From: Ens, Amanda [redacted]
Sent: Tuesday, February 14, 2017 3:47 PM
To: jeffrey E.; Richard Kahn
Subject: *TEVA 7% TEVVF - Play the preferred if you believe there's a dvd cut coming

Would add to your position. We have a BUY on TEVA and like being long via the mandatory convert preferreds yielding 11.2%.

There has been a lot of speculation about TEVA possibly cutting their common dividend. The company has stated they want to keep their IG rating and have even considered asset sales. TEVA did mention yesterday on earnings call that they don't plan on cutting their dividend, however with a new CEO coming in and a rough landscape ahead, it's still a possibility.

If there is a cut in the dividend, the 7% convertible pfds would have some room to run higher if you factor in the high delta and the need for yield in the marketplace. The TEVA 7% TEVVF pfds trade at $623 vs. $34 and yield 11.24% vs. 4% dvd yield currently in the common. On a +/- 20% move in the common, you participate 90% of the upside and 76% of the downside. On a +/- 10% move in the common, the Pfds participate 95% on the upside and only 59% on the downside. This was highlighted a couple weeks ago after the stock fell and BAML upgraded the stock to a BUY. Not only will you outperform the stock here, if there is a cut, you can win big.

The options market is pricing in a 25-40% dvd cut which would put the dvd to $0.20-0.28 from $0.34. There are 8 dividends left in the pfd and the theoretical delta is 14.5 shares per that you're short per pfd you are long. If they cut to $0.28 (6c), the pfds should move up at least 0.06 x 8 x 14.5 = $6.96 or equivalent of 70c in bond terms. This would just be the change to theoretical value. There could also be good size richening outside of this as in what happened to the KMI A 9.75% mandatory pfds after the company cut their dvd. The shares went from fair value to 11.5% rich now.

Table showing the impact of various dividend cuts over the life of the convert:

An important point is that these pfd dvds are cumulative. The company cannot pay dividends on the stock without paying dividends on the preferred. Dividends on the mandatory are payable only in cash, no option to pay it in stock. Fundamental holders with concerns about the common dividend could swap into the preferred for greater cash flow protection.

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This preferred will continue to be very topical as investors are trying to figure out the best way to play this company. The preferreds check a lot of boxes as they out yield the common (with greater cash flow assurances), participate 90% on a move to the upside while protecting you some on the downside, and also gives you a kicker if the company happens to cut the dividend.

Global Research

Teva

Reassuring Q, focus remains on execution; reiterate contrarian Buy
<http://rsch.baml.com/r?q=0SRJwAfnhxOFfgOxK0a3jQ&e=amanda.ens%40baml.com&h=4QtHtw>

Reiterate Rating: BUY

PO: 42.00 USD | Price: 34.00 USD

Equity | 13 February 2017

Key takeaways

* Adj. 4Q EPS of $1.38 beat our est. of $1.33; higher revenue and gross margin, offset by higher op. expenses, drove the beat.

* TEVA reiterated '17 outlook and stated it has no plans to change its dividend, which may reassure investors after CEO exit.

* We continue to like the risk-reward on TEVA as the company executes against reset expectations and on its pipeline.

FULL REPORT <http://rsch.baml.com/r?q=0SRJwAfnhxOFfgOxK0a3jQ&e=amanda.ens%40baml.com&h=4QtHtw>

<http://rsch.baml.com/r?q=0SRJwAfnhxOFfgOxK0a3jQ&e=amanda.ens%40baml.com&h=4QtHtw>

Concerns on dividend and 2017 outlook cut eased somewhat

TEVA reported 4Q adj. EPS of $1.38 vs. our est. of $1.33 and consensus of $1.35. Higher revenue (Specialty, ex-US generics) and higher gross margin, offset by higher operating expenses, drove the beat vs. our model. While Teva sees an incremental $0.10-0.15 downside if 2 generics of Copaxone 40mg are launched in Feb-17 (vs. prior outlook issued on 1/6), Teva reiterated its base case outlook (no generic Copaxone 40mg in '17). Importantly, the co. also stated it had no plans to change its dividend at this time. If Teva continues to execute well, that could reassure investors who may have worried a cut to Teva's 2017 view and dividend, particularly after the departure of its CEO on 2/6 (see here <http://research1.ml.com/C?q=hG3kJT!KWpJyShKn1j!jbw>). As noted in our recent out-of-consensus upgrade to Buy <http://research1.ml.com/C?q=OX0V-tRcQHjB6iVg2p0aPw> , limited visibility into US generic launches is a risk to TEVA's 2017 outlook (we already model Copaxone generics in 1Q17). That said, we continue to like the risk/reward on the shares especially if Teva could execute against somewhat reset expectations and focus on extracting value from its best-in-class generic and under-appreciated brand pipelines; reiterate Buy.

Cash generation remains key near-term focus

In our view, Teva's debt ($35.8bn as of end-'16) remains a key concern for investors. We model Teva generating $5.1bn in cash flow from ops. in 2017; recall we model generic competition to Copaxone in 1Q17. We believe Teva could exit 2017 at a net debt/EBITDA of 3.6x and operate within its covenants. While Teva has said it has no plans to cut dividend, such a move, if it were to occur, could lead to downside. That said, we see a path forward on repaying Teva's debt, which could drive shares higher over time.

Adjusting our model, DCF-based PO remains $42

On generics, we are lowering our US sales estimates, increasing our ex-US sales estimates, and tweaking gross margins slightly higher. On Specialty brands, we now model generic competition to Treanda in 2019 vs. 2018 (appeals ongoing, see here <http://research1.ml.com/C?q=5cF26nx-BdfuQUSLMLhY7g>) and continue to model generic competition to Copaxone in 1Q17, though we note no generic has approval yet. We are adjusting our operating expenses higher in 2017 as Teva expects to spend more on defending its Copaxone franchise. Our new 2017 and 2018E revenue/ EPS are

$23.0bn/$4.34 and $22.6bn/$4.47 vs. $23.1bn/$4.50 and $22.5bn/$4.45, respectively. Our DCF-based PO remains at $42.

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This report is intended for [redacted]

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