

Allergan, Inc

Allergan Puts Up Another Very Strong Quarter: Adj. Est. **\$95.23**

01 November 2005

Specialty Pharmaceuticals

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- Allergan beat 3Q top and bottom-line expectations by a wide margin: \$40M more revenues and \$0.04 higher EPS, even with higher than expected spending, which is a nice change from an earnings season that's been characterized by soft sales and earnings "hits" on lower spending within the speciality pharma sector (except for Sepracor).
- Net sales were \$606M, much higher than our \$566M and the Street's \$569M. EPS was \$0.83, 4 cents higher than consensus of \$0.79. As an added bonus, guidance was taken up by the amount of the beat. We adjust our '05 EPS to \$3.27 (guidance \$3.26-\$3.27), and '06 to \$3.69, down from \$3.75 due to higher expenses.
- The top-line strength was driven by outperformance of all the major product franchises. Relative to our estimates, Botox beat by \$9M; Alphagan/P/Combigan beat by \$10M; Lumigan beat by \$4M; Restasis beat by \$4M; and dermatology beat by \$3M. Overall, the main drivers were strength in international markets, strong US performance, and a longer quarter in terms of selling days. Wholesaler inventory remains less than 8 weeks for all the major products. We sum it up as "operational excellence".
- At \$96, the stock trades at 26x our new '06 EPS of \$3.69. With leading fundamentals, a strong pipeline, and an eye towards execution, we find the valuation reasonable and stay at OW.

Allergan, Inc (AGN;AGN US)

	2004A	2005E (Old)	2005E (New)	2006E (Old)	2006E (New)
EPS (\$)					
Q1 (Mar)	0.59	0.76A	0.76A		
Q2 (Jun)	0.63	0.78A	0.78A		
Q3 (Sep)	0.67	0.79A	0.83A		
Q4 (Dec)	0.86	0.90	0.89		
FY	2.75	3.23	3.27	3.75	3.69
P/E FY	33.3		29.2		25.9
Revenue FY (\$ mn)	2,046	2,303	2,303	2,437	2,437

Source: Company data, Reuters, JPMorgan estimates.

Company Data

Price (\$)	95.23
Date Of Price	01 November 05
52-week Range	69.01 - 95.43
Mkt Cap (\$ mn)	12,028.71
Fiscal Year End	Dec
Shares O/S (mn)	135

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3Q Analysis

Allergan beat 3Q top and bottom-line expectations by a wide margin: \$40M more revenues and \$0.04 higher EPS, even with higher than expected spending, which is a nice change from an earnings season that's been characterized by soft sales and earnings "hits" on lower spending within the speciality pharma sector (except for Sepracor). Net sales were \$606M, much higher than our \$566M and the Street's \$569M. EPS was \$0.83, higher than our and the Street's \$0.79.

The top-line strength was driven by outperformance of all the major product franchises. Relative to our estimates, Botox beat by \$9M; Alphagan/P/Combigan beat by \$10M; Lumigan beat by \$4M; Restasis beat by \$4M; and dermatology beat by \$3M. International markets were apparently quite strong, complementing strength in the US. In addition, traditional script analyses that suggested a softish top-line were confounded by a larger number of actual selling days in 3Q. Wholesaler inventory remains less than 8 weeks for all the major products.

On expenses, we're encouraged by the GM at ~84%, up 270bp sequentially and 320bp y/y reflecting the drag the AMO contract revenue business had on the margin. Excluding, AMO, the margin was flat to down, but newer, higher margin products are beginning to improve the mix and have seemingly stemmed further pharma-only GM deterioration. Allergan expects this level of GM to continue into 4Q, as implied by its upwardly revised GM expectation for the year of 83-84%.

Our delta table showing the difference in line-items from our model is below (Table 1).

Table 1: 3Q05 Actuals vs. Estimates

(\$M)	Actual	JPM Est.	Variance	Consensus
Pharma sales	605.9	566.1	39.8	
Botox	214.8	206.0	8.8	
Alphagan	75.1	65.6	9.5	
Lumigan	72.8	69.0	3.8	
Restasis	54.0	50.0	4.0	
Total Derm	33.0	30.4	2.6	
Other sales (contract sales)	0.2	0.0	0.2	
Total Revenues	606.1	566.1	40.0	569.2
Gross margin	83.8%	82.1%	1.7%	
R&D	106.7	99.6	7.1	
SG&A	250.5	218.0	32.5	
Operating Margin	24.8%	26.0%	(1.2%)	
Tax Rate	27.8%	28.3%	(0.5%)	
Net Income	112.1	107.2	4.9	
EPS - adjusted	\$0.83	\$0.79	\$0.04	\$0.79
Shares out	134.7	135.6	(0.9)	

Source: Company reports and JPMorgan estimates.

New Guidance

Allergan raised a number of key guidance items for the full year ending Dec '05 and offered first-time 4Q05 guidance.

For the year (December 2005 YE):

- **Net sales** are now expected to be \$2.24-\$2.26B, about 30M higher than the mid-point of the previous \$2.175-\$2.225B. Drivers of this increase are

- **Restasis** is now expected to be \$180-\$200M (previously \$165-\$185) as that product continues to gain traction. The company reported strong patient satisfaction and compliance, which generated strong refill scripts. With the recently signed co-promo deal with NPS, the product will be detailed to rheumatologists, perhaps adding another aspect to the growth outlook of this product.
- **Alphagan** franchise sales are now expected to be \$255-\$275M (previously \$235-\$255M). Emerging markets like Latin America and Asia/Pacific seem to be the drivers of continued growth with flattish US and EU sales. Allergan hasn't explicitly stated when it plans to launch Alphagan P 0.1% (fka Alphagan Z), but we continue to expect a 1H06 launch. The company appears to be trying to coordinate reimbursement and other franchise issues before putting the product in the market.
- **GM's** of 83-84%, up from 82.5-83%. Newer, higher margin products have stemmed GM pressure and Allergan has become more optimistic in its outlook.
- **SG&A** as a % of pharma net sales of 40%, up from 38-39%. Allergan is confident it's making the right investments in DTC on major products like Restasis, Botox cosmetic, and Botox hyperhydrosis, especially in the DTC-sensitive US market. It's also expanding two key sales forces: Botox in EU; and a doubling of the Botox neuroscience presence in the US. We continue to believe the Allergan's preparation by making personnel investments and gaining experience with Imitrex via the Glaxo deal are solid steps towards ensuring a strong launch of this indication upon approval.
- **R&D** as a % of pharma net sales of 17.5%. This is no change, but a strong reminder how focused this company is on internal development compared to many specialty pharma "peers" and perhaps the biggest confounding aspect of comparables valuation. Even at these levels, it's seemingly highly analytical of programs it does invest in as evidenced by it finally throwing in the towel on Tazorol in psoriasis.
- **Tax rate** – unchanged at 29%.
- **EPS** guidance was raised to \$3.26-\$3.27 - effectively taking the top-end of the previous \$3.20-3.23 range and adding this quarter's \$0.04 beat. That both the top and bottom-lines are being taken-up by about the amount of today's beat is a good sign to us about Allergan's confidence in its outlook.
- **Shares outstanding** – unchanged at 133-134M.

For 4Q05, **Net sales** is expected to be \$565 - \$580M and **EPS** is expected to be \$0.88-0.89. We have only slightly trimmed our EPS to be at the top end of this range, being careful to note Allergan's tendency as well as indicated expectation for the following quarter to reinvest any upside before throwing extra down to the bottom line.

Valuation and Rating Analysis

Our June upgrade was based on several catalysts, and as Allergan continues to hit on those catalysts, we still envision a 3-year investment time horizon with substantial and steady returns in each of those years, driven by consistent and *possibly* accelerating earnings growth, with low risk compared to peers. At \$96, the current multiple has expanded up to nearly 26x, from the low 20's earlier this year, and we still find it reasonable. Specialty pharma "peers" trade at about a 19x group average, however the level of R&D spend at Allergan is much more like that of a big pharma or biotech firm. Thus, we find broad group comparisons difficult, however, given the generally poor fundamentals of many members of the group and thus we find few true "peers."

Risks to Our Rating

We do not think there are any major fundamental risks in the near term like generic exposures that seem to plague many of the companies in this universe. New product launches are generally what drives specialty pharma stocks and Allergan has none in the near-term. With the recent run in the stock (up ~29% since May 2 compared to ~6% for S&P), investors will now place more scrutiny on the longer-term pipeline that will be required to maintain the growth at the current rates. Hence, any pipeline setback, no matter how minor, may have more of a negative impact on the stock than it would have just a few months ago such as: delay in the start of the Botox Phase III migraine study, and in OAB, a hint that the Posurdex trials are not going well, and/or negative news on the potential for Combigan U.S. approval in 2006. Other specific risks would include a slowing Botox growth rate, which we have no visibility on due to lack of Rx data, and entry of Reloxin into the U.S. market sooner than 2008 with a deep discounting pricing strategy.

Financial Snapshot

Table 2: AGN Income Statement

(In millions except per share amount)

FY: December	FY04	Q105	Q205	Q305	Q405E	FY05E	FY06E
Botox	705	176	213	215	231	835	960
Y/Y Growth	25%	17%	20%	23%	14%	18%	15%
Alphagan Family	269	67	64	75	62	268	264
Y/Y Growth	-6%	-4%	3%	3%	-3%	0%	-1%
Lumigan	233	62	62	73	69	265	298
Y/Y Growth	28%	16%	7%	21%	11%	14%	12%
Restasis	100	37	46	54	53	191	248
Y/Y Growth	160%	75%	130%	124%	55%	91%	30%
Total Derm	101	30	30	33	30	123	129
Y/Y Growth	-8%	21%	25%	33%	9%	22%	5%
Total Revenues	2,046	527	591	606	579	2,303	2,437
Y/Y Growth	17%	12%	17%	19%	4%	13%	6%
Gross Margin	81%	82%	81%	84%	84%	83%	83%
SG&A	781	210	241	251	208	909	946
% of total revenues	40%	42%	42%	41%	36%	40%	39%
Y/Y Growth	13%	15%	22%	28%	1%	16%	4%
R&D	346	82	91	107	115	394	414
% of total revenues	18%	16%	16%	18%	20%	17%	17%
Y/Y Growth	13%	-5%	3%	29%	31%	14%	5%
Operating Margin	27%	28%	26%	25%	28%	27%	28%
Tax Rate	30%	29%	30%	28%	28%	29%	28%
Net Income	369	101	105	112	121	436	500
Net Margin	18%	19%	18%	18%	21%	19%	21%
EPS	\$2.75	\$0.76	\$0.78	\$0.83	\$0.89	\$3.27	\$3.69
Y/Y Growth	19%	29%	23%	24%	3%	19%	13%
Shares Outstanding	134	133	135	135	135	134	136

Source: Company reports and JPMorgan estimates.

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