

Equity Research
North America

United States of America

Pharmaceuticals, Specialty

Allergan Inc.

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Analysis of Sales/Earnings

April 30, 2004

The Well-Oiled Machine Delivers Again

STOCK RATING	OVERWEIGHT
Price (April 30, 2004)	\$88.05
Price Target	\$100
52-Week Range	\$92.61 - 69.65

Stock ratings are relative to the analyst's industry (or industry team's) coverage universe.

GICS SECTOR	HEALTH CARE
US Strategist Weight	15.3%
S&P 500 Weight	13.8%

WHAT'S CHANGED	
Change of Target Price	\$92 to \$100

- AGN reported 1Q04 operating EPS of \$0.60, a penny above our estimate**
 The quality of the quarter was very high (pharma sales ex-currency were +17%), in our view. A strong top line and a strong gross margin (pharma only of 84.5%) drove the upside, even with significantly higher spending in the quarter.
- AGN's key products are performing well**
 Botox, Lumigan and Restasis, the key growth drivers for AGN, all posted strong numbers. The only shortfall in the quarter was in Tazorac/Avage, which is not as critical a growth driver for AGN and not a significant concern to us.
- 2004 guidance remains unchanged and we're not changing our EPS estimates**
 2004 EPS guidance remains \$2.72-2.75 and absorbs a higher tax rate for the year and a reduction in Tazorac/Avage sales guidance for 2004 of \$15MM. 2Q04 guidance was basically in line with our forecasts.
- We are increasing our price target for AGN to \$100 from \$92**
 This is based on a P/E multiple of 30x (up from 27x), or a PEG of 1.3x (up from 1.2x) our 2005E earnings of \$3.35. We maintain our Overweight rating for AGN and continue to believe it has the most attractive product pipeline for a company relative to its size in the pharma industry.
- We maintain our In-Line view of the specialty pharma industry**
 We still believe this is a year of investment with limited upside to earnings expectations. We do believe, however, that positive long-term trends remain in place for the group.

Fiscal Year Ends (Dec 31)	2003	2004e	2005e	2006e
EPS (\$)	2.31	2.75	3.35	-
Prior EPS Ests. (\$)	-	-	-	-
First Call Consensus (\$)	2.31	2.74	3.33	-
P/E	38.1	32.0	26.3	-
P/E Rel. to (local index) (%)	-	-	-	-
Price/Book	12.6	9.4	7.2	-
EV/EBITDA	24.9	20.6	17.5	-
Yield (%)	-	-	-	-
Market Cap (\$mn)	11,710.7			
Enterprise Value (\$mn)	12,446.2			
Debt/Cap (12/03) (%)	43.5			
Return on Equity (12/03) (%)	14.6			
LT Est EPS Growth ('yy - 'yy) (%)	22.5			
P/E to Growth	1.70			
Shares Outstanding (mn)	133.0			

	Q'trly EPS	2003 actual	2004e curr	2004e prior	2005e curr	2005e prior
Q1	0.54	0.60	-	NA	-	-
Q2	0.53	0.61e	0.62e	NA	-	-
Q3	0.57	0.67e	-	NA	-	-
Q4	0.67	0.87e	-	NA	-	-

e = Morgan Stanley Research estimates

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The Well-Oiled Machine Delivers Again

Company Description

Allergan is a global provider of specialty therapeutic eye care products with niche pharmaceutical products in skin care and movement disorders. Products areas include ophthalmology and skin care.

Summary Thoughts on 1Q04

AGN reported 1Q04 operating EPS of \$0.60, a penny above our estimate and consensus. Once again, the quality of the quarter was very high, in our view. A strong top line and a strong gross margin (84.5% pharma only) drove the upside, even with significantly higher spending in the quarter. Importantly, Botox, Lumigan and Restasis, the key growth drivers for AGN, all posted strong numbers. As the company has guided, it continues to reinvest the sales upside back into the business. But it was nice that AGN let a penny drop to the bottom line, which it has not done in the last couple of quarters.

As expected, EPS guidance for 2004 remains unchanged at \$2.72-2.75. EPS guidance for 2Q of \$0.61-0.62 was in line with our forecasts. Revenue guidance for 2Q was a little below our number (although the first quarter was just about equally above our number, and thus, probably just a timing issue), but has not changed for the full year. The only guidance change with respect to products is Tazorac/Avage sales for 2004, which was reduced by \$15 million (to \$70-80 million). This is not as critical a growth driver for AGN as the previously mentioned products and not a significant concern to us. And importantly, AGN expects to absorb this shortfall in the rest of its business. Also, the tax rate for 2004 is now 30% (up from 28.7%) and the EPS guidance absorbs this change. *This means that guidance for the underlying business is even higher by roughly \$0.05 per share.*

We have made no changes to our EPS estimates of \$2.75 for 2004 and \$3.35 for 2005. We maintain our Overweight rating on AGN with no changes to our investment thesis. We continue to believe that AGN has the most attractive product pipeline for a company relative to its size in the pharma industry. It has more products than it can sell itself, a unique problem in the pharma industry.

We are increasing our price target to \$100 from \$92, which is based on a P/E multiple of 30x (up from 27x), or a PEG of 1.3x (up from 1.2x) our 2005E earnings. Our PEG ratio is only in line with the group average yet the fundamentals for AGN are much better, but we choose to *Allergan Inc. - April 30, 2004*

remain conservative. There are risks to the stock achieving our price target. These include (1) moving the product pipeline through on time, (2) execution of product life cycle extension strategies to help sustain growth, (3) creating the dry eye franchise through physician education, and most importantly, (4) achieving the SG&A leverage during this strong new product cycle that is necessary to achieve 22-25% growth while still reinvesting significantly in R&D over the next 5 years.

POSITIVES FROM THE QUARTER

Strong top line in 1Q. Driven primarily by upside in Eye Care Pharma (including Restasis and other Eye Care). Lumigan and Alphagan were right in line. The Ocuflax to Zymar switch is going very well.

Botox continues solid performance. Botox grew 22% in 1Q (seasonally the weakest quarter of the year) and was in line with our estimate. Botox remains the most important growth driver for AGN, in our view, and imminent renewed DTC advertising should help. The US hyperhidrosis approval is expected in 2H04 and headache data should be presented by the end of 2004.

EPS and revenue guidance remains unchanged for 2004, but absorbs a higher tax rate assumption. *Notably, the higher tax rate is reducing EPS by \$0.05 for the year, so EPS guidance for AGN's underlying business is actually \$0.05 higher than before.* EPS guidance for 2Q04 was also in line with our forecast.

There could be upside to Alphagan forecasts for 2004. It depends on the timing of generics. AGN remains very conservative with its Alphagan forecasts this year. Alcon indicated that it will be filing its 505(b)(2) generic in 2Q04. Hence, given this NDA route, we wouldn't expect an FDA approval until next year. And B&L indicated that it was not pursuing a generic strategy for this product. Thus, competition for this product beginning in '05 should not be nearly as impactful as a traditional generic product would.

Oral Tazorac for psoriasis on track. The PDUFA date is September 26, and management indicated there would be a

panel meeting in mid-July. There are Phase 4 comparative studies ongoing, and management would not provide detail for competitive purposes. But we assume the studies will be comparing oral Tazorac to a whole range of different psoriasis therapies, including biologics and oral retinoids. We remain bullish on the oral Tazorac opportunity.

Triamcinolone project with NEI could be promising.

AGN is working with the National Eye Institute to evaluate its new intravitreal triamcinalone injection formulation for macular edema. Management indicated this could be a \$100 million opportunity, and we don't disagree. This could have a place next to AGN's Posurdex, an intravitreal implant for macular edema (Phase III studies ongoing).

CONCERNS FROM THE QUARTER

Reduction in guidance for Tazorac/Avage by \$15MM.

Management indicated that Avage has been a disappointment with an annual run-rate of less than \$5 million. This combined with an expected competitor for Tazorac topical in 2H04 is driving the lowered guidance. Tazorac/Avage is not as critical a growth driver for AGN, and the lowered guidance is not a significant concern to us. AGN expects to absorb this shortfall in the rest of its business.

Revenue guidance for 2Q was a little below our number.

However, the first quarter was just about equally above our number, and thus, this is probably just a timing issue. Also, revenue guidance has not changed for the full year.

EPS for 2004 is still back-end loaded. Management attributes this to higher spend from continued investment in Botox DTC, salesforce in Europe for Botox, and flat R&D spending throughout the year rather than the usual build-up.

Variance Analysis

Exhibit 1 below details our income statement variance analysis from the quarter.

Exhibit 1

AGN 1Q04 Variance Analysis - Income Statement

(\$ Millions Except EPS)	Estimate		Actual		Variance	Comments
	Y/Y		Y/Y			
	Amount	%Chg	Amount	%Chg		
Sales						
Botox	150.2	22	150.7	22	0.5	1Q seasonally lower than 4Q; impressive YoY growth
Eye Care Pharma						
Alphagan franchise	70.0	-9	69.3	-10	(0.7)	Price increase of 9% in January for Alphagan P
Lumigan	55.0	45	53.5	41	(1.5)	Price increase of 5% in January for Lumigan
Restasis	18.0	NM	21.3	NM	3.3	
Other	115.6	9	128.0	21	12.4	Price increases in January of 9% for Zymar, 5% for Ocuflax and 9% for Acular
Total	258.6	17	272.1	23	13.5	
Skin Care Pharma	29.0	12	24.7	-5	(4.3)	Tazorac/Avage sales of \$18M (-\$4.5MM b/c of Avage); Tazorac 9% price increase
Contract Rev	22.0	NM	24.9	NM	2.9	
Total Sales	459.8	18	472.4	21	12.6	Eye Care upside more than offset Skin Care shortfall
COGS	92.5	35	87.6	28	(4.9)	
Gross Profit	367.3	14	384.8	19	17.5	
Net R&D Svc. Revs.	0.0	NM	0.0	NM	0.0	
SG&A	174.7	3	183.0	8	8.3	Excludes \$2.4M pre-tax related to patent infringement settlement
R&D	81.8	46	86.1	54	4.3	Sales upside reinvested
Operating Income	110.7	13	115.7	18	5.0	
Interest Income	2.6	-37	2.0	-51	(0.6)	
Interest Expense	-3.4	-8	-3.7	0	(0.3)	
Other Income	0.0	NM	-0.1	NM	(0.1)	Excludes \$0.1M pre-tax related to unrealized loss on derivative instruments
Total Other Income	-0.8	NM	-1.8	NM	(1.0)	
Pretax Income	109.9	11	113.9	15	4.0	
Taxes	31.5	14	34.2	24	(2.7)	
Tax Rate	28.7%	3	30.0%	7	-1.3%	30% is now the expected tax rate for 2004
Minority Interest	0.2	NM	0.3	NM	0.1	
Net Income	78.2	10	79.4	12	1.2	
Shares	132.7	1	133.0	1	0.3	
EPS - Diluted	\$0.59	9	\$0.60	11	\$0.01	
Margin Analysis						
Sales	100.0%		100.0%			
COGS	20.1%		18.5%		1.6%	
Gross Profit	79.9%		81.5%		1.6%	Pharma only gross margin was an impressive 84.5%
R&D	17.8%		18.2%		-0.4%	
SG&A	38.0%		38.7%		-0.7%	
Operating Income	24.1%		24.5%		0.4%	
Other Income	-0.2%		-0.4%		-0.2%	
Pretax Income	23.9%		24.1%		0.2%	
Net Income	17.0%		16.8%		-0.2%	

NM = Not Meaningful; NA = Not Available

Source: Company data, Morgan Stanley Research

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Key Changes to MS Estimates

Exhibit 2 below details our income statement variance analysis from the quarter.

Exhibit 2

Summary of Key Changes to Our Model in 2004

	Current	Previous	Comments
EPS	\$2.75	NC	In line with management's guidance
Botox	\$690M	NC	Botox growth remains strong for both the cosmetic and therapeutic indications
Alphagan franchise	\$255M	NC	Generic Alph. P looking less likely for 2004
Lumigan	\$237M	NC	Share in US has been slowly moving upward; 1st line therapy status in Europe should help
Restasis	\$90M	\$84M	Ramp going as expected
Tazorac/Avage	\$80M	\$97M	Avage has been a source of disappointment, management lowered guidance by \$15MM
Other revenue	\$95M	\$90M	Reflects contract sales to AMO; it is in line with guidance
R&D	\$350M	\$345M	In line with management's guidance
SG&A	\$752M	\$746M	In line with management's guidance

NC = no change

Source: Company data, Morgan Stanley Research Estimates

Management Guidance

Exhibit 3

2004 Financial Guidance (MM except EPS)

	2Q04 Mgmt. Guidance	2004 Mgmt. Guidance	2004 MS Estimate
Pharma only sales	\$465-480	\$1,850-1,925	\$1,924
Botox	NA	\$660-700	\$690
Alph. franchise	NA	\$200-240	\$255
Lumigan	NA	\$210-235	\$237
Restasis	NA	\$75-95	\$90
Tazorac/Avage	NA	\$70-80	\$80
Other revenue	\$20	\$80-100	\$95
Gross profit*	NA	83-84%	\$83.9%
R&D*	NA	18%	18.3%
SG&A*	NA	38-39%	41.3%
Diluted shares	NA	133-134	133.9
Diluted EPS**	\$0.61-0.62	\$2.72-2.75	\$2.75

* As a percentage of pharma only sales

For 3Q04, AGN estimates diluted EPS growth of 17-19% versus prior year

NA = not available

Source: Company data, Morgan Stanley Research

Industry View

Our specialty pharmaceuticals industry view is In-Line as we believe that, on a market-cap weighted basis, our coverage universe will perform roughly in line with the S&P 500. We believe 2004 will be a year of investment with limited upside to earnings expectations. There are new important products, but in our view, few have the opportunity to significantly outperform. Competition for drug acquisition/in-licensing opportunities has increased significantly, with some larger companies reemerging as competition for specialty pharma. And we believe some companies may enter into defensive transactions that will probably end up dilutive to short-term GAAP earnings. We

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do believe, however, that the positive long-term trends remain in place for the group

Upcoming Events

Exhibit 4

AGN Expected Upcoming Events

Date	Product	Milestone/Event
2004		
2Q04	Posurdex	Phase III for macular edema starts
Mid-July	Tazorac Oral	FDA advisory panel meeting
July 30	Lumigan/timolol	PDUFA date
3Q04	Restasis	Initiate DTC campaign
3Q04	Combigan	Filing of additional Phase III data
Sept. 26	Tazorac Oral	PDUFA date
2H04	Lumigan/timolol	EU filing
2H04	Botox	US hyperhidrosis approval
2H04	Androgen tears	Begin Phase III trials
late '04	Botox	Headache Phase 2 data presented
late '04/early '05	Tazorac Oral	Approval for psoriasis and launch
late '04/early '05	Lumigan	Filing in Japan
2005		
1H05	Combigan	Product approval
2005	Diquafasol	Product launch
2005	Tazorac Oral	Data from Phase 4 studies
2006		
1H06	Botox	US filing for spasticity
mid '06	Memantine	NDA filing for glaucoma
end '06	Botox	Japan cosmetic approval
2H06	Lumigan	Launch in Japan
2H06	Tazorac Oral	Filing for acne
2H06/1H07	Posurdex	US approval

Source: Company data, Morgan Stanley Research

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