Morgan Stanley

Equity Research
North America

United States of America

Pharmaceuticals, Specialty

Allergan Inc.

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Analysis of Sales/Earnings

January 30, 2003

Strong 4Q02; Botox Doesn't Disappoint

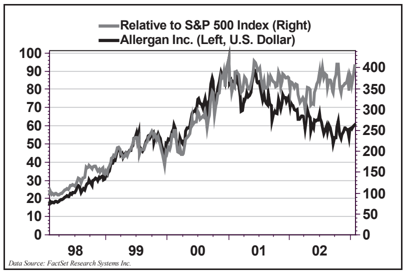
STOCK RATING	OVERWEIGHT
Price (January 29, 2003)	$60.98
Price Target	$72
52-Week Range	$70.24 - 49.10

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

GICS SECTOR	HEALTH CARE
US Strategist Weight	16.6%
S&P 500 Weight	15.1%

- **AGN reported 4Q02 operating EPS of $0.54, in line with our estimate**
  Slightly lower than expected revenues were offset by a slightly higher than expected gross margin and lower then expected operating expenses, which led to the in-line quarter. On a 16% sales increase, operating income grew 19%, pretax income 24%, net income 25%, and EPS 27%.
- **We believe this was a strong quarter for AGN**
  Positives: (1) Botox sales in the quarter beat our estimate, (2) AGN also provided Strong Botox guidance for next year, (3) the glaucoma franchise outperformed as well (specifically Lumigan and Alphagan P). Concerns: (1) the shortfalls for Tazorac and Other Eye Care Pharma sales and (2) reduced Alphagan franchise forecasts for 2003.
- **We maintain our Overweight stock rating and EPS estimates**
  ...of $2.33 for 2003. Our price target remains $72 based on a P/E multiple of 31x (PEG of 1.3x) on our 2003E earnings.
- **We maintain our Attractive view on the Specialty Pharma industry**
  We believe our coverage universe (on a market-cap weighted basis) can outperform the market for the rest of the year.

Stock Price Performance



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, skin care, intraocular lenses, and contact lens care products.

Fiscal Year Ends (Dec 31)	2001	2002e	2003e	2004e
EPS ($)	1.48	1.88	2.33	–
Prior EPS Ests. ($)	–	–	–	–
First Call Consensus ($)	1.96	1.87	2.30	–
P/E	41.3	32.4	26.2	–
P/E Rel. to (local index) (%)	–	–	–	–
P/CE	28.8	24.8	19.6	–
Price/Book	8.4	8.0	6.4	–
EV/EBITDA	24.3	20.8	16.7	–
Yield (%)	–	–	–	–

Market Cap ($mn)	7,884.7
Enterprise Value ($mn)	8,499.2
Debt/Cap (12/01) (%)	34.7
Return on Equity (12/01) (%)	24.3
LT Est EPS Growth ('yy - 'yy) (%)	24.0
P/E to Growth	1.72
Shares Outstanding (mn)	129.3

Q'trly EPS	2001 actual	2002e curr	2002e prior	2003e curr	2003e prior
Q1	0.35	0.43	0.00	0.53e	0.00
Q2	0.35	0.43	0.00	0.55e	0.00
Q3	0.35	0.48	0.00	0.58e	0.00
Q4	0.43	0.54e	0.00e	0.67e	0.00

e = Morgan Stanley Research estimates

Please see the important disclosures at the end of this report.

Strong 4Q02; Botox Doesn't Disappoint

Summary Thoughts on 4Q02 and the Stock

Allergan (AGN) reported operating EPS for 4Q02 of $0.54 versus $0.43 last year, in line with our estimate and $0.01 above consensus. On a 16% sales increase, operating income grew 19%, pretax income 24%, net income 25%, and EPS 27%. Slightly lower than expected revenues were offset by a slightly higher than expected gross margin and lower then expected operating expenses, which led to the in-line quarter.

Investor focus clearly has been on Botox, and Botox did not disappoint. Botox sales came in at the high end of the range, beat our forecast by $3 million and was about $18 million above 3Q levels. This number should boost investor confidence in the seasonality feature of the product. Importantly, the company provided strong Botox sales forecasts for next year, which we believe should drive consensus sales estimates higher from the $540-550 million range. The two key glaucoma products — Lumigan and Alphagan P — also provided sales upside.

The disappointments for the quarter, in our view, were shortfalls in Tazorac and the non-glaucoma eyecare products and the sales guidance for Alphagan P in 2003. Management addressed the issues. With respect to Tazorac, the market is clearly slowing and it appears that some of the competing products have begun to regain some share from incremental promotional activity. There was an inventory buy-in by wholesalers in 3Q02 that was above the company's previous expectations and that was corrected in 4Q02. Our sales assumptions were a little high (roughly $3 million) based on our Rx driven revenue model, and we had included $5 million of inventory stocking for Avage in 4Q, which was pushed out to 1Q03. Other Eye Care Pharma products will be buoyed with new product launches this year and our estimates were probably just too high in the quarter. And with respect to Alphagan P, the sales guidance is more a reflection of AGN's strategy for the entire glaucoma franchise (only promoting Lumigan) and not a result of expected penetration of generic Alphagan on Alphagan P. We also believe that AGN is being very conservative to eliminate this product as an investor concern.

We continue to be surprised by the level of investor skepticism with the stock. Even with the good quarter and solid 2003 guidance, the stock sold off a $1 on the day. Perhaps there was some "selling on the news" after the stock had run up leading into the quarter in anticipation of strong results. We just wonder when AGN will get a little more respect. Management's track record of success has been excellent. The company has multiple current growth drivers with Botox, Lumigan, Restasis, and Tazorac/Avage that should drive revenue growth in the 15-17% range. One of these products, Botox, has the potential to be a blockbuster, i.e. $1 billion product. And the most important near-term product in the pipeline (an oral version of Tazorac) is moving forward a little faster than expectations and should be an incremental growth driver by late next year.

Additionally, we would note four areas that we believe are under-appreciated by investors.

- ***First is the company's financial flexibility, i.e., operating leverage****,* which should begin to become more visible this year as AGN continues to grow earnings in the 22-25% range while repurchasing its Bardeen off balance-sheet partnership.

- ***Second, we don't believe the biotech component of Allergan is well appreciated.*** Botox accounts for roughly one-third of revenues and a higher percentage of profits. We believe an important reason that biotech companies have higher P/E multiples than pharma companies and usually over 2x their growth rates is that there is no current pathway for generic biologics in the US, i.e., the annuity stream is longer for biotech drugs than typical pharma products. We don't believe the stock accounts for this fact.

- ***Third is our belief that the product pipeline is also under-appreciated by investors and not appropriately factored in to the stock's valuation.*** AGN has multiple product opportunities in multiple ophthalmic areas as well as several non-ophthalmic areas. AGN is spending 16-17% of revenues on R&D, which is similar to large-cap pharma companies and yet the stock trades at a P/E multiple barely above the company's growth rate. Where is the multiple premium? We believe large-cap pharma trades at 2x their growth rates because of their significant R&D spending and investor confidence in the R&D productivity, which we view as reflected in the stocks' terminal multiples. We would argue that AGN has been at least as productive as many of these larger companies.

- ***And fourth is the company's strength with product life cycle extension strategies.*** Last year was Alphagan to Alphagan P and this year should be Acular to a next generation version with a different formulation.

Positives from the Quarter

- **Botox exceeds expectations**. Botox sales of $128 million increased 45% over sales in 4Q01 and exceeded our expectations by $3 million. Going into the conference call, there was heavy investor skepticism regarding Botox's performance during the quarter, but given a seasonal increase in demand, a price increase on December 1 and strong growth in therapeutic uses, the product was able to exceed investor expectations. Management did indicate that the price increase was told to its customers on November 15, and thus, physicians had the opportunity to build inventories. However, management indicated that January sales have been strong, and it appears the buy-in had minimal impact. (This should not be surprising given that physicians don't have the room for significant inventory levels and do not have sophisticated buying programs as do the wholesalers). Management also provided bullish sales guidance of $540-580 million for 2003, and reminded investors that sales are normally sequentially lower in 1Q than the prior 4Q.

- **Management broke out Botox growth for both the therapeutic and cosmetic segments for the first time, and both are demonstrating strong growth**. *Management indicated that worldwide Botox therapeutic sales for 2002 increased over 30%.* Even the most mature parts of the therapeutic segment (e.g., movement disorders) are still enjoying attractive growth. Much of this is due to geographic expansion — such as the cervical dystonia approval in Japan in the fall of 2001 and focal spasticity approval in Europe in 2002. With respect to additional therapeutic indications, hyperhydrosis is already approved in the UK, Canada, Australia and the Netherlands, and should be approved across the EU in 2Q03 and rolled out to individual countries thereafter. *With respect to cosmetic use, Botox sales for the full year increased by over 60%.* Even though economic weakness has been felt in many markets where Botox Cosmetic is available, management indicated that sales of the product do not appear to be negatively impacted so far. In Europe, management indicated that it anticipates cosmetic approval any day (marketed as Vistabel in France). France is acting as the reference member state for the European Union.

- **Lumigan continues to perform well**. Lumigan sales of $35 million in the quarter slightly exceeded our expectations by $1 million. Lumigan has gained market share since the increased salesforce promotional attention and the publication of head-to-head data in the American Journal of Ophthalmology which demonstrated that Lumigan lowered IOP more than Pharmacia's Xalatan (the market leader). Exhibit 7 details Lumigan Rxs throughout 2002. With respect to the European Lumigan launch, management indicated that its launch trajectory has been the best of any glaucoma product launched thus far and that hyperemia (red eye), which in our view has been the major reason the product has not done even better in the US, has not been an issue in Europe. Lumigan was also approved in Australia in 4Q. Overall, we have been pleased with how Allergan has been able to successfully manage its entire glaucoma franchise.

- **Strong Alphagan franchise performance.** Alphagan franchise (mostly Alphagan P) sales of $65 million in the quarter exceeded our expectations by $9 million. Management indicated that worldwide sales of Alphagan and Alphagan P, were down 2.5% (constant currency) versus 4Q01 mainly because of less use of Alphagan as first line therapy in the US. Management also indicated that in Europe, Alphagan is being only marginally impacted by the successful launch of Pharmacia's Xalcom. Alphagan P has been launched in Brazil and India, and AGN expects to launch it across Latin America and Asia during 2003. AGN also continues to work on a European filing. With respect to the potential impact of a generic Alphagan on Alphagan P performance, management indicated that almost all Alphagan prescriptions have been switched over to Alphagan P, the product has over 90% formulary coverage, and there are only a handful of accounts that have any interest in replacing Alphagan P with a generic Alphagan on formularies.

- **Restasis early approval and expected launch in 2Q03**. On December 24, AGN announced that Restasis was approved by the FDA for chronic dry eye. The approval came a lot sooner than we expected and is a significant positive as it provides another important growth driver to the company's story. Restasis will be the first prescription product for any form of dry eye on the market (all dry eye products sold today are OTC tears products), and the company believes that the therapeutic segment of the chronic dry eye market could grow to $300-500 million over the next three to five years. While management could not give specific details with respect to Restasis pricing, management did describe pricing in the lubricating tears OTC market for comparison. More specifically, the cost per day of lubricating tears is on the order of about $0.39 and AGN's most recent launch, in the Refresh line (Refresh Endura, a premium product) costs in practice approximately $0.74 per day. Management indicated that Restasis will be priced at a multiple of Endura and will be "a very expensive product."

- **Pipeline moving forward in 2003**. Management noted a number of anticipated pipeline highlights for 2003 which include the following: (1) Restasis is expected to be launched in 2Q03, (2) Gatifloxacin is expected to be launched in the US in 2Q03, (3) an improved version of Acular is expected to be launched in 2Q03, (4) Vitrase, AGN's project with Ista Pharmaceuticals, will be going to an FDA advisory panel in March with a potential launch in 2003, and (5) Epinastine will complete the mutual recognition process in Europe in 1Q03, and should be approved in the US in 4Q03 with a 1Q04 launch, (5) Avage is currently being launched in the US and Canada, and (6) Oral Tazorac for psoriasis is expected to be filed in 3Q03 (a quarter earlier than we expected).

- **Operating leverage**. SG&A of $148 million for the quarter was $5 million below our expectations, and once again, demonstrated AGN's ability to leverage operating expenses. Management indicated that its SG&A ratio of approximately 43% for 2002 is approximately 10 points higher than the industry average, thus it believes it has substantial opportunity to lower costs. Overall, management believes it will be able to realize an SG&A ratio of approximately 39-40% in 2003 which still leaves the company with room for further improvement relative to the industry.

Concerns from the Quarter

- **Tazorac sales below expectations**. Tazorac/Zorac (tazarotene cream) sales of $15 million in the quarter were $8 million below our expectations. We had included $5 million of stocking for the launch of Avage but this was pushed out to 1Q03. Management indicated that the product was negatively impacted by inventory movement among US wholesalers. According to management, wholesaler buy-ins at the end of 3Q02 ultimately corrected themselves in 4Q02. We would note that while sales fell on a sequential basis, year-over-year growth increased approximately 35%. Also, management pointed out that this market has been more challenging as of late, and admitted that maybe the weak economy has affected this business (although that did not seem to be a factor for Botox).

- **Bardeen repurchase not in the guidance**. While it is anticipated that Bardeen will most likely be repurchased in April 2003, management's current guidance does not include the potential earnings impact of the buyback. Even though management has indicated that the Bardeen repurchase should result in little or no dilution to EPS, we believe it will remain an investor concern until the partnership is eliminated.

- **Alphagan franchise guidance below expectations**. Management's guidance for the Alphagan family is down approximately $33-43 million versus 2002, and management indicated that the impact of a generic competitor is not the major reason for the downward guidance. Rather, management pointed to increased usage of the prostaglandin drugs as first line therapy and less use for Alphagan as a first-line agent (Alphagan is positioned now as more of a second line or add-on therapy), and hence, less promotional activity for Alphagan with the primary focus being on Lumigan.

- **Acular litigation**. Even though AGN plans to introduce an improved version of Acular in 2Q03, management has previously indicated that litigation against Apotex over a generic version of Acular is set to begin in May. As background, Apotex filed an Acular ANDA in mid 2001 and AGN sued Apotex in June 2001 to start the 30 month clock. At issue between the two companies is the Acular formulation patent that is set to expire in May 2009. Our models currently assume that Allergan's formulation patent holds, but if Apotex is successful in its patent challenge, there could potentially be downside to our sales forecasts. However, we would note that this downside would probably not be significant enough to negatively impact the company's bottom line.

Management Guidance

Exhibit 1 summarizes financial guidance management provided during the conference call.

Exhibit 1

Financial Guidance

	Current	MS Estimate
1Q03 Revs.	$375-395MM	$389MM
1Q03 diluted EPS	$0.52-0.53	$0.53
Full Year 2003		
Total Revs.	$1,610-1,690MM	$1,643MM
Diluted EPS	$2.29-2.31	$2.33
Botox Revs.	$540-580MM	$565MM
Alphagan franch. Revs.	$205-215MM	$213MM
Lumigan Revs.	$175-195MM	$195MM
Tazorac/Avage Revs.	$75-85MM	$82MM
Restasis Revs.	$20-40MM	$30MM
Contract Revs.	$60-80MM	$70MM
Pharma Only Revs.	$1,550-1,610MM	$1,573
Gross Margin**	85.0%	81.8%*
SG&A	39-40%	39.3%
R&D	16-17%	16.8%
Op. Profit	25-26%	25.8%
DSO	60-65 days	--

NC = no change; NA = not applicable
** = including Contract Revenue*
*** = excluding Contract Revenue*
Source: Company data, Morgan Stanley Research

Key Changes to MS Earnings Estimates

Exhibit 2 below details key changes to our financial model.

Exhibit 2

Summary of Key Changes to Our Model

	Current	Previous
2003		
Total Revenues	$1,643MM	$1,699M
SG&A	$646M	$681M
R&D	$274M	$289M
EPS	$2.33	NC
Botox	$565M	$547M
Alphagan franch.	$213M	$234M
Lumigan	$195M	$197M
Tazorac/Avage	$82M	$100M

NC = no change
Source: Company data, Morgan Stanley Research

Company Stock Rating and Industry View

We are making no changes to our Overweight stock rating or $72 price target. Our price target is based on a P/E multiple of 31x (PEG of 1.3x) on our 2003E earnings. Our investment thesis remains that AGN has (1) a diverse revenue base with several key growth drivers — Botox, Tazorac, the glaucoma franchise and now Restasis, (2) a strong pipeline for a company of its size that supports a five-year sustainable growth rate forecast of 24%, and (3) P/E multiple expansion as the AMO spin-out results in a faster-growing residual pharma business. We believe there are risks to the stock achieving our price target, including sustainability of the Botox and glaucoma franchises, significant delays in FDA product approvals, and competition from generic manufacturers.

Our view of the specialty pharma industry remains Attractive as we believe our coverage universe — on a market-cap-weighted basis — can outperform the market for the rest of the year and into 2003.

Upcoming Milestones & Events

Exhibit 3 below details important upcoming milestones and events for Allergan.

Exhibit 3

AGN Expected Upcoming Events

Date	Product	Milestone/Event
2003		
2003	Botox	France approval for cosmetic use
3/03	Vitrase	FDA advisory panel
1Q03	Epinastine	Approval through EU MRP process
2Q03	Gatifloxicin	FDA approval and launch
2Q03	Restasis	Product launch
2Q03	Acular	Launch of reformulation
mid ‘03	Botox	US filing for hyperhidrosis (excess sweat)
mid ‘03	Botox	European approval for hyperhidrosis
mid ‘03	INS365	NDA for dry eye
3Q03	Tazorac Oral	Filing for psoriasis
4Q03	Lumigan/timolol	NDA filing
4Q03	Epinastine	FDA approval for allergy
2004		
2004	Lumigan/timolol	EU filing
1Q04	Epinastine	Product launch
mid ‘04	Combigan	NDA filing
late ‘04	Tazorac Oral	Filing for acne
late ‘04	Lumigan/timolol	FDA approval & launch
late ‘04	Tazorac Oral	Approval for psoriasis
late ‘04	Botox	US filing for spasticity
2005		
1H05	Combigan	Product approval
late ‘05	Tazorac Oral	Approval for acne

Source: Company data, Morgan Stanley Research

Variance Analysis and Additional Financial Highlights

Exhibit 4 below details our income statement variance analysis from the quarter.

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