB currently comprises the parent company, UCB SA, and around 140 subsidiaries and associated companies based in Western Europe, the Americas and Asia. UCB employs almost 11,600 people, 58% of them in the Pharma Sector. Celltech will add approximately 2,000 employees to the Pharma side.

2003 capex was seriously distorted by the acquisition of the Solutia activities for approximately € 500m. A more normal distribution would be approximately 50%-50%.

Comparison of UCB's divisions in 2003



Source: UCB

Pharmaceuticals

The development of UCB's pharmaceutical business dates back to the 1950s. Its research has resulted in the discovery of drugs for treating allergies and central nervous system (CNS) disorders. On a global scale, UCB is one of the smaller pharma players, focussing its efforts on two specialist disease areas: allergy and CNS. With the acquisition of Celltech, cancer becomes a third specialisation, while the Allergy franchise expands to be renamed Inflammation.

UCB's first antihistamine, hydroxyzine, was developed in the 1950s. It was followed in the 1980s by the discovery of the flagship drug, Zyrtec, for the treatment of allergies. UCB Pharma also developed Nootropil, for the treatment of cognitive disorders. Its expertise in this field has led to the discovery and development of Keppra for the treatment of epileptic diseases.

Although UCB Pharma has been mainly active in allergic and CNS disorders, it also produces and distributes drugs for other specific diseases such as oesophageal varices or gastric ulcers, non-steroidal anti-inflammatory drugs, mucolytics, and anti-cough drugs.

Two-thirds of UCB's R&D expenditure is targeted at the Pharma Sector. In 2003, approximately € 210m or almost 14% of Pharma turnover was spent on R&D. The Pharma division aims to channel 15% of its annual turnover in to research in the field of its two major franchises. UCB Pharma's main research centre is situated in Braine-l'Alleud (Belgium) where production also takes place. Pharma employs approximately 6,650 people or 57% of the total UCB workforce. Celltech will add approximately 2,000 employees to the Pharma side and the Celltech headquarters in Slough (UK) will replace Braine as the headquarters of UCB's Pharma division.

Tactical products

To enhance its medium and long-term growth, UCB Pharma has an active acquisition strategy. As all pharma companies seek to acquire interesting products, UCB has to focus on its core strengths. UCB has a strong sales presence in Europe with approximately 1600 reps. The company is therefore looking to acquire the rights of what it calls "tactical" products for this geographic region. The products are usually for specialist markets and may be outside UCB's own therapeutic core areas.

Strategic acquisitions

"Strategic acquisitions" are products or companies with global reach that fall within UCB's core Allergy and CNS franchises. Recent examples of such acquisitions are the Dynavax's allergy vaccine project (ragweed, grass and peanuts) and Celltech. We expect no other large-scale acquisitions in the near future and the Surface Specialties division probably needs to be sold before UCB can acquire the rights to individual products.

A large Pharma acquisition was not unexpected

Last year's enlargement of the Surface Specialties division was justified as a way of increasing the leverage potential for a large pharma acquisition. Although we had been expecting a large strategic acquisition before year-end, the speed of the Celltech acquisition surprised us. The deal should attract the attention of pharma investors and may lift UCB's valuation ratios towards those of pure pharma players. But in order to be fully rated as a pharma company, UCB needs to gain pure pharma player status.

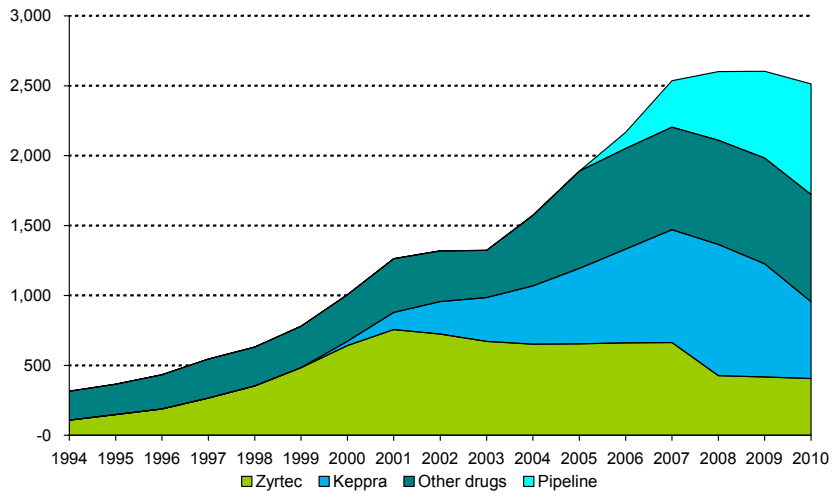
We previously thought that a sale or IPO of the Surface Specialties division was unlikely before 2006, reasoning that the company needed to integrate Solutia successfully first. We now think that UCB is already looking for an acquirer for Surface Specialties. A sale at the right price would make UCB a pure biopharmaceutical company with an improved outlook following the acquisition of Celltech.

Pharma P&L

PHARMA	2002	2003	2004	2005	2006	2007	2008	2009	2010
Consolidated sales	**1,476**	**1,463**	**1,712**	**2,025**	**2,301**	**2,667**	**2,731**	**2,731**	**2,639**
growth	3%	-1%	17%	18%	14%	16%	2%	0%	-3%
Zyrtec	724	670	651	654	661	663	426	417	406
Europe	256	227	225	211	213	203	207	210	212
USA	269	262	253	264	275	287	52	46	39
Japan	141	136	127	133	127	127	120	114	109
ROW	58	54	54	54	54	54	54	54	54
Keppra	231	314	417	538	670	807	938	809	549
Other	364	339	505	697	719	733	745	757	767
Pipeline	0	0	0	0	116	331	491	620	791
EBITDA	**681**	**631**	**761**	**964**	**1,080**	**1,303**	**1,249**	**1,267**	**1,258**
margin	46%	43%	44%	48%	47%	49%	46%	46%	48%
EBIT	**445**	**397**	**360**	**412**	**493**	**679**	**610**	**614**	**594**
margin	30%	27%	21%	20%	21%	25%	22%	22%	23%
OPBT	**440**	**402**	**312**	**262**	**347**	**543**	**486**	**563**	**458**
margin	30%	27%	18%	13%	15%	20%	18%	21%	17%

Sources: UCB and KBC Securities

Pharma sales evolution



Sources: UCB and KBC Securities

Combined product pipeline

		Phase 1	Phase 2	Phase 3	Submission
CNS	Epilepsy	UCB44212	UCB34714	Keppra (IV-formulation, monotherapy, generalysed seizures and pediatric)	
	Multiple Sclerosis	CDP323			
	Other		Keppra UCH34714		Xyrem
Inflammation	Allergy	CDP323 Efletirizine 1/day	Dynavax (ragweed) UCB35440	Xyzal (EPAAC study)	Xyzal Eletirizine 2/day
	Rheumatoid Arthritis	CDP323		CDP870	
	Crohn's Disease	CDP323		CDP870	
Oncology		CMC544 CDP791			
Other		CDP923			Oxybutynin

Source: UCB

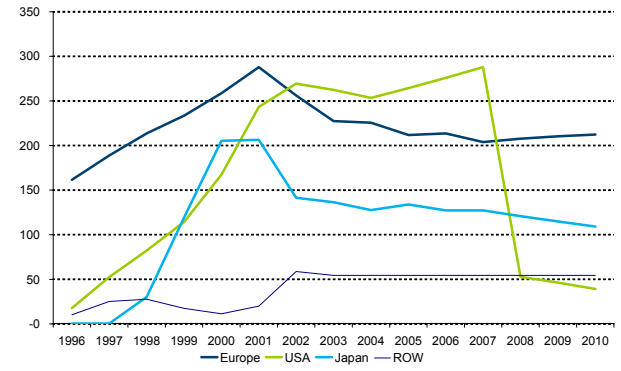
Inflammation/Allergy

Zyrtec

54% of UCB's OPBT

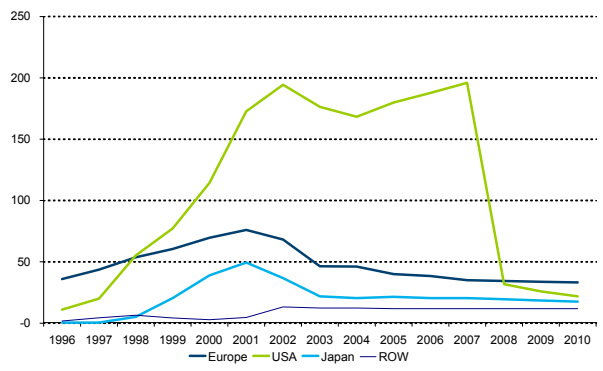
Zyrtec (Cetirizine) is a second-generation non-sedating antihistamine used for the treatment of hay fever and related allergies, both respiratory and dermatological. In volume, it is the top-selling antihistamine in the world. With total sales of € 1.7bn in 2003, it is the biggest drug ever developed by the company. This includes the 59% of sales that are sold by licensees like Pfizer but not consolidated by UCB. Zyrtec represents 54% of total OPBT, and is so crucial to the company's profits and growth that UCB has long been regarded as a one-product company. The arrival of the anti-epileptic Keppra, brings some welcome diversification.

Zyrtec consolidated sales



Sources: UCB and KBC Securities

Zyrtec OPBT



Sources: UCB and KBC Securities

Zyrtec in the USA

Licensed to Pfizer

72% of total Zyrtec sales (including licensees) are realized in the USA. Zyrtec is mainly sold in the USA by Pfizer through a co-promotion and license agreement. As part of the co-promotion agreement, UCB consolidates approximately 22% of total sales in the USA, while the license agreement states that UCB receives an additional royalty rate of approximately 12% on total sales. As such, Zyrtec sales in the USA account for 69% of total Zyrtec OPBT, 45% of total Pharma OPBT and 37% of total UCB OPBT. In 2003, total sales of Zyrtec in the USA, including the sales of Pfizer, increased by almost 20% to $ 1,336m. Expressed in euros, however, sales remained stable at € 1,183m.

The market has been hit

More than one year after the patent expiry of the market leader Claritin, the concerns about the impact on Zyrtec have completely disappeared. Not only did Zyrtec sales not fall, they even increased by 20% in local currency. The reasons underpinning this strong performance are:

- Schering-Plough's choice to move Claritin from the prescription only (Rx) market to the over-the-counter (OTC) market moved most of the price competition to another market segment.
- Many plans already had Zyrtec in the tier 3 drug category with higher co-payments.
- Claritin, Allegra and Zyrtec are not completely substitutable as they have a different efficiency versus side-effect profile. Claritin is known to be the least sedating but with the lowest efficiency. On the other hand, Zyrtec is the most efficient but with the strongest sedative side-effects. As a consequence, patients using Zyrtec cannot always be helped with Claritin. This market segmentation becomes more apparent when we see that Zyrtec succeeded in capturing significant market share, even though at the time of its launch, the market was already dominated by Claritin.
- The strong overall performance of Zyrtec was also due to new formulations (Zyrtec-D, syrup, chewable tablet), which have gradually expanded its target population.
- UCB's strategy is to move Zyrtec away from OTC-able allergic rhinitis indication to more severe pathologies like asthma, conjunctivitis and sinusitis.

Zyrtec-D

Zyrtec-D, a late entrant

In September 2001, UCB and Pfizer launched Zyrtec-D on the US market to strengthen the Zyrtec franchise. In addition to cetirizine, the active ingredient of Zyrtec, Zyrtec-D also contains pseudoephedrine, a nasal decongestant. Zyrtec's main competitors, Claritin and Allegra, already had a decongestant form of their antihistamine on the market. Claritin-D accounts for 25% of all Claritin prescriptions in the USA. Zyrtec-D sales represent approximately 15% of total consolidated Zyrtec sales in the USA.

Zyrtec is protected in the USA by a composition-of-matter patent with a paediatric extension until 25 December 2007. Zyrtec-D has additional patents running until 2016 and 2019 and the chewable tablet has a patent until 2019 listed in the FDA's Orange Book.

Zyrtec in Europe

Generic

In 2003, Europe accounted for approximately 17% of total Zyrtec sales, with more than 80% being consolidated by UCB. In several important European countries like Germany, the UK, Scandinavia and the Benelux, Zyrtec has already lost patent protection. France and Italy will follow in 2004 and 2007. The overall trend is therefore down.

Xyzal / Xusal (Levocetirizine)

Keeping up Zyrtec sales

To defend its current market share, UCB has developed and launched Xyzal, a single-isomer form of Zyrtec with patent protection until 2013. Zyrtec is a racemic mixture of the left- and right hand forms of cetirizine. Xyzal is the purified active left-hand form. Single-isomer forms of a drug generally have a reduced side-effect profile and improved dosage forms. In fact, Schering-Plough is following the same strategy in the USA. To defend its Claritin franchise, Schering-Plough has tried to shift patients from Claritin to its single isomer form Clarinex/NeoClaritin before patent expiration. This strategy only seems to have been partially successful however.

Elements of differentiation

In a head-to-head trial with NeoClaritin from Schering-Plough, UCB proved that Xyzal has a more rapid onset (1 instead of 3 hours) and a longer-lasting action. Such evidence of clinical superiority will certainly improve Xyzal's position in the future, as UCB is gaining arguments for the differentiation from competing products.

In Europe, generic pressure is generally weaker than in the US due to the fact that prescription drugs are usually less expensive. Since Zyrtec has already gone generic in the countries with the strongest generic tradition, the downward sales trend should stabilise gradually. We therefore estimate that the future drop in Zyrtec sales will be low single-digit on average.

France the next big challenge

This differentiation is also facilitating the switch from Zyrtec to Xyzal. In anticipation of the patent expiry in France in December 2004, UCB has asked the French government to remove Zyrtec from the list of reimbursable drugs and switch it to OTC from 2005. This should encourage doctors to prescribe Zyrtec from today, since patients would not need to make a return appointment for a Zyrtec prescription in 2005. Zyrtec's market shares currently range from approximately 5% in Denmark, Italy and the UK to more than 20% in Belgium, the Netherlands and Greece. In Germany and France the market share was around 12% in February 2004.

UCB's Xyzal is licensed from Sepracor. To market the drug in Europe and the rest of the world (except the USA and Japan), UCB pays an estimated royalty rate of 5%. This means that the margin on Xyzal sales will be lower than that of Zyrtec.

Zyrtec in Japan

Declining sales

Zyrtec was launched in Japan in September 1998. In 2003, sales slipped to € 136m, 4% down on 2002. Average market share dropped from 16.5% in 2002 to 15.5% in 2003 These figures reflect the increased competition on the Japanese market since the launch of Allegra by Aventis in November 2000 and of Claritin from Schering-Plough in September 2002. Allegra and Claritin have a non-sedating label in Japan, which is not the case for Zyrtec.

Another factor explaining the negative trend in Japan is that the government is imposing average price reductions of 6% on prescription drugs. In line with the country's tradition, we anticipate further price decreases every two years. As a consequence of these negative factors, combined with a probable appreciation of the Euro versus the yen, we expect Zyrtec's growth in Japan to decline slightly in the coming years. Zyrtec's patent in Japan expires in 2007.

Both Aventis and GlaxoSmithkline have blamed a poor allergy season in Japan as the cause of the disappointing sales of their allergy products. We therefore see no improvement for Zyrtec 2004 sales in Japan. The other geographic areas also saw weak sales for allergy treatments in the first months of 2004.

Efletirizine

Phase 3

Efletirizine is a new generation antihistamine, currently in Phase 3 as a twice-a day formulation. Phase 3 trials are also planned as a once-a-day formulation. Although UCB does not plan to release detailed clinical data, the company said that Efletirizine's enhanced safety profile makes it an improvement over Zyrtec.

Efletirizine or Xyzal?

UCB has not yet decided whether Efletirizine will be launched in the USA to convert Zyrtec patients before patent expiry. An alternative strategy would be to launch Xyzal in the USA. One of these drugs will probably be launched at least one year (2006) before Zyrtec's patent expires in the USA (2008). Whether UCB sells Xyzal or Efletirizine with or without Pfizer will depend on the negotiations between UCB, Pfizer and Sepracor. A decision should be announced by the end of 2004. Our model includes € 500m peak sales after a US launch for Xyzal or Efletirizine.

CDP870

Phase 3 for Crohn's disease and rheumatoid arthritis

The main driver for the acquisition of Celltech was certainly CDP870, a PEGylated antibody fragment targeted at TNF-α, a proinflammatory signaling molecule. CDP870 is being developed for Crohn's disease and Rheumatoid Arthritis (RA). This product was co-developed by Pharmacia, but after the acquisition by Pfizer, Celltech won back the rights. Nevertheless, Pfizer retains a 20% interest share of the net profit from Crohn's disease-related sales.

Rejected by Pfizer

The fact that Pfizer's interest in CDP870 waned is not a good sign, suggesting they think resources can be better used elsewhere. Part of Pfizer's decision may also have been motivated by the excellent terms awarded to Celltech by Pharmacia. But even though Pfizer has spurned part of the profits from a product with a sales potential of € 1bn, CDP870 can be a very interesting product for a smaller company like UCB. In fact we think it will be crucial to UCB's future, since its launch will coincide with Zyrtec's patent expiry in the USA.

Limited but positive phase 3 data in RA

Two phase 3 trials are ongoing with CDP870 for RA treatment. Partial results have been released of the first study (014). 247 patients received CDP870 (400mg 1/month) or placebo in addition to methotrexate and were followed for 24 weeks. The primary endpoint was the proportion of patients achieving more than 20% improvement of their symptoms (ACR20). The improvement with CDP870 was significant from week 1 onwards. 18 other end-points were measured in this study, but the results will not be presented until the American College of Rheumatology Conference in October. By then, the results of the second 011 study (CDP870 monotherapy) should also be available.

2008 launch in RA

A launch of CDP870 for RA is planned for 2008. It appears that it will be the fourth entrant in this market after Remicade (1998, J&J), Enbrel (1998, Amgen/Wyeth) and Humira (2003, Abbott). RA therapy is a large ($ 3.3bn), fast growing market with sufficient room for new entrants with 30%-40% of patients switching treatment each year. However, other therapies are still under development for RA (Rituxan, BMS 188667 and MRA) and could further intensify the competition in this segment.

2007 launch in Crohn's disease

2007 should see a launch of CDP870 for Crohn's disease. For the moment only Remicade has been approved for the disease. Currently two phase 3 studies are underway for this indication: PRECISE-1 and 2. The difference between them is that PRECISE-1 only enrolled patients with elevated C-reactive protein (CRP) levels. CRP is a general marker of inflammation. PRECISE-2 enrolled all patients, but they were nevertheless also stratified on their CRP levels. The primary endpoint is the same for both studies: the improvement of patients with elevated CRP-levels. The improvement in patients regardless of their CRP-levels is only a secondary endpoint. The CRP-stratification is used to increase the statistical significance of the results versus the increasing placebo response. The increasing placebo response has led to the failure of several competing compounds for Crohn's disease.

An easier formulation would be welcome

Crucial to the success of CDP870 will be its ability to stand out from competing products. Currently, CDP870 is a lyophilised powder that has to be reconstituted and administered by two 1ml injections once a month. This hardly offers the drug a commercial advantage. Celltech is working on a more user-friendly system, but a bioequivalence study may be required. As CDP870 is produced in bacteria and not in mamalian cells, UCB-Celltech will have sufficient pricing flexibility to be competitive. In our model we included peak sales of € 1bn for CDP870, with an 80% probability of reaching the market.

UCB 35440

Phase 2a

In July 2002, UCB started clinical trials with UCB 35440, a molecule that has both anti-histamine and leukotriene-synthesis inhibitor properties (5-lipoxygenase inhibitor). Leukotrienes are known to play a role in the pathogenesis of asthma. The targeted disease is allergic asthma. The new drug could become an oral alternative to the available inhalation products for asthma. UCB started Phase 2a trials with asthmatic patients in September 2003. However, we suspect that the higher emphasis UCB is now placing on Keppra and its follow-up molecules is an indication that the development of UCB 35440 might not running as smoothly as expected. A failure of the product would reduce our UCB valuation by 5%. We have nevertheless included peak sales estimates of € 1bn with a 30% probability that the product will be launched in 2009.

Ragweed vaccine

Phase 2b

In February 2004, UCB acquired the exclusive worldwide rights to Dynavax' allergy treatments against ragweed and grass, with an option for the peanut allergy treatment. The Phase 2b trial for the ragweed allergy treatment is ongoing and patient recruitment has been completed. Patients will receive a 3-month pre-treatment before the 2004 ragweed allergy season (autumn). This product and the treatment for grass allergy complement Xyzal and Zyrtec, since they are intended for non-responders to antihistamine. A launch may be possible by 2008. UCB hopes to capture a large part of the treatment cost which might amount to $ 2,000 per patient. In our model we include peaks sales of € 500m with a 40% probability of a 2008 launch.

CDP484

Phase 1/2

CDP484 is another PEGylated humanised antibody fragment, but which inhibits IL-1β, another pro-inflammatory cytokine. It has entered phase 1/2 trials for RA. IL-1 is thought to cause bone resorption and cartillage destruction rather than influencing joint swelling and inflammation. Kineret from Amgen is a small molecule inhibitor of the IL-1 receptor, but has not been a commercial success until now. As CDP484 is an antibody fragment it might have a higher affinity for the receptor and also a longer half-life thanks to the PEGylation.

CDP323

Phase 1

CDP323 is a small molecule inhibitor of α4-integrins, which is also being developed for RA. Integrins are adhesion proteins expressed on the cell surface of leukocytes that bind to selectins, which are expressed on the vascular lining. Blocking the integrins may result in reduced recruitment of leukocytes to the sites of inflammation.

A competitor molecule, Antegren (Biogen IDEC), has recently shown some promising phase 3 results for Multiple Sclerosis. This could bring some positive upside for CDP323 as Antegren is a monoclonal antibody that has to be administered intravenously. Launch is slated for 2005. Antegren is also under development for RA and Crohn's disease.

CDP146

Phase 1

CDP146 is an orally available small molecule inhibitor of p38 MAPK, a protein involved in the upregulation of inflammatory responses. The molecule is set to enter phase 1 trials in 2004.

For Celltech's three phase 1 molecules we have assumed peak sales of € 600m with launch dates ranging from 2010 to 2012 and a 20% probability of reaching the market. The overall net present value is limited, but important for UCB nevertheless as its early stage clinical pipeline gets some critical mass thanks to the Celltech acquisition.

Central Nervous System diseases

Nootropil (Piracetam)

Old, but not dead

In the field of Central Nervous System (CNS) disorders, UCB Pharma developed Nootropil, a drug for the treatment of cognitive disorders that gave its name to a new class of drugs, nootropics. While Nootropil has seen average annual sales growth of 5% in recent years, 2002 appears to have been less successful with a drop of 5% to approximately € 129m. Although the basic patent expired in 1984 and generic competitors are numerous, sales remain significant, especially in Asia/Pacific and in Latin America. For the coming years we expect flat sales on average.

Keppra (Levetiracetam)

Epilepsy

UCB's expertise in the CNS field has led to the discovery and development of Keppra, a new compound for the treatment of epileptic diseases. It is indicated as an adjunctive therapy for the treatment of partial seizures in adults with epilepsy. This means that it is yet to be approved for monotherapy, for generalized epilepsy or for children. Keppra was launched in the United States and Switzerland in April 2000, and the roll out of the product has continued all over Europe.

Very safe

Clinical trials have shown that Keppra significantly reduces the frequency of epileptic attacks. In addition, it is well tolerated and is the only anti-epileptic drug that has no undesired drug-drug interactions on its label. However, UCB is keeping the exact mechanism of the drug under wraps as it tries to strengthen its intellectual property position. More news is expected in the coming months.

Extension of indications

Research is continuing on line extensions, such as for paediatry (4 to 16 years), monotherapy and generalized epilepsy. Registration files for paediatry should be submitted in 4Q04, for generalized seizures in 4Q05 and for monotherapy in 2006. Although Keppra has not yet been approved for monotherapy, some major off-label use is already taking place. Some patients are on monotherapy because after a combination treatment with Keppra, the original antiepileptic was withdrawn, but de novo monotherapy is no exception.

Unknown mechanism of action

UCB has discovered that Keppra works through a completely new mechanism of action. It is therefore unlikely that it will be effective for the same indications as other epileptic drugs. Phase II studies are underway for neuropatic pain, psychiatric indication (bipolar disorder) and movement disorders (Parkinson's disease).

The next blockbuster

In 2003, Keppra's sales reached € 314m: € 209m in the USA, € 100m in Europe and € 5m in the rest of the world. Bridging studies are currently underway in Japan and it may be filed there in 2005, with a launch in 2006. When indication extensions are included, Keppra has blockbuster potential according to UCB.

IV formulation

UCB is also developing an intra-venous formulation, which could be filed for approval late 2004 or early 2005. Approximately 30% of epilepsy patients are diagnosed in hospital and treated with an intra-venous antiepileptic. The epilepsy market is fairly conservative. Once a patient is controlled with a drug physicians are reluctant to switch to other drugs. This means that having an IV formulation to administer to newly diagnosed patients in hospitals is an important way to gain loyal clients.

UCB 34714

Phase 2a

UCB 34714 originated from the same research program as Keppra and showed efficacy in pre-clinical models for suppression of experimental seizures and chronic pain. It showed greater activity and potency than Keppra in pre-clinical models of epilepsy. Clinical trials were therefore initiated in November 2001 and it entered phase 2a trials in September 2003. In addition to affinity for the Keppra binding site the molecule also appears to have some activity on the Na-channels, a target of other traditional antiepileptics. This might lead to broader indications than for Keppra. The molecule is therefore being evaluated for the treatment of acute pain, tremor and epilepsy related disorders.

UCB 44212

Phase 1

UCB 44212 is the newest member of the Keppra family to have started clinical trials in April 2004. Like Keppra, it has none of the traditional mechanisms of action, which means that its indications will probably be restricted to those of Keppra. However, UCB 44212 is appears much more potent than Keppra, which can lead to does that are 30-50 times smaller. Smaller pills are not only easier to swallow, but they are also easier to turn into other galenic formulations such as extended release tablets. Although the indications will overlap with Keppra, UCB 44212 is an important step forward, not only because it is more potent, but also because it can take over when Keppra loses patent protection in 2009 in Europe and 2010 in the USA.

Other products

Atarax

tranquilizer

Atarax (hydroxyzine) is a non-benzodiazepenic tranquilizer produced for many years by UCB. Over 2003, consolidated sales increased 5% to € 43m.

Lortab

pain

Lortab (hydrocodone-paracetamol) is an analgesic that reduces sensitivity to most types of pain sold in the USA. In 2003, sales fell 33% to € 28m and we expect a further decline of 5% a year on average.

Metadate CD / Equasym XL

ADHD

Metadate CD is Celltech's methymphenidate which is sold in the USA for the treatment of Attention Deficit Hyperactivity Disorder (ADHD). In 2003 sales increased by 22% in local currency to € 29m. The European equivalent Equasym XL should be launched during 2004.

Xyrem

sleep

Xyrem is a treatment for a sleeping disorder called narcolepsy, for which Celltech acquired the rights from Orphan Medical during 2003. The product was filed for approval in Europe in the first quarter of 2004 and a launch is expected during 2005.

Anti-tussives

Anti-cough therapies

Duratus (hydrocodone-pseudoephedrine-guaifenesin) is an anti-cough expectorant with sales around of € 24m in 2002. No figure was given for 2003. Also Celltech has a hydrocodone-based anti-tussive called **Tussionex**, which had sales of € 98m in the USA in 2003. The product loses patent protection in August 2005, so sales should start to decline soon. In response, Celltech has filed **Codeprex**, a new 12-hour codeine-based cough medicine for a launch in 2H04. **Delsym** is Celltech's OTC anti-tussive, whose sales increased by 37% in local currency to € 26m in 2003.

Oxybutynin transdermal patch

incontinence

Earlier this year, UCB acquired the European rights from Watson for the commercialisation of its Oxybutrin transdermal patch. The product is aimed at treating urinary urge incontinence. Approval and launch is expected soon, but as this is a relatively small and competitive market segment, we expect sales of only € 50m for UCB.

BUP-4

incontinence

BUP-4 (propiverine-hydrochloride) is a medicine UCB acquired from Fujirebio that also treats urinary incontinence, but which is only sold in Japan. In 2003, consolidated sales were stable at € 28m.

Dipentum

intestinal ulcers

Dipentum is a treatment for ulcerative colitis acquired from Pharmacia in 2002. In its first full year under Celltech control global sales amounted to € 25m.

Zaroxolyn

oedema

Zaroxolyn (metazolone) is a diuretic sold in the USA for congestive heart failure associated oedema. Sales decreased by 3% in local currency to € 37m in 2003. The product lost patent protection during 2002 and in 2H03 Celltech launched its own generic. In December 2003 the FDA approved three generic competitors. The product is no longer promoted and sales should decline rapidly.

Peptides

Peptide production

UCB-Bioproducts is a subsidiary of the UCB Pharma division. It develops and manufactures peptides and peptidomimetics, which are the active ingredients in new medicines, for the pharmaceutical and biotechnological industries. Sales fluctuate between € 40m and € 50m a year.

Surface Specialties

Chemicals + Films

The Surface Specialties division was created in February 2003 by the merger of UCB's Chemical and Films division and the acquisition of Solutia's Resins, Additives and Adhesives activities for € 510m. The price was certainly not cheap given the uncomfortable financial position of Solutia, which resulted in Chapter 11.

Complementary Solutia acquisition

Nevertheless, the acquired activities clearly complement UCB's current product portfolio. While UCB's chemical sales were dominated by radiation curable resins and powder coating resins, Solutia's portfolio contained mainly high-end water-borne and solvent-borne resins and technical resins. The combination of both product portfolios allows UCB to offer all possible solutions to its clients. In the powder segment, the existing overlap is manageable, as UCB was strong on the furniture market and Solutia on the metal and automotive market.

Move to environmental friendly technologies

In 2003, Solutia contributed € 540m to sales. It was consolidated for 11 months. Synergies (€ 20m - € 50m) should begin to kick in slowly before 2005. As a rule, growth of the coating resins market tracks GDP, but UCB targets slightly higher growth rates by promoting the substitution from solvent-borne resins to more environmental friendly technologies. A little under 50% of the coatings market is still solvent borne and could largely be substituted by more environmental friendly radiation curable, water-borne or powder coatings.

Improvement expected in the coming years

Our model assumes that sales will grow 4% a year on average. Thanks to the synergies generated by the integration of the activities acquired from Solutia, UCB hopes to raise the average profit level much closer to the historical maximum. While historically the profit margin ranged between 3.3% and 9.3%, we built in a top cycle with 11% in 2007 and a long-term average of 8%. These higher than average margins are justified by the expected synergies and favourable product mix changes. The mix effect is due to the divestment of methylamines in 2003 and the decreased weight of the lower-margin film activities following the Solutia acquisition.

Prices increases are difficult

For 2004, sales volumes are expected to improve, but with no immediate effect on margins as suppliers try to pass on higher oil prices to raise their own historically low margins. UCB is also trying to increase prices, but delays can be expected so any price-driven improvement of margins is unlikely for 1H04. But margins may improve thanks to the cost cutting at and synergies with the Solutia activities. Synergies should flow from sales, manufacturing (similar technologies), R&D and administration. Overlaps between the R&D centres in Graz, Springfield and Drogenbos have been removed by specializing in different areas.

Use Surface Specialties for Pharma

Investors have been worried by this large acquisition in specialty chemicals because UCB is profiling itself as a pharma company. UCB justified the acquisition as an opportunity to create shareholder value. UCB's Chemicals and Films divisions were too small to fetch a good price, while Solutia's activity offered a good opportunity to enlarge their critical mass. The enlarged division could be used to generate sufficient cash to make a major pharma acquisition. The acquisition of Celltech is a good example of this strategy in action.

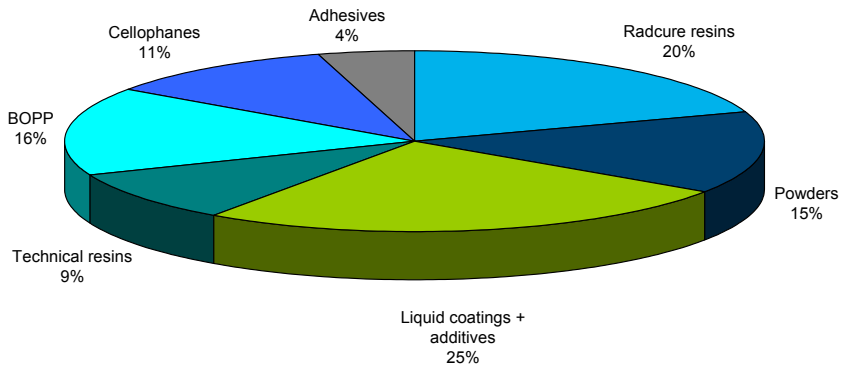
The Surface Specialty division is divided into two large business lines Coating Resins & Additives and Films & Adhesives.

Surface Specialties P&L

SURFACE SPECIALTIES	2003	2004	2005	2006	2007	2008	2009	2010
Consolidated sales	**1,501**	**1,395**	**1,467**	**1,584**	**1,667**	**1,747**	**1,823**	**1,894**
growth	45%	-7%	5%	8%	5%	5%	4%	4%
Coatings, resins & additives	940	968	1,026	1,119	1,186	1,250	1,310	1,368
Radcure resins	269	277	293	320	339	357	375	391
Powders	201	207	219	239	254	267	280	292
Liquid coatings + additives	345	355	377	411	435	459	481	502
Technical resins	125	129	137	149	158	166	174	182
Films & adhesives	422	427	441	465	482	498	513	527
BOPP	213	219	233	253	269	283	297	310
Cellophanes	149	146	143	140	137	135	132	129
Adhesives	60	62	66	71	76	80	84	87
EBITDA	**203**	**218**	**258**	**307**	**284**	**274**	**282**	**295**
margin	14%	16%	18%	19%	17%	16%	15%	16%
EBIT	**91**	**104**	**141**	**187**	**160**	**148**	**152**	**157**
margin	6%	7%	10%	12%	10%	8%	8%	8%
OPBT	**66**	**84**	**125**	**174**	**150**	**140**	**146**	**152**
margin	4%	6%	9%	11%	9%	8%	8%	8%

Sources: UCB and KBC Securities

Surface Specialties sales 2003



Source: UCB

Coating resins & Additives

Large industrial clients

Coating Resins & Additives can be further subdivided into Radcure resins, Powder resins, Liquid coatings & Additives and Technical resins. For certain grades of coating resins UCB is the only provider of a client, but never for all grades a client is using. The client can also switch supplier quite easily as it will take a new supplier only 6-12 months to develop the new product according to the client's specifications. In coatings the biggest clients are Akzo, Dupont and PPG. In inks the biggest clients are Sun and Sigma.

Radcure resins

A world leader in a specialist market

In Radcure resins UCB is the world leader with a market share of 35%, a production capacity of 60,000 tons per year and sales of € 269m in 2003. This is 2% more than the previous year, but sales haven't really grown since 2000. For the future we built in a top cycle in 2007 with 9% sales growth, where after sales growth rapidly stabilises at 3%. Radcure resins accounted for 41% of Chemical sales in 2002.

Radcure resins polymerise immediately when irradiated by ultra-violet light (UV) or an electron beam current (EBC). They are used in inks, coatings and other materials that need to dry fast when applied. This UV/EBC technology is also gradually replacing traditional coating processes, thanks to the productivity gains achieved, energy savings and the absence of solvents, which make it a more environmentally friendly process.

Graphic arts

In graphic arts, Radcure resins serve as the base for inks and coating varnishes, both in flexible and rigid packaging and in publishing.

- Inks and coatings: Radcure's products are used in inks and coatings to improve both decorative and functional properties.
- Glass: Glass substrates benefit from the low thermal load obtained through radiation curing.
- Metal: The superior chemical resistance and gloss provides lasting aesthetics and protection on beer and other beverage containers.

Industrial coatings

Radiation curable protective coatings: UV/EBC coatings are favoured for their finish and hard wearing performance. They are used in decorative and protective coatings of compact discs, sporting goods (from golf balls to fishing rods), ready to assemble furniture, PVC flooring tiles and wood parquet flooring, printed circuit boards, fibre optics, outdoor furnishings and building panels, high quality casting papers and decorative automotive parts

Resins for glass laminates for sound-deadening and security applications: These liquid resins, which are cast between sheets of glass and UV cured, confer impact resistance allowing security laminates to be made for overhead glazing, burglar protection or bullet proof glass. Others are used to confer acoustic barrier properties. They have also led to the development of a lightweight bottle, combining very thin glass with a resistant layer of Radcure.

Coatings for the building industry: Roofing and paving products used in the building industry are painted and protected by water-based acrylic coatings for which UCB develops the tailor-made binders.

Water-based protective coatings: water-based polyurethane coatings have a high abrasion resistance and protection against chemicals for which they are used as clear lacquer on parquet, furniture, window frames or PVC flooring.

Powders

A very competitive market

Thanks to the Solutia acquisition in 2003, consolidated sales jumped from € 141m in 2002 to € 201m in 2003. UCB is one of the biggest producers of Crylcoat polyester resins for powder paints. After some years of steady growth, today's powder resin market is characterized by fierce price competition. This has resulted in increasing volumes, but stable sales. For the Radcure resins we modelled a 2007 top cycle with growth normalising at 3% afterwards.

Powder coatings are applied using an electrostatic process whereby charged air-carried particles are attracted to the earthed object to be painted. This object is then put in the oven where the powders melt, forming a continuous film and a protective coating. It is used for washing machines, refrigerators, office furniture, aluminium window profiles, automotive components, garden equipment, air-conditioning systems.

Resins represent approximately 50% of the value of powder coatings. While the EU was evaluating the acquisition of the Solutia activities, it thought that UCB's production capacity was already fully utilised. UCB's management is however convinced that it can easily stretch the production by 10%-20% by planning the batch production process more efficiently. Hence, UCB will be able to fully benefit from an improvement of market conditions, both through a price and volume effect. Powder coatings are no substitutes for radcure or liquid coatings, so growth through substitution is not possible. UCB's main competitors are DSM, Eastman, Cray Valley and Akzo Nobel.

Liquid coatings and additives

From solvent-borne to water-borne

Liquid coating resins and additives are used to manufacture stains and varnishes for automotive and transportation, industrial and architectural applications. The move towards more environmental friendly technologies is causing a move from solvent-borne coatings towards water-borne coatings. Where substitution is technically feasible, a shift towards curable resins is also occuring. In 2003, liquid coatings and additives realised a turnover of € 345m. The vast majority of this business comes from the former Solutia activities.

Films & Adhesives

The Films & Adhesives are divided into BOPP (Bi-axially Oriented Polypropylene), Cellophane and Pressure Sensitive Adhesives.

BOPP

Previously the BOPP film activity was divided into four product areas, but since 2003 UCB no longer provides separate sales figures for Self-Adhesive Labels, Coated films, Bank Notes and Ordinary films. BOPP film is produced using the "bubble" manufacturing process that allows for a very wide range of thicknesses and is more stable during high-speed conversion. The ordinary BOPP films are used for wrapping of CD/DVD discs, food packaging, cigarette packs, etc.

UCB Films has also developed a unique opacified BOPP product for the securities market, which, with the addition of special coatings, may be printed using traditional paper and cotton fibre presses. The product is called Guardian and is marketed by Securency Pty Ltd – a joint venture with the Reserve Bank of Australia. Australia was the first country to convert entirely to UCB films and experienced a four-fold increase in banknote longevity and a rapid decline in counterfeit. The material also offers the potential for many security features not possible with paper products. The Guardian product was also adopted by Brazil, Bangladesh, China and New Zealand. Although an interesting application, sales have never been significant.

In 2003 BOPP sales declined by almost 4% to € 213m, due to currency fluctuations, while volumes continued to increase. For the future, we incorporated the same sales trends (+9% in 2007, 3% LT) as for the other Surface Specialties activities.

Cellophane

A shrinking market

Cellulose film is made from wood pulp and is biodegradable. Cellophane is used in twist-wrapping for confectionery, permeable packaging for soft cheese and baked goods and in adhesive tapes. A new application is as a membrane separator in batteries used in portable telephones, PCs and in the future, in electric cars. Another niche application is the use of pigmented cellophane as colouring in the moulding of plastic. A cellulose film, called Cellopore, is also being developed which enables drinkable water to be produced through osmotic filtration systems.

Cellophane is four times more expensive than OPP, but for UCB the margins are similar to those of BOPP. The demand for ordinary cellophane is receding to the benefit of synthetic films. UCB has therefore restructured its activities (closure of the factory at Burgos, Spain), whilst developing new specialities with high added value film. With its production capacity of 60,000 tons per year, UCB is the largest player in the world. For the future we project a 2% decline in sales annually.

Pressure Sensitive Adhesives

The combination of Films and Coatings

The replacement of paper labels by OPP labels continues in industrial sectors, where products are processed in the package: food, drinks, medicines, cosmetics, etc. The adhesives are also used in medical patches. The film facilitates and reduces the costs of recycling. In addition, new legislation and the market's demand that more technology and information is incorporated in the label. They are a product of the synergies between the technologies of the coating resins and film activities.

Financial data

INCOME STATEMENT (€ m)	2001	2002	2003	2004E	2005E	2006E
Sales	2,475	2,514	2,966	3,107	3,492	3,885
Other revenue	428	409	362	411	449	491
Personnel costs	-585	-604	-692	-725	-815	-906
Other operating costs	-1,853	-1,817	-2,149	-2,315	-2,559	-2,774
EBITDA	578	614	647	672	810	948
Depreciation and amortisation	-112	-110	-158	-151	-158	-168
Goodwill amortisation	-1	-1	-2	-42	-85	-85
EBIT	466	502	487	478	567	695
Net interest	-4	-9	-4	-68	-165	-159
Other financial result	0	0	0	0	0	0
Associates before tax	0	0	0	0	0	0
Exceptional results	-6	-27	-4	0	0	0
Pre-tax profit declared	456	466	479	410	402	536
Taxes	-136	-136	-140	-144	-154	-198
Associates after tax	-2	1	0	0	0	0
Minority interests	0	0	-2	0	0	0
Net attributable profit	319	332	338	267	247	339
Retained earnings	208	215	218	143	120	207
Net current result before goodwill	306	352	339	322	359	450
Net current result after goodwill	305	351	337	280	274	366
Current cash flow	597	687	708	761	868	997

BALANCE SHEET (€ m)	2001	2002	2003	2004E	2005E	2006E
Goodwill	23	28	95	1,694	1,609	1,524
Other intangible assets	241	255	463	552	655	757
Tangible assets	580	589	726	1,401	1,474	1,555
Associates	0	6	5	5	5	5
Other financial assets	90	83	57	58	64	70
Inventories	432	416	404	404	454	505
Trade debtors	741	684	800	808	908	1,031
Other current assets	28	56	58	65	73	81
Cash and equivalents	428	505	483	1,050	801	534
Short-term liabilities (excl debt)	562	546	593	624	662	725
Provisions for pensions and other	214	185	184	184	184	184
Long-term liabilities (excl debt)	35	21	72	72	72	72
Financial debt	362	304	459	3,206	3,054	2,801
Minorities	8	10	11	12	13	14
Shareholder's equity	1,383	1,555	1,772	1,940	2,060	2,267
Restated net financial debt	360	230	-5	2,174	2,271	2,286
Capital employed (restated)	2,147	2,162	2,638	5,073	5,415	5,780
Restated net financial debt / Equity	26%	15%	0%	111%	110%	100%
Restated net financial debt / Equity ex GW	26%	15%	0%	842%	490%	302%

CASH FLOW STATEMENT (€ m)	2001	2002	2003	2004E	2005E	2006E
EBITDA	578	614	647	672	810	948
Change in working capital	-127	-51	62	11	-130	-129
Change in provisions	65	-27	-26	0	0	0
Other non-cash items	-50	-1	-15	0	0	0
Gross operating cash flow	467	535	669	683	680	819
Net interest paid	-4	-9	-4	-68	-165	-159
Tax paid	-136	-136	-140	-144	-154	-198
Net operating cash flow	327	391	525	471	361	463
Capital expenditure	-159	-122	-659	-2,438	-193	-212
Free cash flow	168	269	-135	-1,967	167	251
Disposals	55	2	117	0	0	0
Acquisitions	0	0	0	0	0	0
Dividends	-95	-112	-118	-120	-124	-127
FX and others	-33	-40	-50	0	0	0
New equity	1	6	2	1	1	1
Change in net debt	95	125	-183	-2,086	45	125

PER SHARE DATA (€)	2001	2002	2003	2004E	2005E	2006E
EBITDA per share	3.96	4.21	4.44	4.60	5.55	6.50
EBIT per share	3.19	3.44	3.33	3.28	3.89	4.77
Published EPS	2.19	2.28	2.32	1.83	1.70	2.32
Current EPS before GW (diluted)	2.10	2.41	2.32	2.21	2.46	3.09
Current EPS after GW (diluted)	2.09	2.40	2.31	1.92	1.88	2.50
Current cash flow per share	4.09	4.71	4.85	5.22	5.95	6.83
Gross operating cash flow per share	3.20	3.67	4.58	4.68	4.66	5.61
Free cash flow per share	1.1	1.8	-0.9	-13.5	1.1	1.7
Net dividend	0.57	0.60	0.62	0.64	0.66	0.68
NBV per share	9.5	10.7	12.1	13.3	14.1	15.5

PERFORMANCE CRITERIA	2001	2002	2003	2004E	2005E	2006E
EBITDA margin	23.4%	24.4%	21.8%	21.6%	23.2%	24.4%
EBIT margin	18.8%	20.0%	16.4%	15.4%	16.2%	17.9%
EPS annual growth	23%	15%	-4%	-5%	11%	25%
CFPS annual growth	20%	15%	3%	8%	14%	15%
Pay-out ratio	35%	35%	35%	46%	52%	39%
EPS CAGR 3y historic	21%	17%	11%	2%	1%	10%
CFPS CAGR 3y historic	18%	15%	13%	8%	8%	12%
Return on invested capital	14.2%	16.5%	12.8%	7.0%	8.2%	9.2%
Return on equity	23.8%	23.9%	20.4%	17.4%	17.9%	20.8%

VALUATION DATA*	2001	2002	2003	2004E	2005E	2006E
Financial year high (€)	46.70	49.00	30.39	40.10	-	-
Financial year low (€)	33.75	23.90	19.16	28.72	-	-
Reference market capitalisation (€ m)	5,948	5,282	3,669	5,852	5,852	5,852
Enterprise value (€ m)	6,441	5,618	3,796	8,159	8,251	8,261
PER high (x)	22.3	20.3	13.1	18.2	-	-
PER low (x)	16.1	9.9	8.2	13.0	-	-
PER reference (x)	19.4	15.0	10.8	18.1	16.2	12.9
P/CF (x)	10.0	7.7	5.2	7.6	6.7	5.8
P/Bookvalue (x)	4.3	3.4	2.1	3.0	2.8	2.6
Gross dividend yield (%)	1.9	2.2	3.3	2.1	2.2	2.3
EV/EBITDA (x)	11.1	9.2	5.9	12.1	10.2	8.7

Source: KBC Securities

*Historic valuation data are based on historic prices

KBC Securities

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