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SPECIALTY  
PHARMACEUTICALS

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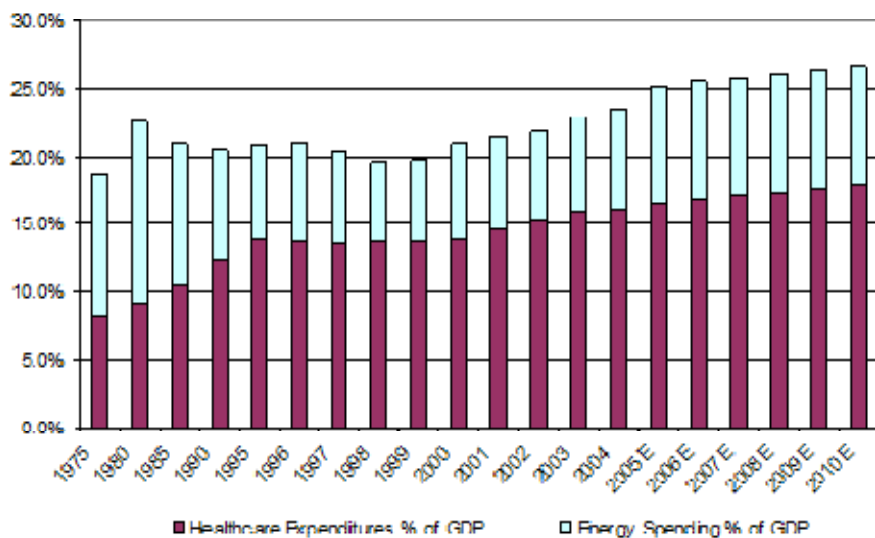
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**A WORLD TURNED UPSIDE DOWN: DEFENSIVE ROTATION, SLOWING ECONOMY, ELECTIONS, VALUATION VS. NEGATIVE SENTIMENT: TEVA SHOULD WORK, STICK WITH SHPGY; NKTR AT \$16 WITH EXUBERA FINALLY LAUNCHING AND STILL TOP SMALL CAP NAME TO OWN HERE**

**Summary:** Yesterday brought back the recent memory of watching the counterclockwise motion after a Chilean flush; things flow the other way in the southern hemisphere, but still go down the drain. Looking back 12 months, fundamentals (earnings visibility, new product stories, catalysts) have improved, but with a few exceptions, most stocks are cheaper today than a year ago, erasing most gains. So with history as our teacher – a slowing economy with more economists mentioning the “R” word, leading to defensive rotation which favors large caps and healthcare which includes pharmaceuticals which have generics of which the only large cap best of breed is TEVA (TEVA: Buy) (in our view) and has superior visibility and accelerating comps should be working. But TEVA is down 20% YTD (and nobody had Zocor in their model in January!) and trades at historic low multiples and superior strategic position. Nektar (NKTR: Buy) is down a full 20% since the positive FDA panel meeting a year ago today and now down for 2006 as Exubera finally gets out to diabetics this month. If saving healthcare dollars is the unifying business model which our eclectic coverage universe shares and the companies are delivering results, then why were many of these companies worth more a year ago when the risk was higher than today when risk profiles are lower? Perhaps, just a hunch on our part, the market is so forward looking that investors have correctly concluded that there simply isn’t enough money to pay for all this (even low cost generics?) and that the threshold of pain – energy + health care as percent of GDP, has hit the ceiling and that if we can’t control energy costs (not in the short run), it will have to be health care, and judging by all the traffic and near 0% unemployment where we reside, defense and new homeland security have taken billions more on Washington’s carte blanche budget.

EXHIBIT 1: PAIN THRESHOLD 25%?: HEALTHCARE AND ENERGY AS % OF GDP



Source: Centers for Medicare and Medicaid Services, Energy Information Administration

Please see the [Important Disclosures Section](#) at the end of this report.

Meanwhile, election politics will soon remind us that there are now 46 million Americans with out health care insurance and while most seniors finally signed up for Medicare Part D, millions are now finding the donut hole gap forcing thousands toward unexpected out of pocket spending whose discontent just may reach a high around the first Tuesday in November and we all know who votes most in midterm elections. So if more Americans (check out the recent polls) think the country is moving in the wrong direction – the world feels turned upside down, then maybe Congress will be upside down in November which might not be good for stocks in general. But our view remains unchanged and for investors looking at fundamentals and valuations, we believe there are plenty of compelling ideas to choose from in our industry update that follows.

**Coverage Universe Stock Performance:** For the first time in seven years, our universe of specialty pharmaceuticals has underperformed big pharma. Our year to date performance ending August 31<sup>st</sup> based on percent change of price is 6%, compared to the S&P's 4%, NASDAQ Composite's -1%, and Dow Jones Industrial at 6%. However, the American Exchange's Drug Index YTD performance is at a 9% high, helped by the investor rotation into healthcare and positive results from large cap pharma. Our large cap coverage names in TEVA and FRX (Forest Laboratories: Hold) show mixed performances, where our large cap choice TEVA has not enjoyed increase in price even with great Q2 results, while FRX gained investor confidence with what seems to be an increased competition for its flagship Lexapro franchise. After the exciting Q2 report, we would not be too surprised at the repeat performance for the next quarter for TEVA, fueled by "hidden" growth drivers which the Street might have overlooked in the vertical integration and supply chain side of the business, not to mention the ex-U.S. growth drivers. Some of the break out performance in our buy universe includes Shire (SHPGY: Buy), Andrx (ADRX: Buy), Endo (ENDP: Buy) and Emisphere (EMIS: Buy) with an average of 44%, tempered by TEVA, Durect (DRRX: Buy), Depomed (DEPO: Buy) and Acusphere (ACUS: Buy). A quick review: recent Shire settlement with Barr, delayed Exubera launch and first of a kind alcohol dependence deterrent Vivitrol all provided excitement to our portfolio, but the upcoming events to watch which could impact stocks within the year's end include the Exubera launch, Barr's merger with Pliva, NRP104 PDUFA, and finalized Andrx/Watson Pharmaceuticals merger.

## EXHIBIT 2: COVERAGE UNIVERSE

Company	Symbol	Rating	Price on 12/31/2005	Closing Price 9/7/06	YTD Perf.	Market Cap (millions)	2007 P/E Ratio	Catalyst Table	
								Positive	Negative
Teva	TEVA	Buy	\$43.01	\$34.45	-20%	\$27,266	16	Zocor/Zoloft, ex-US Growth, IVX synergies	FDA, litigation, exchange rate risk
Forest Labs	FRX	Hold	\$40.68	\$45.99	13%	\$14,897	16	Lexapro/Nemanda sales	Zocor/Zoloft eroding Lexapro sales
Shire	SHPGY	Buy	\$38.79	\$47.15	22%	\$8,480	23	NRP104 1H:07 launch, HGT pipeline	Slow rotation or launch of NRP104
Barr	BRL	Buy	\$62.29	\$53.53	-14%	\$5,858	15	Pliva deal, litigation with JNJ, Allegra D	Litigation with JNJ, AllegraD
Amylin	AMLN	Hold	\$39.92	\$45.23	13%	\$5,610	NE	Resolved supply issue, LAR formulation	Exubera, DPP4 competition
Endo	ENDP	Buy	\$30.26	\$31.69	5%	\$4,257	16	Opana launch, new CFO	Litigation risk
Watson	WPI	Hold	\$32.51	\$25.73	-21%	\$2,628	18	Merger with Andrx, Litigation wins	Continuing weak fundamentals
Andrx	ADRX	Buy	\$16.48	\$24.14	46%	\$1,781	NE	Merger with Watson	Weaker than expected sales
Alkermes	ALKS	Buy	\$19.12	\$15.52	-19%	\$1,618	NE	Vivitrol sales, AIR Insulin, Byetta LAR	Maintaining Risperdal Consta sales
Nektar	NKTR	Buy	\$16.46	\$15.97	-3%	\$1,472	NE	Exubera launch in September	Exubera supply, market penetration
New River	NRPH	Buy	\$25.94	\$22.60	-13%	\$928	23	October 6th - NRP104 PDUFA	Rotation from Adderall XR
MannKind	MNKD	Hold	\$11.26	\$18.76	67%	\$916	NE	Exubera's performance	Cash burn, product launch in 2011
Durect	DRRX	Buy	\$5.07	\$3.50	-31%	\$247	NE	Positive trial results, Opana results	Pipeline timeline and approval risk
Emisphere	EMIS	Buy	\$4.34	\$8.09	86%	\$229	NE	Multiple partnerships, increased visibility	Litigation, product approval risk
Depomed	DEPO	Buy	\$6.00	\$4.65	-23%	\$196	NE	Glumetza Sales	Proquin sales, Gabapentin approval
Acusphere	ACUS	Buy	\$5.34	\$3.21	-40%	\$92	NE	Positive RAMP2 trial results 1Q:07	Negative RAMP2 trial results
<b>Coverage Universe Average</b>					<b>3%</b>				
S&P 500			1,248.29	1,300.26	<b>4%</b>				
Nasdaq Comp.			2,205.32	2,167.84	<b>-2%</b>				
Dow Jones			107.17	114.06	<b>6%</b>				
Drug Index			319.99	347.57	<b>9%</b>				

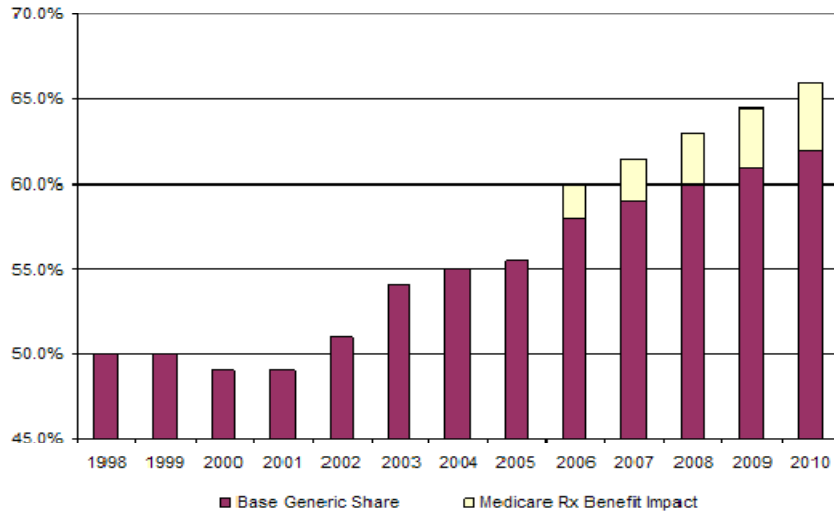
Source: First Call, Capital IQ, WR Hambrecht + Co estimates

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**TEVA (TEVA: BUY, \$34.45, \$50 PT): VALUATION CHEAP, EPS ACCELERATING NEXT FEW QUARTERS; VISIT TO LAB CHILE REINFORCES POWERFUL GLOBALIZATION THESIS WHICH MANY U.S. INVESTORS CONTINUE TO MISUNDERSTAND OR WORSE, IGNORE, IN OUR VIEW.**

TEVA remains the top strategic, global generic company, strengthened by its acquisition of IVAX, while also creating a low-cost position in the global generic market. TEVA already has 20% market share of a U.S. generic market which is accelerating to reach 60% share of all TRx. This is a tremendous phenomenon because expanding market share as industry share accelerates provides top line growth and lends stability to expanding margins even as prices erode, which is the case with generics. The low cost position of TEVA is a direct result of vertical integration and well structured global supply chain management which produced record 55% gross margins and 30% operating margins in Q2. Also, the IVAX acquisition already provides synergies according to the CEO Makov Israel, and with the successful launch of Zocor, which was the largest generic production launch to date at the end of Q2, and upcoming Zolof launch could provide a hefty one two upside to the top line. Then comes all the growth from ex-U.S. generic business which is a stealth growth driver now and a visible driver of growth in 2007 and beyond, in our view. We believe TEVA is (or should be) a core holding in a healthcare portfolio because it delivers average CAGR of 15-20% on its global best of breed generic pharmaceutical business. The world's 6 billion (not just the 5% in the U.S.) are all consuming pharmaceuticals, the vast majority generics, and TEVA can leverage its leading market share and low cost position. Wall Street's U.S. centric perspective tends to oversimplify stocks, in this case, assigning a lower P/E multiple to projected slower U.S. growth in 2007 and ignoring growth drivers in international markets that are perceived as less visible. In response to this issue, we visited the Laboratorio Chile (acquired by IVAX in 2001, now part of TEVA) which is the #1 pharmaceutical company in the strongest economy in Latin America and TEVA's most valuable strategic asset in this 400 million person emerging market where a relatively homogeneous culture favors branded generics. With 2005 sales around \$125M projected to reach around \$200M by 2010, Lab Chile represents 25% of TEVA's estimated \$500M Latin American market which TEVA management projects will double by 2010. Following our visit with Hernan Pfeifer, General Manager of Laboratorio Chile in Santiago, we conclude that there is tremendous upside to our and TEVA's projections for sales and earnings growth in Latin America. A major part of our investment thesis for TEVA is that it typically grows best when economic times are worse and particularly in a slowing economy when everybody ratchets back spending (which is where we are right now). TEVA may be one of the few stocks to own as a hedge against U.S. healthcare inflation, a slowing economy, globalization, and emerging market risk with a business model that has proven superior earnings growth in any economy in any market anywhere, in our view, especially when the stock has gained visibility while still trading at a discount compared to other names.

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**EXHIBIT 3: TOTAL PROJECTED GENERIC SHARE OF U.S. PRESCRIPTIONS**

Source: PricewaterhouseCoopers, IMS Health, WR Hambrecht + Co estimates

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**SHIRE (SHPGY: BUY, \$47.15, \$60 PT): BARR SETTLEMENT ALLOWS ADDERALL SALES INTO 2009, AMPLE TIME TO ROTATE INTO NRP104 PENDING OCT. 6<sup>TH</sup> PDUFA; HGT PROVIDES DIVERSIFICATION AND ACCRETION**

With no generic Adderall XR expected until April 2009, Shire's Adderall XR franchise is secure for nearly three more years and now 2007 formal estimates will surely come up from current consensus, in our view. We recently raised our 2007 EPS estimate from \$2.50 to \$2.75 (\$3.00 is still in the cards) and with this 10% bump raised our target price to \$60. Like John Nash, whose theory of competitive behavior and game theory won the Nobel prize for mathematics and was featured in the film *A Beautiful Mind*, this deal structure came right out of Bruce Downey's playbook which we estimate may amount to the equivalent of a 5-10% royalty, or \$0.15 to \$0.30 of EPS impact for Barr (this will likely never be disclosed, however). Essentially, Shire gets the certainty of no generic competition and allows two full years to switch to NRP104. Barr monetizes its first to file status and in this quid gets another source of very high margin revenue onto its P&L which has become less visible in light of the expected Pliva acquisition that should close in Q4. Now we think both management teams can plan accordingly and should both be able to raise guidance above expectations. With the Barr settlement behind us effectively delaying any Adderall XR generics until April 2009 and the NRP104 PDUFA date just a month away, investors should begin looking more closely at other growth drivers; more specifically, the contribution of TKT, now housed under the HGT (human genetic therapy) in Cambridge, Massachusetts. This was the objective of our visit last week which revealed near-, medium- and long-term growth potential from a unique micro specialty marketing business model that is targeting the top 50 of some 600 human genetic diseases. Given the highly targeted micro-niche specialty pharmaceutical marketing model - there are only a handful of Shire reps needed to talk with just 300 clinical geneticist specialists to get Elaprase used for the estimated 125 patients who should be entering therapy in the U.S. by early 2007; that means the usual early earnings drag from heavy SG&A spend around a new launch won't be a drag for Shire. HGT should be accretive in 2007, perhaps by around \$0.50

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in EPS or close to 20% of EPS which along with an ADHD franchise with no generic threat until 2008 appears likely to exceed our \$949M 2007 forecast and suggests that there's substantial EPS leverage in the model across the entire Shire portfolio, in our view. Considering the ominous clouds that Shire faced on its horizon just a few years ago, the strategic decisions that management made now appear likely to pay off. Recent settlement with Barr over Adderall XR is a big win for Shire and the management continues to reinvest in the business with robust spend in support of rotating Adderall XR into NRP104 in 2007. Shire launched Daytrana in June, and received FDA approval for Elaprase in July. Further, three more products are expected to launch - NRP104 (H1:07), Mesavance (H1:07), and Dynepo (H1:07), and the company remains strategically positioned for strong long-term earnings growth on its high growth product portfolio, including its Human Genetic Therapies business (TKT acquired products). We consider Shire the mid cap name to own in this space.

**BARR (BRL: BUY, \$53.53, \$75 PT): MINOR GAIN FROM ADDERALL SETTLEMENT, PLIVA MERGER MORE ON ITS MIND; WATSON WINS APPROVAL FOR GENERIC SEASONALE TODAY, FOCUSING ON ROTATION INTO SEASONIQUE**

A strong quarter with double digit increase in generic product sales and surprising out-performance by Barr's branded franchise helped to beat the FQ4 consensus EPS of \$0.73 by 3 cents, as well as our estimates on the top and bottom line. Barr's diversified product line provides it with favorable strategic position which delivers quarters like this, where increase in product revenue was due to better than expected generic oral contraceptive sales and more modest other generic product sales. Barr's settlement with Shire was also positive news, monetizing another product opportunity, though we believe Shire may be the big winner overall in this win-win scenario. Also Barr plans to convert to a fiscal year ending in December at the end of this year. Barr continues to hold a strong strategic position in the generics market, which we expect to be further strengthened by the pending Pliva acquisition in H2:06. The Pliva merger effectively doubles Barr's revenues as well as catapulting it to the #2 spot in the generics pipeline past Mylan Pharmaceuticals (MYL: Not Rated) with combined 60 ANDAs. Strategically Barr gains EU foothold in one of the fastest growing generics markets, while increasing its product diversification. In our opinion, this merger provides better strategic positioning for Barr via increased pipeline, global presence and placing it as a #2 player behind TEVA in the rapidly growing global generics market. Watson's approval of generic Seasonale puts a damper on the firm, but successful rotation into next generation Seasonique could lessen the pain. Other catalysts include litigation issues with Johnson and Johnson regarding the Ortho Tri-Cyclen Lo product, which could end up in a similar deal structure to Shire's settlement which could be a positive catalyst. Further, upcoming launch of Allegra D could add upside for the firm as well. Also, let's not forget the OTC status of Plan B, which we believe does not impact the firm financially, but may lend intangible upside to Barr. With continued strong growth expected and additional momentum from the Pliva deal further solidifying growth, we reiterate our Buy rating on BRL shares.

**EXHIBIT 4: BARR'S STRATEGIC POSITION HAS DRAMATICALLY IMPROVED;  
VALUATION SHOULD FOLLOW**

	Strategic Position	Total Rx Mkt Share	# Rxs (mlns)	Rx Growth	# Drugs Sold	ANDA pipeline		Targeted Brand sales	Replenishment Indicator	Pipeline Quality	Vertical** Integration	Global Reach	Biogeneric Score	Net Cash
						Total	Para IV*							
TEVA	9.4	6.2%	230	9%	230	141	34	84	61%	24%	1	2	29	-1.0
IVX	9.3	3.2%	94	30%	100	60	13	26	60%	22%	2	3	27	-1.0
New BRL***	8.0	2.9%	95	4%	80	60	11	20	55%	30%	1.5	1	30	0.0
Old BRL	4.7	2.5%	85	3%	68	35	10	10	51%	29%	0	0	20	0.6
MYL	3.6	5.9%	200	5%	150	41	10	32	27%	24%	0	0	12	0.0
ALO	3.3	2.2%	80	-1%	130	17	1	8	13%	6%	1	1	15	-0.7
ADRX	3.3	0.6%	<25	5%	21	25	4	10	119%	16%	1	0	8	0.3
WPI	3.1	5.2%	177	8%	150	35	1	24	23%	3%	1	0	10	-0.2
PRX	2.9	1.8%	69	13%	72	50	8	20	69%	16%	0	0	10	0.2
RDY	2.8	0.1%	<40	NA	35	39	8	22	111%	21%	0	1	8	0.2
TARO	2.7	0.7%	<20	NA	35	25	0	1	71%	0%	0	1	10	0.2
ABRX	1.2	0.4%	<10	NA	27	6	1	0.5	22%	17%	0	0	5	0.2
ELAB	1.1	0.8%	<20	NA	55	27	1	14	49%	4%	0	0	5	0.1
IPXL	0.8	0.1%	<5	NA	13	14	1	4	108%	7%	0	0	5	0.0
Average	4.0	2.3%			83	41	7	20	60%	16%				

\*\*\* with PIIva: pipeline improves, adds vertical integration with sourcing to give lower COGS, globalization and triples biogeneric capability

\* Para IV credit for first to file with likely sole exclusivity \*\* Backward (Raw materials), Forward (Distribution or marketing of branded generics)

Replenishment indicator = ANDA pipeline divided by drugs sold (no credit given for generics under development, only ANDAs filed)

Strategic Position: values pipeline quantity and quality, vertical integration, globalization, biogeneric capability and net cash

Note: Strategic position assigns no value for brand business, however brands are included in Total Rx prescription data

Source: IMS, NDC Health, Company Reports, WR Hambrecht + Co estimates

**ENDO PHARMACEUTICALS (ENDP: BUY, \$31.69, \$36 PT): KING OF PAIN DODGES A LITIGATION ARROW WITH SETTLEMENT WITH PURDUE; OPANA FRANCHISE BUILDING UP FOR AN EXPECTANT LAUNCH**

Endo's last earnings call showed strong fundamentals, with top line growth driven by its Lidoderm revenue. Last month, Endo settled a patent infringement suit with Purdue Pharma regarding Endo's sale of generic OxyContin, which will cease by the end of 2006. We believe this is a big win for Endo since it removes a litigation overhang which saved litigation expenses for a product with waning revenues. Further, Endo's focus is on the ramp up and launch of the Opana franchise, which carries high expectations for the firm. Endo revised its 2006 guidance to account for the approval and launch of Opana, raising revenues to \$880-\$910 million with Opana expected to add \$20-\$30 million to the top line. Endo sees Opana as arguably its strongest product and intends to increase resources for the launch of the franchise. With cash at the end of Q2, Endo continues to seek strategic product acquisitions to fill out its brand portfolio and further leverage its investment into its sales and marketing infrastructure, especially focusing on Opana commercialization settling an agreement with Penwest. Endo's focus is on the impending Opana launch and finding a new CFO, and Rapinyl and ketoprofen pipeline, all of which could cause ENDP to break out of the lower valuation, increasing mid cap visibility.

**AMYLIN (AMLN: HOLD, \$45.23): POSITIVE BYETTA TEST DRIVE, SUPPLY ENROUTE TO MEET DEMAND BUT PROBABLY NOT UNTIL H1:07. CAN IT STAY THE COURSE WITH EXUBERA AND DPP4 AT ITS HEELS?**

Byetta is now the 4<sup>th</sup> most prescribed diabetes treatment in the U.S, and roughly 50% of covered lives in the U.S. have access to Byetta at a favorable tier 2 reimbursement status. In light of current supply constraints relative to demand, Amylin continues its marketing activities designed to stimulate new patient starts. In its last earnings call, management reported alleviating some of the supply constraints but we do not foresee supply meeting 100% of

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demand until Q1:07 or beyond. We also estimate Byetta LAR won't be able to launch until 2010. Even if Amylin and partner Alkermes (ALKS: Buy) have completed the build out of manufacturing sites, FDA has to qualify with a PAI (pre-approval inspection) which can't even be scheduled until all the boxes have been checked internally, which most importantly includes NDA lots manufactured at this site that will be needed before the sNDA is filed. Our experience suggests this will take a few quarters. Our worldwide \$2B revenue estimate (>90% Byetta) assumes at least half all sales are LAR as conversion should be rapid. There may be a few diabetics out there who may not switch after they may pass out when they see the size of the needle to get 14 injections into one dose, but this still should be the gold standard that gets Byetta on the way to super blockbuster status, in our view. What is AMLN worth today? The question now is what should investors pay today for what's nearly four years away? Wall Street appears to have priced 2006, 2007 and 2008 sales into the stock and even 2009 EPS. Even if we felt supremely confident about Amylin hitting our newly published 2010 Byetta and EPS estimate, the valuation still appears robust considering AMLN is trading over 3 times our 2010 Byetta/LAR sales estimate (which must be shared with Lilly), and over 30 times our 2010 EPS estimate, undiscounted, not to mention the potential impact of other new product launches in the next three years including Exubera, two DP-IV inhibitors and likely a second GLP-1 entrant from Novo Nordisk around 2009. So far we have enjoyed four quarters of spectacular blissful growth and can raise our Byetta estimates based on the favorable run rate with nary a wince. But AMLN stock has long since past the best case estimates. We conclude that AMLN should remain a core holding in our "overweight diabetes" thesis, and overweight in healthcare portfolios with superior visibility, but we suspect investors may be able to add to positions at lower levels later this year once Byetta supply is bolstered and the marketing machine revs up again and we see accelerating Rx trends, which may be a few more months away. Additional diabetes entrants may crowd the market and potentially add some risk to the ramp of Byetta, and despite a robust pipeline, Amylin has a relative lack of upcoming news flow and catalysts which could provide upside potential, which caps our enthusiasm for the shares in the near term, and we maintain our Hold rating on the shares.

**WATSON PHARMACEUTICALS (WPI: HOLD, \$25.73): SMALL POSITIVE WITH GENERIC SEASONALE APPROVAL; STILL SADDLED WITH WEAK FUNDAMENTALS; ANDRX MERGER LOOMS NEAR**

Watson's weak fundamentals keep our estimates conservative, as can be seen by its last earnings call for Q2. Yes, there was some nice sequential growth from an ugly Q1, but the reaffirmed top line and EPS guidance with just four months left in the year which depends on generic Duragesic and a few other approvals that now probably won't happen isn't going to help the stock which is astonishingly trading at a higher multiple than TEVA. Wait, can that be right? Even forgiving the usual accounting gymnastics and going with the adjusted \$0.27 in Q2 and accepting management's "we have faith in FDA" strategy as CEO Allan Chao said on the call and keeping our estimates at around consensus, then WPI closed last night at -- yikes -- 18x 2006 while TEVA closed at just 16x after a blow out quarter and raised guidance. Worst in breed at 18x with deteriorating fundamentals and Best in breed at 16x. For Q3:06 we are at \$0.39, compared to the consensus at \$0.34, with our total revenue estimate at \$497 million, essentially in line with the consensus at \$478 million. We believe there is significant downside pressure on our estimates, due to lower than expected margins on distributed products as well as weak prescription trends for brand products Trelstar and Oxytrol. With expectations so low on the quarter and brand business performance, and the focus on the Andrx acquisition, the downside may be limited. While we believe the merger with Andrx could allow Watson to improve its strategic position within the U.S. generic market through

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increased share and distribution, we await improved visibility on fundamentals for both Watson and Andrx and maintain our neutral rating.

**NEKTAR (NKTR: BUY, \$15.97, \$30 PT): EXUBERA DEVICE READY BEFORE PFIZER'S OFFICIAL LAUNCH; WITH PENT UP DEMAND WE CAN PICTURE VARIOUS DIABETICS USING DEVICE IN PUBLIC VERY SOON**

Delayed launch of Exubera reduced the visibility of this name until September when the launch is expected to occur. With all the talk of round the clock manufacturing to meet pent-up demand, Nektar posted dramatically higher second quarter Exubera manufacturing revenue while incurring no Exubera royalty revenue due to the delayed launch. In accordance with its guidance, Management has also increased top line guidance. Considering NKTR stock has retreated over 25% since ADA two months ago, this upside surprise wasn't exactly priced in the stock, but with many investors tuning out after Pfizer effectively pushed the launch out by a quarter, we could jump up and down about the implications of filling the channel, but suspect the market may shrug this obvious positive inflection point and wait for the real Rx data this fall. If this is the case, there's not much point in reminding investors about the now clearly advancing pipeline with two other partner launches in 2007 and four other proprietary products (one heading into Phase 3, two into Phase 2 and another in Phase 1), but at current prices, suffice it to say that investors now get a free call option on the rest of Nektar's portfolio even under the most cynical Exubera forecasts that fall well below Pfizer's \$2-3B 2010 target. You can expect the Exubera device to be out in the market before the official launch; we can picture a wide spectrum of diabetics in the next few weeks walking around with the loaded device where we can bypass the marketing surveys and ask directly, how do you like the product? This will suffice for us for now to gauge the market penetration from the consumer side before Pfizer's and IMS data will draw a clearer trajectory of the product uptake. With this kind of scenario likely to unfold, and expected pent up demand asking for and awaiting the release of the product, an investor could enter before all the buzz starts in a few weeks prior to launch at an all time low price tied to conservative sentiment of the market.

**DEPOMED (DEPO: BUY, \$4.65, \$12 PT): GLUMETZA LAUNCH 2 DAYS AGO WITH PARTNER KING PHARMA; GABAPENTINE IN PHASE 3**

Depomed found a partner for Glumetza in King Pharmaceuticals which has commercialization expertise, and we anticipate economics of a potential deal could be far better than our 15% royalty assumption considering the product is already approved with a differentiated label. We find this marriage to be a logical one with mutual benefits where Depomed will gain sales experience to market its products on its own in the future. Emphasis is on Glumetza which actually launched today, flanked by phase 3 program for Gabapentin GR which began enrolling in May. The phase 3 trial could include 400 PHN patients, and is expected complete enrollment by year end or early 2007 with FDA filing expected in H2:08, which could impact top line in 2010. The ramp of Proquin XR has been relatively modest, but we await the impact of the expanded sales force and broadening of the target market from urologists to include Women's Health and key primary care physicians on Q3 sales. We predict increased R&D and SG&A spend will be offset by continuing milestone payments and royalties, with favorable cash position the firm will focus its efforts on the successful Glumetza launch and support. Depomed also increased its guidance on cash burn rate to \$20 million to the end of FY:06 from previous the \$17 million estimate. Current cash reserve of \$45 million will leave the company with about \$25 million at the end of 2006. We have increased our total Glumetza sales estimates up at \$150 million in 2010 from \$100 million predicated on the fact that

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Glumetza's competitive product Fortamet's sales figures of \$30 million in 2005 and expected \$50 million in 2006 utilizing 1/4<sup>th</sup> of King's sales force indicate a favorable Glumetza market penetration rate since we believe Glumetza is a viable substitute. We believe Depomed has strong earnings growth potential based on its promising product portfolio, which features two diabetes products, currently has two FDA approved products with estimated \$150 million U.S. sales potential, and a potential \$1.4 billion diabetic neuropathy product moving into phase 3 trials featuring the first potential once-daily Gabapentin. We rate the shares a Buy with a \$12 price target, which is based on 23x our 2010 EPS estimate of \$1.00 discounted annually at 25%.

**NEW RIVER PHARMACEUTICALS (NRPH: BUY, \$22.60, \$42 PT): 10% PULLBACK REPRESENTS ATTRACTIVE ENTRY POINT; FREE CALL OPTION ON IMPROVED SCHEDULING; STOCK PRICING IN APPROVAL LETTER WITH SHIRE LAUNCH IN 2007 WITH MODEST INITIAL PENETRATION.**

A potential approval for NRP104 is now just a month away, and we continue to forecast an early 2007 product launch, as Shire continues preparing for rotating Adderall XR patients to NRP104. In addition to the FDA timeline, we believe favorable results from the abuse study support an improved schedule for NRP104, which we handicap at 50:50. Beyond NRP104, New River's pipeline continues to advance with NRP409 IND filing in Q2, and NRP290's next step includes finalization of the formulation to pursue development (with and without acetaminophen), and the company is expected to request an end of phase 2 meeting with the FDA to determine phase 3 study design and regulatory strategy. Further, New River closed the sale of \$135 million convertible notes in July. New River's favorable cash position will be used to support its co-promotion activities for NRP104 and also to continue to support development of its pipeline for NRP290 and NRP409.

**Revisiting (not revising) our assumptions to consider downside:** Even our most conservative set of assumptions still implies NRPH is undervalued at these levels. Our EPS estimates of \$0.13 in 2007, \$1.87 in 2008 and \$3.25 in 2009 flow from revenue projections of \$52M, \$132M and \$269M, respectively. These assumptions capture New River's share of NRP104 which reflects a 50% chance of improved scheduling. More specifically, in our scenario where there is a delayed generic launch (that's now 100% with the Barr settlement pushing out generics until April 2009) AND a best case scheduling label, we had forecasted NRP104 2007-2009 sales of \$271M, \$775M and \$1.1B; the home-run scenario. But while the delayed generic scenario (where we were most confident all along) has played out, we still have the October 6 PDUFA risk right in front of us. Our view was, and still is, that FDA will either give full approval, with more likely an approvable letter which we view as more likely. To be conservative let's cut our delayed generic best case label scenario in half, but still assume a launch in H1:07 (Shire's most recent guidance) but factor in a slower rotation given the Barr settlement. That would take New River 2007-2009 revenue estimates down to \$38M, \$95M and \$171M (NRP104 sales of \$133M, \$378 and \$545M) respectively with our EPS estimates moving to a loss of (\$0.16), \$1.04 and \$1.71, respectively. Applying a 30 P/E multiple to this lower 2008 estimate and discount back a year by 30%, we arrive at a \$23 stock price which is about where NRPH closed last night. This suggests that the market is pricing these reduced expectations for a schedule 2 approval, a potential delay in the launch for an approvable letter, and slower rotation from Adderall XR with the upside from a schedule 3 or 4 label a free call option at these levels. All things considered, in this nervous market, this tempered outlook is more or less rational, in our view.

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**ALKERMES (ALKS: BUY, \$15.52, \$24 PT): TOO EARLY TO GAUGE VIVITROL LAUNCH; STOCK MAY BE RANGE-BOUND FOR BALANCE OF 2006**

Alkermes reported what is a fourth consecutive profitable quarter excluding stock compensation charges. For the June quarter, steady Risperdal Consta sales helped by Vivitrol revenue provided the company with \$22.2 million manufacturing revenue. Alkermes continues to have significant long-term earnings potential with multiple product growth drivers, including strong Risperdal Consta sales, Vivitrol's promising numbers, and AIR Insulin and exenatide LAR both targeting the sizable diabetes market and progressing in Phase 3. We estimate Vivitrol to ramp up sales adding to top line growth for the upcoming quarters. We are maintaining our Buy rating on ALKS shares with a \$24 price target, or 40x our 2009 EPS estimate of \$0.75 discounted back one year at 25%.

**DURECT (DRRX: BUY, \$3.50, \$10 PT): PIPELINE ON TRACK; REMOXY TO FILE IN ABOUT A YEAR; MAIN PRODUCT POSIDUR EXPECTED TO START PHASE 3 TRIAL IN H1:07; BUY ON WEAKNESS**

While earnings for Q3 are not expected to be significant, we place majority of our focus on products in development. If investors had ignored DRRX over the first half of 2006 and then looked at today's stock price, most of us would assume that there was a major setback in one of its programs. But there hasn't been. Remoxy is approaching NDA filing in about a year, Suragesic is moving toward phase 3 (albeit slower than we would like), and with Opana launched by partner Endo Pharmaceuticals (ENDP: Buy), should now move up to the top late stage pain product to launch in the late 2008 or 2009 timeframe, and SABER bupivacaine (Posidur) has emerged as the flagship Durect product as management aggressively funds this program with intentions to sell the product themselves. Posidur is expected to move into phase 3, in early 2007, and a Remoxy NDA filing is targeted in H2:07 by partner Pain Therapeutics (with King). The sufentanil transdermal patch remains in Endo's hands who has shown strong commitment to this product, ramping up manufacturing capabilities which could sufficiently support a potential launch, though we await more visibility on the clinical development plan and timeline for this product. Durect has also announced that it plans to reveal two additional new candidates this year, one of which has been revealed to be an abuse resistant opioid with Pain Therapeutics. With its advancing pipeline targeting large markets, improving visibility and multiple upcoming milestones, we believe that DRRX offers a compelling risk-reward profile. We continue to rate the shares a Buy with a \$10 price target, or 24x our 2010 EPS estimate of \$1.00 and discounted back by three years at 30%.

**EMISPHERE (EMIS: BUY, \$8.09, \$14 PT): ORAL INSULIN DATA COULD MOVE STOCK IN NEXT FEW MONTHS**

As with other developmental firms of similar size, Emisphere's quarterly earnings have little impact as of yet. We initiated coverage of Emisphere recently focusing on the pipeline and its development as well as partnerships on taking several products targeting large markets such as oral insulin, oral calcitonin. Recent settlement with Lilly (LLY: Not Rated) removes litigation overhang and award possible monetary compensation which is a considerable positive incremental in our view. We believe Emisphere has gained visibility of its proprietary drug delivery technology with recent partnerships with Novartis on human growth hormone product and positive study results for the oral calcitonin product. Currently Emisphere has oral heparin in phase 3 with oral calcitonin and oral insulin in phase 2 with the limelight on oral insulin especially with Exubera, first innovative product in diabetic care for many decades, launching this month. We estimate the parallel progression of products targeting very large markets will provide the break into positive bottom line beginning in 2010. With its advancing

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pipeline targeting large markets, improving visibility and multiple upcoming milestones, we believe that EMIS offers a compelling risk-reward profile. We continue to rate the shares a Buy with a \$14 price target, or 30x our 2010 EPS estimate of \$1.00 discounted back by three years at 30%.

**ACUSPHERE (ACUS: BUY, \$3.21, \$10 PT): LESSONS LEARNED FROM RAMP1; AI-700'S RAMP2 TRIAL ON TRACK WITH REDEFINED STUDY DESIGNS; RESULTS IN Q1:07**

While the RAMP1 data was successful on specificity and accuracy, which could be sufficient for FDA approval, the missed endpoint of sensitivity, likely due to variability among readers, is being addressed by management in designing the RAMP2 trial. With the results of RAMP2 expected in the Q1:07 timeframe, which was postponed from Q4:06 due to design considerations, NDA submission remains on track for a H1:07 timeline. Acusphere's recent cash raise provides it time to wait out RAMP2 results, which will have the benefit of lessons learned in RAMP1, with a potential partnership deal in our view not likely until these results are released. Assuming favorable RAMP2 data, the commercial potential of AI-700 as a cheaper, safer and faster alternative to nuclear stress test remains sizable, and we are encouraged by Acusphere's progress in improving RAMP2 trial design, as well as progress along other fronts including a strengthened IP position and manufacturing build out. We continue to believe that Acusphere offers an attractive risk-reward profile on the potential of AI-700 to see widespread use in the coronary artery disease diagnostic market. The key upcoming catalysts of RAMP2 data is expected by early 2007, followed by an NDA filing in H1:07. We forecast a mid 2008 AI-700 product launch driving profitability in 2008, and sales reaching \$200 million by 2010. We maintain our Buy rating on this medical device maker.

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