4 April 2013 | 35 pages

Pharmaceuticals (GICS) | Specialty Pharmaceuticals (Citi)
North America | United States

Warner Chilcott PLC (WCRX)

Nothing Some BD Can't Fix. Neutral

- Company Update
- Initiation of Coverage

- **Initiating with Neutral rating and TP of $14.50 –** While we acknowledge that the valuation of WCRX is materially lower than that of its peer group, at a 2014e earnings multiple of 4x vs. the sector average of 14x, we forecast a negative 5-year overall revenue CAGR of -5% vs. the peer group average of +7%. We prefer to remain on the sidelines pending execution on business development activities that could contribute to the company's longer term growth profile.

- **Executing against a challenging business environment –** We forecast negative 5 year ('12e-'17e) sales and earnings CAGRs of -5% for WCRX. The growth profile of the base business (ex- Actonel) will be impacted going forward by an increasingly challenging payor environment, we believe, as the company's core franchises face incremental competition from generic alternatives over the near to medium term. Our 5-year sales and earnings CAGRs for the base business are -2% and 0%.

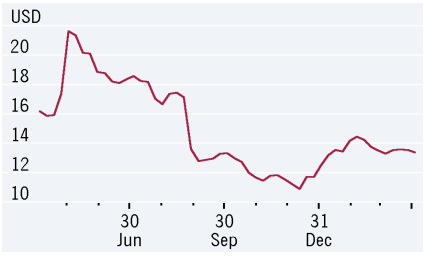
- **Asacol franchise intact, for now –** We see limited threat to WCRX's key Asacol franchise (ulcerative colitis – c.31% of 2012 revenues) over the near term. Despite the challenges associated with the development of generic mesalamines, our due diligence leads us to believe that a generic approval of Asacol is unlikely until 2H14 at the earliest. Generic Asacol, when approved, will likely negatively affect overall Asacol franchise revenues due to reimbursement pressures from managed care.

- **Business development the key to unlocking value –** WCRX generates robust free cash flows (c.$970mn in 2013e) and has the debt capacity to engage in business development activities in the range of $4-4.5bn, on our estimates. Management has indicated its willingness to acquire and/or in-license products in order to boost growth, and the company's cost base and favorable tax structure implies that a potential acquisition is likely to be value enhancing, in our view.

- **Valuation compelling, but not enough to make us buyers –** Our TP implies a target multiple of 4.4x 2014e earnings, which is a 69% discount to the peer group, however reflects the company's negative growth profile in the absence of pipeline catalysts and/or business development execution.

Neutral	**2**
Price (03 Apr 13)	US$13.40
Target price	US$14.50
Expected share price return	8.2%
Expected dividend yield	3.7%
Expected total return	**11.9%**
Market Cap	US$3,358M

Price Performance
(RIC: WCRX.O, BB: WCRX US)



EPS	Q1	Q2	Q3	Q4	FY	FC Cons
2012A	1.16A	1.03A	0.99A	0.91A	4.09A	4.09A
2013E	**0.92E**	**0.88E**	**0.86E**	**0.85E**	**3.50E**	**3.28E**
Previous	na	na	na	na	na	na
2014E	**na**	**na**	**na**	**na**	**3.30E**	**3.08E**
Previous	na	na	na	na	na	na
2015E	**na**	**na**	**na**	**na**	**3.17E**	**3.24E**
Previous	na	na	na	na	na	na

Source: Company Reports and dataCentral, Citi Research. FC Cons: First Call Consensus.

Liav Abraham
+1-212-816-1635
liav.abraham@citi.com

Nirav Jhaveri, CFA
nirav.jhaveri@citi.com

Andrew S Baum
andrew.baum@citi.com

WCRX.O: Fiscal year end 31-Dec — **Price: US$13.40; TP: US$14.50; Market Cap: US$3,358m; Recomm: Neutral**

Profit & Loss (US$m)	2011	2012	2013E	2014E	2015E
Sales revenue	2,728	2,541	2,392	2,213	2,033
Cost of sales	-356	-311	-311	-288	-264
Gross profit	2,372	2,230	2,081	1,925	1,769
Gross Margin (%)	86.9	87.8	87.0	87.0	87.0
EBITDA (Adj)	**1,380**	**1,417**	**1,204**	**1,135**	**1,086**
EBITDA Margin (Adj) (%)	50.6	55.8	50.3	51.3	53.4
Depreciation	-39	-35	-41	-48	-54
Amortisation	-596	-498	-439	-369	-291
EBIT (Adj)	**1,371**	**1,368**	**1,193**	**1,117**	**1,061**
EBIT Margin (Adj) (%)	50.3	53.8	49.9	50.5	52.2
Net interest	-340	-236	-214	-197	-181
Associates	0	0	0	0	0
Non-op/Except	-104	-153	0	0	0
Pre-tax profit	**300**	**495**	**510**	**521**	**559**
Tax	-129	-92	-112	-106	-100
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net profit	**171**	**403**	**398**	**415**	**459**
Net Margin (%)	6.3	15.9	16.6	18.7	22.6
Core NPAT	974	1,024	882	830	797

Per share data	2011	2012	2013E	2014E	2015E
Reported EPS ($)	0.67	1.61	1.58	1.65	1.83
Core EPS ($)	3.83	4.09	3.50	3.30	3.17
DPS ($)	0	0.04	0.01	0.01	0.01
CFPS ($)	4.63	3.58	3.53	3.25	3.15
FCFPS ($)	4.45	3.33	3.29	3.02	2.91
BVPS ($)	0.28	-2.40	-1.39	-0.33	0.90
Wtd avg ord shares (m)	252	248	250	250	250
Wtd avg diluted shares (m)	254	250	252	252	252

Growth rates	2011	2012	2013E	2014E	2015E
Sales revenue (%)	-8.3	-6.9	-5.9	-7.5	-8.1
EBIT (Adj) (%)	5.7	-0.2	-12.8	-6.3	-5.0
Core NPAT (%)	9.4	5.2	-13.9	-5.8	-3.9
Core EPS (%)	9.2	6.8	-14.3	-5.8	-3.9

Balance Sheet (US$m)	2011	2012	2013E	2014E	2015E
Cash & cash equiv.	616	474	727	906	1,055
Accounts receivables	266	195	197	182	167
Inventory	119	113	115	106	98
Net fixed & other tangibles	349	346	331	336	334
Goodwill & intangibles	3,449	2,846	2,437	2,098	1,837
Financial & other assets	231	244	191	177	163
Total assets	**5,030**	**4,218**	**3,998**	**3,806**	**3,654**
Accounts payable	54	29	39	36	33
Short-term debt	185	179	400	400	600
Long-term debt	3,678	3,796	3,175	2,775	2,175
Provisions & other liab	1,044	814	731	676	621
Total liabilities	**4,961**	**4,818**	**4,345**	**3,887**	**3,429**
Shareholders' equity	69	-600	-347	-82	225
Minority interests	0	0	0	0	0
Total equity	**69**	**-600**	**-347**	**-82**	**225**
Net debt	**3,246**	**3,501**	**2,848**	**2,269**	**1,720**
Net debt to equity (%)	nm	na	na	na	765.3

Valuation ratios	2011	2012	2013E	2014E	2015E
PE (x)	3.5	3.3	3.8	4.1	4.2
PB (x)	48.5	-5.6	-9.7	-41.1	14.9
EV/EBITDA (x)	5.2	4.8	5.4	5.2	4.9
FCF yield (%)	33.2	24.8	24.6	22.5	21.7
Dividend yield (%)	0	0.3	0.0	0.0	0.0
Payout ratio (%)	0	1	0	0	0
ROE (%)	nm	na	na	na	nm

Cashflow (US$m)	2011	2012	2013E	2014E	2015E
EBITDA	1,380	1,417	1,204	1,135	1,086
Working capital	179	-173	-83	-16	-16
Other	-382	-347	-233	-300	-278
Operating cashflow	**1,177**	**897**	**888**	**819**	**792**
Capex	-46	-63	-60	-60	-60
Net acq/disposals	0	0	0	0	0
Other	0	0	0	0	0
Investing cashflow	**-46**	**-63**	**-60**	**-60**	**-60**
Dividends paid	0	-1,052	-125	-129	-133
Financing cashflow	**-914**	**-978**	**-575**	**-579**	**-583**
Net change in cash	**215**	**-142**	**253**	**180**	**149**
Free cashflow to s/holders	**1,131**	**834**	**828**	**759**	**732**

For further data queries on Citi's full coverage universe please contact Citi Research Data Services at CitiRsch.DataServices.Global@citi.com
For definitions of the items in this table, please click here.

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Peer Group Analysis

Figure 1. Specialty pharma companies

Company	Market cap ($mn)	P/E		EV/EBITDA		2012-15E CAGR		2012-17E CAGR		Div. yield	FCF yield
		2013E	2014E	2013E	2014E	Sales	EPS	Sales	EPS		
US Specialty Pharma											
Warner Chilcott	$3,328	3.8	4.0	5.7	6.0	-7.2%	-8.1%	-5.2%	-5.1%	3.7%	25.1%
Allergan	$33,998	23.9	20.7	15.9	13.9	9.5%	15.1%	9.6%	15.0%	0.2%	3.5%
Endo Health Solutions	$3,721	7.5	8.6	6.3	7.2	-6.6%	-4.9%	N/A	N/A	0.0%	16.3%
Forest Labs	$9,940	40.5	23.2	169.3	18.3	3.9%	8.1%	7.1%	17.5%	0.0%	-4.3%
Shire	£11,072	12.8	11.1	9.2	8.2	6.8%	13.0%	6.1%	11.2%	0.6%	6.5%
Valeant	$22,021	12.7	10.9	13.0	11.8	13.3%	10.4%	N/A	N/A	0.0%	2.2%
Zoetis	$16,110	21.7	19.5	13.8	12.0	5.7%	15.1%	5.9%	12.8%	0.0%	2.2%
US Specialty Pharma (equal wt avg)		***15.7***	***14.2***	***11.6***	***10.6***	***5.8%***	***9.8%***	***7.2%***	***13.0%***	***0.2%***	***4.4%***

Source: Citi Research, FactSet.

Note: FCF yield defined as FCF (OCF – capex) per share divided by current price. FCF for Zoetis is from fiscal year 2013.

Note: Zoetis EPS CAGR is based on net income. Zoetis dividend yield based on Citi estimates for its 2013 dividend.

(AGN.N; US$113.82; 1); (ENDP.O; US$33.60; Not Rated); (FRX.N; US$37.40; 1); (SHP.L; £19.67; 1); (VRX.N; US$72.08; Not Rated); (ZTS.N; US$32.16; 1)

Summary and Investment Conclusion

Initiating with Neutral and TP of $14.50

Initiating coverage with a Neutral rating and a Target Price of $15. Our near-term projections are 2%-7% ahead of the Street; however, we see limited upside to current valuation levels in the absence of business development activities that could unlock value. We forecast 3-year sales and earnings CAGRs of -7% and -8%, while our sales and earnings CAGRs ex-Actonel (20% of group revenues in 2014), which loses exclusivity in June 2014, are -2% and -1%, reflecting the incremental generic and/or competitive pressures that the company faces going forward.

Our TP of $14.50 is based on a target multiple of 4.4x 2014e cash earnings, which is materially lower than that of the peer group, however adequately reflects the uncertainty regarding the longer term growth profile of the company. We acknowledge the company's robust cash flow generation and manageable debt levels (debt/EBITDA of 2.8x at YE'12) as important in providing management with the flexibility to undertake business development activities; however, we prefer to remain on the sidelines pending execution on potential transactions.

Figure 2. Our near-term projections are ahead of consensus

($ in milllions, except per share data)

	2013E	2014E	2015E	2016E
Sales				
Citi	$2,392	$2,213	$2,033	$1,973
Consensus	$2,345	$2,142	$2,063	$2,168
% Difference	*2.0%*	*3.3%*	*-1.5%*	*-9.0%*
Operating Income				
Citi	$1,193	$1,117	$1,061	$1,044
Consensus	$1,216	$1,113	$1,141	$1,350
% Difference	*-1.9%*	*0.4%*	*-7.0%*	*-22.7%*
Adjusted cash net income per share (non-GAAP)				
Citi	$3.50	$3.30	$3.17	$3.20
Consensus	$3.28	$3.08	$3.26	$3.59
% Difference	*6.8%*	*7.1%*	*-2.8%*	*-11.0%*

Source: Citi Research, FactSet.

We see two key debates in the investment thesis for Warner Chilcott:

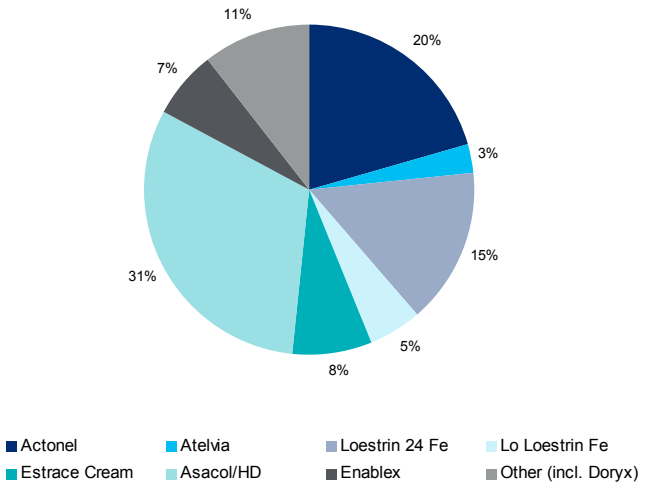
(1) What is the growth profile of the company's core franchises (ex-Actonel)?

(2) What is the timing/outlook for pipeline and/or business activity, which could boost the company's long-term sustainable growth profile?

Navigating an increasingly challenging business model. We note management's success in executing on its key business objectives thus far; however, we view the company's strategy of (i) life-cycle management of core assets; and (ii) incremental growth through pipeline opportunities and/or business development execution as increasingly challenging going forward. We see three reasons for this:

(i) **WCRX's core franchises are facing incremental generic pressures over the near to medium term.** Actonel (osteoporosis), Asacol (ulcerative colitis), Doryx (acne), and Loestrin 24 (oral contraceptive), which together accounted for c.70% of group sales in 2012, are all either currently facing generic competition, or are anticipated to face incremental generic competition over the next 12-24 months, in our view. While the growth profiles of Asacol/Delzicol, Doryx and the company's women's health franchises are likely to be positive over the near to medium term, we are concerned that an incrementally onerous US payor environment will limit the growth potential of these franchises going forward as generic competition intensifies. We forecast a 3-year revenue CAGR of -2% for the company's core franchises (ex-Actonel).

Figure 3. WCRX sales breakdown by product category (2012)



Source: Citi Research, Company financials.

Figure 4. Declines in key franchises are driving overall sales decline

($ in millions)

	2012	% of sales	2017E	% of sales
Actonel (osteoporosis)	$519	20.4%	$90	4.6%
Atelvia (osteoporosis)	$72	2.8%	$128	6.6%
OC's (incl. Loestrin 24 Fe / Lo Loestrin Fe)	$526	20.7%	$626	32.2%
Estrace cream (hormone therapy)	$194	7.6%	$291	15.0%
Other women's health	$115	4.5%	$91	4.7%
Women's health	$1,426	56.1%	$1,225	63.0%
Asacol/HD/Delzicol (ulcerative colitis)	$793	31.2%	$368	18.9%
Doryx 150	$92	3.6%	$25	1.3%
Dermatology	$92	3.6%	$204	10.5%
Enablex (overactive bladder)	$170	6.7%	$38	1.9%
Urology	$170	6.7%	$119	6.1%
Other	$60	2.4%	$28	1.5%
Total	$2,541		$1,944	

Source: Citi Research.

Note: Pipeline sales added to respective therapeutic areas on a risk-adjusted basis.

Figure 5. We project a modest decline in the core business (excluding Actonel) through 2017e

($ in millions)	2010	2011	2012	2013E	2014E	2015E	2016E	2017E	3-Year CAGR ('12-'15E)	5-Year CAGR ('12-'17E)
WCRX revenue	$2,974	$2,728	$2,541	$2,392	$2,213	$2,033	$1,973	$1,944	-7.2%	-5.2%
Actonel revenue	$1,027	$771	$519	$329	$207	$124	$105	$90	-37.9%	-29.6%
Core revenue	**$1,947**	**$1,957**	**$2,022**	**$2,064**	**$2,005**	**$1,909**	**$1,868**	**$1,855**	**-1.9%**	**-1.7%**
WCRX net income	$890	$974	$1,024	$882	$830	$797	$804	$790	-8.0%	-5.1%
Actonel NOPAT	$509	$397	$276	$173	$110	$68	$58	$50	-37.4%	-29.1%
Core net income	**$381**	**$576**	**$748**	**$708**	**$720**	**$730**	**$746**	**$740**	**-0.8%**	**-0.2%**

Source: Citi Research, Company financials.

We view the potential approval of generic Asacol (the company's largest single franchise, representing 31% in group revenues in 2012) as the most material near to medium term risk. The IP on Asacol 400mg expires in July 2013, and while we do not anticipate generic competition during 2013, we believe that multiple companies are actively pursuing generics. The FDA's response to WCRX's Citizen Petition on Asacol in August 2010, coupled with the draft guidelines for the development of generic mesalamines released in September 2012, indicate the Agency's more lenient approach towards the development requirements for approval of generic mesalamines (bioequivalence studies vs. clinical endpoint studies previously). While we continue to believe that the development of generic mesalamines is a complex and costly process, we note the increasing success of generic companies in obtaining approvals for more complex products, and anticipate that a generic version of Asacol could be approved by the FDA in 2H14.

(ii) **The company's pipeline will likely only yield material revenue opportunities from 2015e at the earliest.** Key disclosed assets in development include two novel oral contraceptives, udenafil (erectile dysfunction), and a novel once-daily tetracycline (serocycline) for the treatment of acne. The most material of these opportunities are udenafil and the novel tetracycline, in our view, however, with udenafil only expected to be filed with the FDA in early 2014e, and the novel tetracycline expected to begin late-stage clinical development in 2H13, these assets will only translate into revenue opportunities from 2015e at the earliest.

(iii) **Business development activity represents the most meaningful source of unlocking near-term value, but visibility limited.** WCRX management has a history of creating shareholder value by executing on acquisitions, both in existing and new therapeutic areas, in order to contribute to the company's growth profile. The company's robust cash flows and target debt capacity support business development activities in the range of $4-4.5bn (Enterprise Value), and would likely leverage the company's existing 700-territory salesforce. This, coupled with WCRX's favorable tax structure (the company is domiciled in Ireland, and has recently extended its APA agreements to ensure its low effective tax rate of c.11-12% is maintained through 2017, at least) implies that a potential deal would likely be value enhancing, in our view.

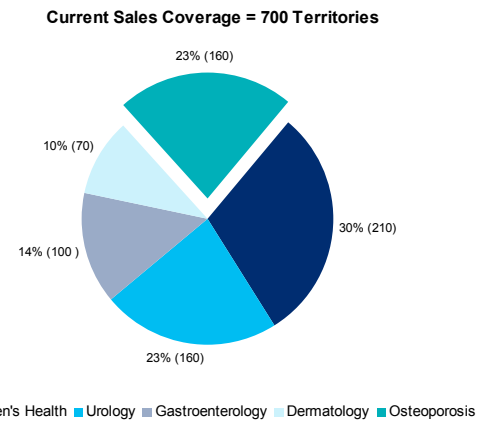
Figure 6. Acquisition multiple at 10x EBITDA and pro forma leverage of 4.5x implies a $4-$4.5bn target

($ in millions)

		Comments
WCRX (acquirer) contribution	2.15x	WCRX debt as a multiple of pro forma EBITDA
Target asset contribution	2.35x	Target debt as a multiple of pro forma EBITDA
Pro forma leverage target	**4.50x**	WCRX stated pro forma leverage target (all-debt deal)
WCRX EBITDA	$1,417	WCRX EBITDA at YE2012
Target EBITDA	$435	Assumed EBITDA plug at 10x EV/EBITDA price
Pro forma EBITDA	$1,852	
Acquisition related-debt	**$4,350**	Assumes all-debt deal at 10x EV/EBITDA price
WCRX debt	$3,975	WCRX debt at YE2012
Pro forma debt	$8,325	

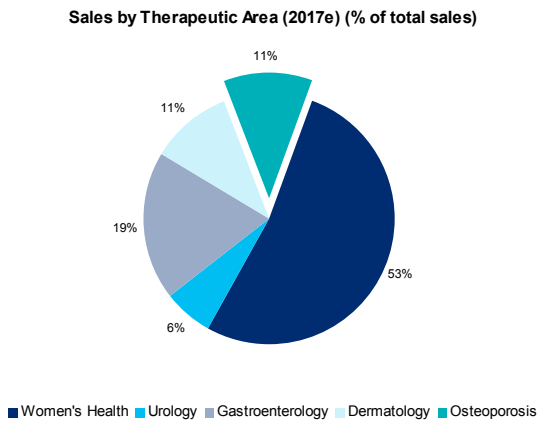
Source: Citi Research

Figure 7. Possible excess capacity in osteoporosis sales force as Actonel goes generic



Source: Citi Research, Company.

Figure 8. Sales focus could be re-diverted to growing women's health and dermatology franchises



Source: Citi Research.

Valuation attractive, but insufficient to justify a Buy rating, by our measures. Based on our analysis, WCRX trades at 4.0x 2014e net cash earnings, a 72% discount to the peer group, with a 3-year earnings growth profile of -8% vs. the peer group average of 10%. Excluding Actonel, the company's 3-year earnings CAGR is -1%. Our Target Price of $14.50 implies a target 2014e multiple of 4.4x. The steep discount in valuation vs. the peer group represents in part the lack of visibility regarding the long-term growth profile of the company, in our view, and we prefer to remain on the sidelines pending additional color on pipeline opportunities and/or execution on business development activities.

Figure 9. Limited near-term catalysts – waiting for pipeline/business development execution

Date	Product	Comment
1Q 2013	WC3043 (udenafil)	Phase III trials expected to complete for Udenafil for treatment of erectile dysfunction
03 Dec 2013	Atelvia	Pre-trial conference call for WCRX's Atelvia patent infringement suit vs. ACT (FTF) at 3:00pm
4Q 2013	Enablex	WCRX expected to assume full manufacturing control (from NVS)
2H 2013	WC3035 (serocycline)	Expected to initiate Ph-III trial for WC3035 (novel tetracycline) in 2H 2013
2H 2013	WC3055 (udenafil)	Phase II trials could initiate in 2H13
2013	Oral contraceptives (pipeline)	Could potentially launch 1 or 2 oral contraceptives in 2013
Jan 2014	Asacol (400 mg)	Expiration of patent (U.S.) (assuming pediatric extension)
Jan 2014	Loestrin 24 Fe	Potential Actavis launch of generic (settlement with WCRX)
Jun 2014	Actonel	Expiration of patent (U.S.)
2014	WC3043 (udenafil)	Expected to file NDA for Udenafil
01 Jan 2015	Actonel	Expiration of collaboration agreement with SNY
2015	WC3035 (serocycline)	Expected to file NDA for Serocycline
2015	WC3043 (udenafil)	Potential launch of Udenafil for treatment of erectile dysfunction
Jun 2016	Enablex	Loss of exclusivity for Enablex, assuming ped. exclusivity (settlement with Teva, Actavis and Anchen)
2016	WC3035 (serocycline)	Potential launch of Serocycline

Source: Citi Research, Company filings

Risks

Downside risks:

- **Approval of generic Asacol in mid-2013.** Although Asacol 400mg loses patent exclusivity in July 2013, due to the complexity and extensive time involved in the formulation and approval of generic mesalamines (see Section titled "**Asacol Franchise: Fine For Now…**" below), current expectations are that a generic version of the drug will not be approved in 2013. Our base case assumption assumes approval of generic Asacol towards the back half of 2014. We understand that multiple generic companies are pursuing this opportunity, however given the lack of paragraph IV applications on Asacol 400mg, we note the lack of visibility surrounding the timing of a potential generic approval. While we do not anticipate multi-source generics for Asacol given the complexity in developing the drug as noted above, approval of a generic version of the drug from mid-2013 still implies c.7% downside to our NPV/share.

- **Generic Estrace cream in 2015e.** Estrace cream is currently a $200mn franchise for WCRX, with no patent protection (IP on the product expired in March 2001). We note the complexity in the development of generic creams, as well as the limited visibility into generic companies' development progress in this regard. Our base currently assumes lack of generics of Estrace going forward, however approval of generics in 2015e implies c.21% downside to our NPV per share, given our assumed profitability contribution of the product.

- **Pipeline failures.** WCRX currently has several disclosed assets in late-stage development (2 oral contraceptives, udenafil for erectile dysfunction, and serocycline for acne). We currently expect potential approval of udenafil in early 2015, and model $135mn in risk-adjusted peak sales for the compound. Lack of approval of udenafil implies c.11% downside to our NPV/share.

Upside risks:

- **No generic Asacol until 2017e at the earliest.** As noted above, although Asacol 400mg loses patent protection in mid-2013, there is lack of visibility regarding generic companies' development timelines for approval of a generic version of the drug. Despite the fact that generic companies have been working on formulating generic mesalamines for several years, the high variability of the compound implies that the development hurdles remain high, and that it could take several more years before a generic is approved. Approval of generic Asacol in 2017e, vs. our base case assumption of late 2014e/early 2015e, implies c.17% upside to our NPV/share.

- **Business development activities with an annual contribution of $100mn to group sales.** We see material potential upside in business development activities that WCRX could potentially undertake to boost its longer term growth profile. The in-licensing of a product that contributes $100mn to group sales implies c.13% upside to our NPV, assuming an EBIT margin of 60% and the company's low tax rate of 11-12%.

- **Success of pipeline assets.** The potential approval of WCRX's two novel oral contraceptives, udenafil, and serocycline, implies c.13% upside to our NPV/share, due to the de-risking of these assets in our financial model.

Valuation

Our Target Price of $14.50 reflects a 4.4x 2014e earnings multiple, a 69% discount to the peer group average of 14.2x. This discount is based on negative '12e-'15e revenue and earnings CAGRs of -7% and -8%, vs. the peer group averages of 6% and 10%, respectively. Excluding Actonel, which generated c.310mn in revenues in 2012 (c.26% of group revenues) and loses exclusivity in June 2014, we forecast 3-year revenue and earnings CAGRs of -2% and -1%.

Our DCF-derived Intrinsic Value is $20 per share. We project free cash flows for an explicit period of 10 years, and thereafter apply terminal growth assumptions. We make use of the CAPM to calculate the cost of equity, and employ a WACC of 8%. The key differences between our multiple-based and DCF valuations stem from (i) WCRX's robust and consistent free cash flow generation, despite the declining revenue and earnings profile, and (ii) the company's pipeline opportunities, which are not factored into our 2014e revenue or earnings estimates.

Actonel, although a declining asset, represents significant cash flow for the company, which supports future business development activities, in our view. We note that the DCF-derived intrinsic value of the base business (ex-Actonel) still implies a valuation above the current stock price. Despite this, we anticipate the stock will trade sideways pending execution on business development opportunities that could boost the longer term growth profile of the company.

Figure 10. Core business (ex-Actonel) still implies DCF value above current stock price

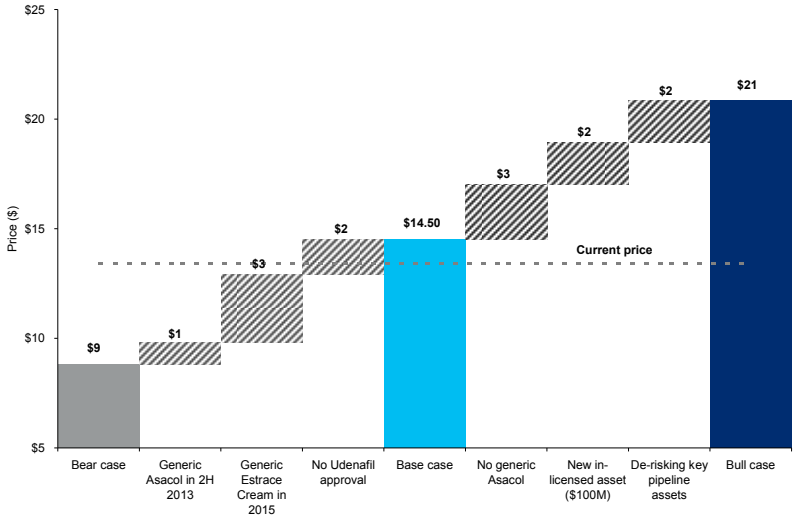
($ in millions)

Valuation (core business) - implied DCF value	
Firm value (DCF analysis)	$8,521.6
- Actonel NPV value	($529.5)
Residual firm value	$7,992.0
- Net debt	($3,501.0)
Equity value	$4,491.0
Diluted share count	251
Implied DCF value per share	**$17.91**

Source: Citi Research

Note: Actonel calculations do not include Atelvia or any follow-on products.

Figure 11. Bull-bear scenarios



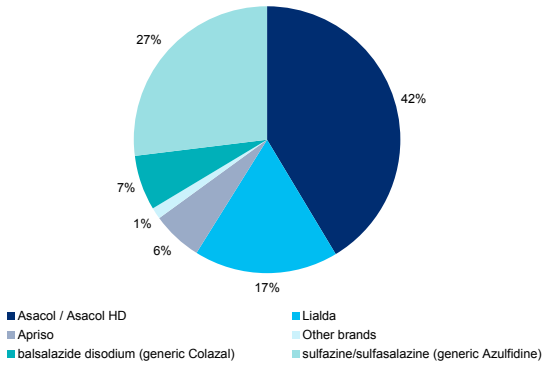
Source: Citi Research

Asacol Franchise: Fine For Now…

We believe the majority of WCRX's Asacol 400mg franchise will be transitioned to Delzicol by YE'13. Longer term, we believe generic Asacol could be approved in 2H14, negatively impacting Delzicol sales.

Warner Chilcott's Asacol franchise, consisting of Asacol, Asacol HD and the recently approved Delzicol, represented 31% of the company's group revenues in 2012. Although Asacol (which we estimate represents approximately 2/3 of the franchise), loses IP protection in mid-2013, we see limited threat of generic competition over the near term, due to the formulation complexity and regulatory hurdles involved in the development and approval of generic mesalamines. We assume that the company will succeed in transitioning the large majority of Asacol patients to Delzicol by the end of 2013. Longer term, based on the FDA's response to WCRX's Citizen Petition with respect to Asacol in August 2010, along with the draft guidelines for the approval of generic meslamines published by the FDA in September 2012 and due diligence with formulation experts, we assume that Asacol generics could be approved by the FDA in 2H14. Due to the anticipated formulary pressures on mesalamine pricing and reimbursement, we anticipate that the approval of generic Asacol will negatively impact Delzicol sales. We model a decline in Asacol franchise sales from 2015e, however acknowledge the limited visibility in accurately forecasting the probability and timing of this event.

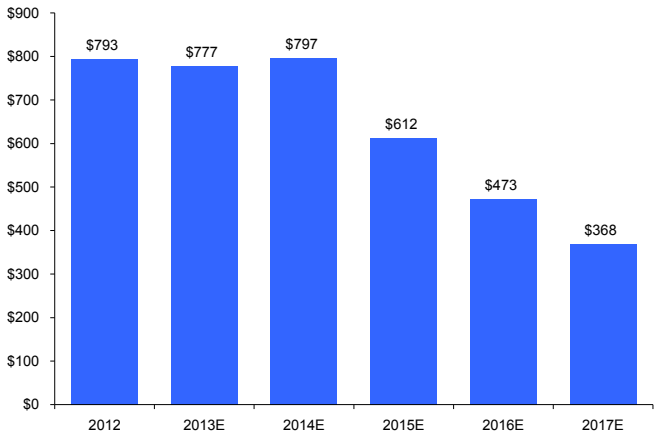
Figure 12. Asacol franchise's leading share of the US mesalamines market has remained stable over time



Source: IMS Health.

Note: Data shown represents LTM TRx market share.

Figure 13. We project a gradual decline for the Asacol franchise from 2015e



Source: Citi Research

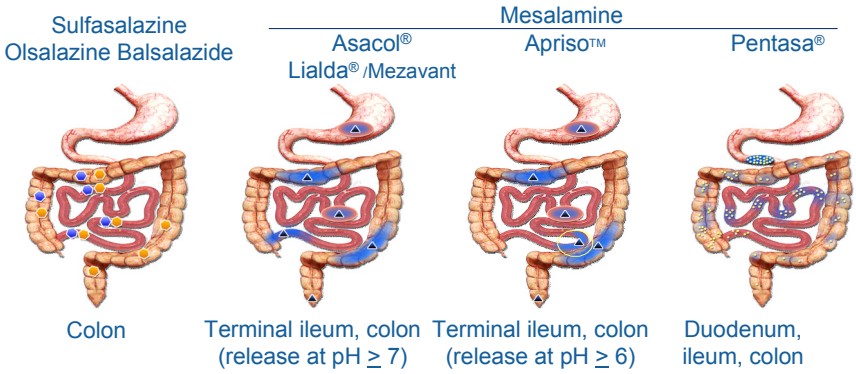
Note: Data shown represents global Asacol sales.

Potential approval of generic Asacol is the most material earnings risk to WCRX, in our view

The prospect of generic Asacol approval is the greatest risk to Warner Chilcott's near and medium term earnings outlook, in our view. Although the bar for the approval of generic mesalamines has been lowered since the FDA's response to WCRX's Citizen Petition regarding Asacol (August 2010), the hurdles for the approval of generic mesalamines by the FDA's Office of Generic Drugs still remain high, but not unattainable. The draft guidelines for the approval of generic mesalamines issued by the FDA in September 2012 recommend a clear regulatory pathway for the approval of generic mesalamines, which includes two primary components: (i) in vitro dissolution studies at varying pH rates; (ii) in vivo crossover bioequivalence studies. This is in line with the Agency's response to WCRX and Shire's respective Citizen Petitions pertaining to Asacol and Pentasa in August 2010. Due diligence with formulation experts indicates that the hurdles likely to be faced by generic companies will be in achieving a formulation that will meet the latter of these two requirements, due to the highly variable nature of the compound,

which affects the reproducibility of the results. We note the FDA's approval of other complex extended release compounds recently, including generic Adderall XR (Actavis, Teva) and generic Concerta (Mallinckrodt).

Figure 14. Asacol has a ph-dependent release (pH ≥ 7) that delivers the drug in a targeted fashion to the terminal ileum and colon



Source: Citi Research, UPenn School of Medicine adaptation of Baumgart DC, Sandborn WJ. Lancet. 2007;369:1641-1657

FDA draft guidance for the development of generic mesalamines recommends in-vitro dissolution studies and in-vivo crossover bioequivalence studies.

FDA's stance on the requirements for the development of generic mesalamines has softened over the years. While earlier FDA guidance had suggested that clinically endpoint studies might be more appropriate for showing bioequivalence given the difficulty in measuring and comparing absorption with locally-acting oral mesalamine drugs, as of 2010 the Agency has moved towards a different recommended protocol. In an August 2010 response to WCRX and Shire petitions, the FDA revisited its stance on the usability of PK data and determined that if it were taken over different points in time, it could simulate a PK profile useful for assessing bioequivalence. In addition, the agency reaffirmed its prior stance on the need for in-vitro dissolution data. Notably, it moved away from the usefulness of clinical endpoint studies, noting they could be "less sensitive, accurate, and reproducible than PK studies." Subsequent communications reaffirmed the usefulness of in-vitro dissolution and PK studies, which crystallized into formal draft guidance in September 2012 (see Figure 16 below).

In a March 2013 response to a subsequent Citizen Peitition filed by WCRX in October 2012 in response to the draft guidelines issued by the FDA, the Agency reaffirmed many of the points stipulated in its earlier guidance. In addition, it clarified that (i) longer sampling times may be formally recommended for Asacol HD dissolution data (to be outlined in separate draft guidance). Asacol HD loses IP protection in November 2021; (ii) generic bioequivalence studies may require a larger subject population when utilizing a reference-scale approval for generic Asacol/Asacol HD, given that within-subject variability is greater than 100%. This reaffirms our stance regarding the complexity involved in the formulation and development of generic mesalamines.

Figure 15. FDA's stance on the requirements for generic mesalamines has softened over the years, from clinical endpoint studies to bioequivalence studies that are currently required

Point of Communication	FDA Guidance
2003 Guidance	● Bioequivalence for oral locally-acting GI drugs could be shown using comparative clinical endpoint studies
2004 and 2005 responses to Shire's Citizen Petition	● After CDER Adcom recommendation, FDA concluded that in vitro dissolution, coupled with comparative PK studies (fasting and fed) required to demonstrate bioequivalence
2007 OGD letter to Shire	● Indicated that data from PK studies may not be good proxy due to variability of site-specific and systemic absorption ● Recommended that clinical endpoint studies (rather than PK studies), in addition to in vitro dissolution studies, for oral, extended-release mesalamine drugs
August 20, 2010 response to WCRX and Shire Citizen Petitions	● Reiterated 2007 position on in vitro dissolution data ● FDA revisited previous stance on PK data and said that PK data over defined time intervals (rather than static data) could be used to analyze PK profiles ● Moved away from recommending clinical endpoint studies, stating that they could be "less sensitive, accurate, and reproducible than PK studies"
July 2011 research report	● Par indicated that FDA had provided verbal feedback that clinical trial data could be sufficient and PK data may not apply for its generic Asacol 400 ANDA
November 2011 response to WCRX Citizen Petition	● FDA agrees to require all generic applicants to adhere to outlines from August 2010 response ● However, FDA does not comment on whether Par's ANDA is approvable
September 2012 Draft Guidance	● FDA provides guidance on one in-vitro dissolution study and two PK studies (fasting and fed) ● Alternatively to PK studies, a reference-scaled bioequivalence study can be used (if high in-subject variability is shown for the RLD)
November 2012 response to Shire Citizen Petition	● FDA denies Shire's request to review previous FDA guidance and require clinical endpoint studies
March 2013 response to WCRX Citizen Petition	● FDA reiterated position on majority of existing guidance ● FDA noted that in-vitro dissolution data for Asacol HD may require longer sampling times (already in consideration for pending Asacol HD draft guidance) and noted that within-subject variability of greater than 100% using a reference-scaled bioequivalence study may require more subjects to adequately power the study

Source: Citi Research, FDA.

Figure 16. Current FDA guidelines for oral mesalamines recommend PK and dissolution (but no clinical endpoint) studies

Type of Study	Parameters Measured
Pharmacokinetics (fasting)	● Single-dose, partially or fully replicated crossover design, in vivo ● Recommended PK parameters: log AUC_{8-48}, AUC_{0-t} and C_{max} (where t ≥ 72 hours) ● Reference-scaled average bioequivalence study can be used (if high in-subject variability ≥ 30% can be demonstrated for RLD)
Pharmacokinetics (fed)	● Single-dose, partially or fully replicated crossover design, in vivo ● Recommended PK parameters: log AUC_{8-48}, AUC_{0-t} and C_{max} (where t ≥ 72 hours) ● Reference-scaled average bioequivalence study can be used (if high in-subject variability ≥ 30% can be demonstrated for RLD)
In-vitro dissolution	● Evaluation at pH 4.5, pH 6.0, pH 6.5, pH 6.8, pH 7.2 and pH 7.5 ● Sample measurement times: 0, 10, 20, 30, 45, 60, 75, 90, 120 and 150 minutes ● Dissolution profiles compared using f2 metric

Source: Citi Research, FDA.

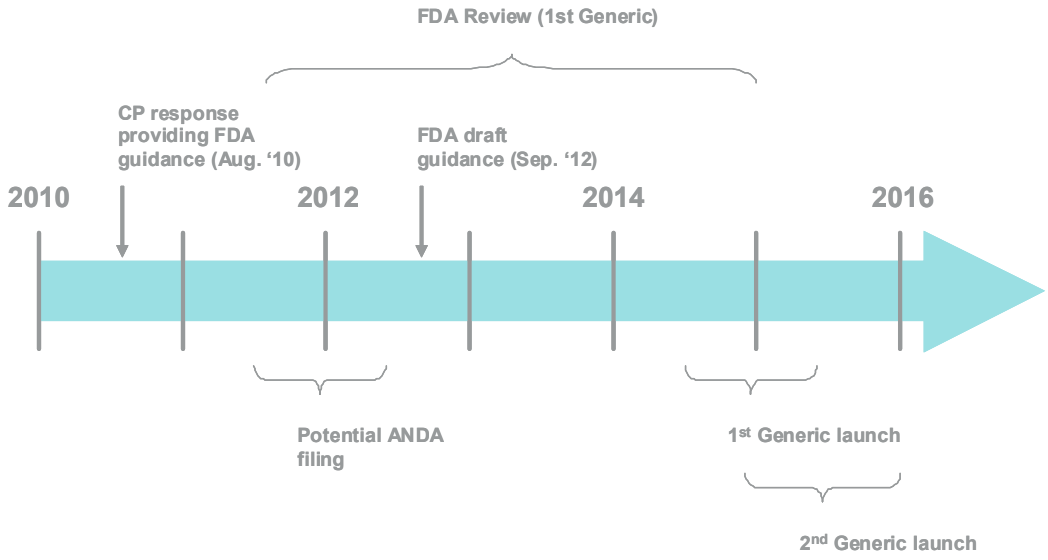
Figure 17. Generic Asacol legal processes dropped

Product	Company	Patent Expiry	Generic Challenger	Patent Litigation Status
Asacol	Warner Chilcott	Jul. 20, 2013	Roxane	Dropped its marketing approval in Dec. 2011
			Par	Dismissed; application switched to Paragraph III certification
Asacol HD	Warner Chilcott	Nov. 15, 2021	Zydus	Discovery
Lialda	Shire	Jun. 8, 2020	Zydus Cadila	Case is administratively closed
			Osmotica	Claims contruction hearing on Mar. 14-15, 2013
			Watson	Jury trial scheduled for Apr. 8, 2013
			Mylan	Bench trial scheduled for Jun. 2014
Pentasa	Shire	Expired	N/A	N/A
Apriso	Salix	Apr. 20, 2018	Lupin	Bench trial scheduled for Sep. 16, 2014

Source: Citi Research, PACER.

Likelihood of generic Asacol increases from the second half of 2014, we believe. Although there are currently no paragraph IVs that have been filed on the Asacol 400 formulation given the pending loss of patent protection (one paragraph IV certification was converted into a paragraph III certification), we believe that multiple generic companies are pursuing this opportunity, including Zydus, Cadila, Actavis, Mylan and Par Pharmaceuticals. Based on a development timeline of 12-18 months, and ANDA approval timelines of c.30 months, we anticipate that the first generic version of Asacol could be approved towards the back half of 2014.

Figure 18. Based on timing of FDA guidelines, we model the first Asacol generic entering the market in early 2015



Source: Citi Research

Delzicol will aid in protecting Warner Chilcott's Asacol franchise… Warner Chilcott's recently approved Delzicol offers some benefits over Asacol (capsule formulation, improved pregnancy warning on the label). Based on our conversations with managed care organizations, we believe that the company will encounter little difficulty in gaining formulary access (the company will be withdrawing Asacol 400mg from the market). We forecast that the large majority of Asacol patients will be converted to Delzicol by the end of 2013, prior to the potential approval of generic Asacol 400mg.

…however generic Asacol, when approved, will negatively impact Delzicol sales. Conversations with managed care lead us to believe that WCRX's Asacol franchise, and in particular Delzicol, will be negatively impacted by the approval of generic Asacol. Given the limited differentiation between Asacol 400mg and Delzicol, formularies are likely to promote usage of generic Asacol by limiting reimbursement to the higher priced branded product. We forecast a decline in Warner Chilcott's Asacol franchise sales from 2015e, however note the difficulty in accurately predicting the exact timing and magnitude of the impact of this event on group revenues and earnings.

Limited Pipeline Visibility

WCRX's disclosed key pipeline assets include 2 OCs, udenafil and serocycline

Warner Chilcott's pipeline strategy is focused on lifecycle management of its existing product portfolio. While the company typically does not provide much disclosure regarding its pipeline assets under development, recent comments from the company indicate at least 4 assets in mid- to late-stage development. Of these, we view udenafil (erectile dysfunction) and serocycline (acne) as the more meaningful potential opportunities, however anticipate that these will only translate into revenue opportunities by 2015e, at the earliest. The nearest term potential opportunities lie in two oral contraceptive products (NDAs filed with the FDA), at least one of which could be approved by the FDA during 2013.

Figure 19. Four identified late stage pipeline assets that could boost near- to mid-term growth

Identified late-stage opportunities

Asset	Indication	Phase of development	Launch year	Peak sales ($M)	Risk adjustment	Risk-adjusted peak sales ($M)	Partner
One / two oral contraceptives	Contraception	Potentially filed	2014	$150	83%	$125	
WC3035 (serocycline)	Acne and rosacea (U.S.)	Phase II	2016	$200	22%	$44	Paratek
WC3043 (udenafil)	Erectile dysfunction (U.S.)	Phase III	2015	$250	54%	$135	Dong-A

Early-stage / unconfirmed opportunities

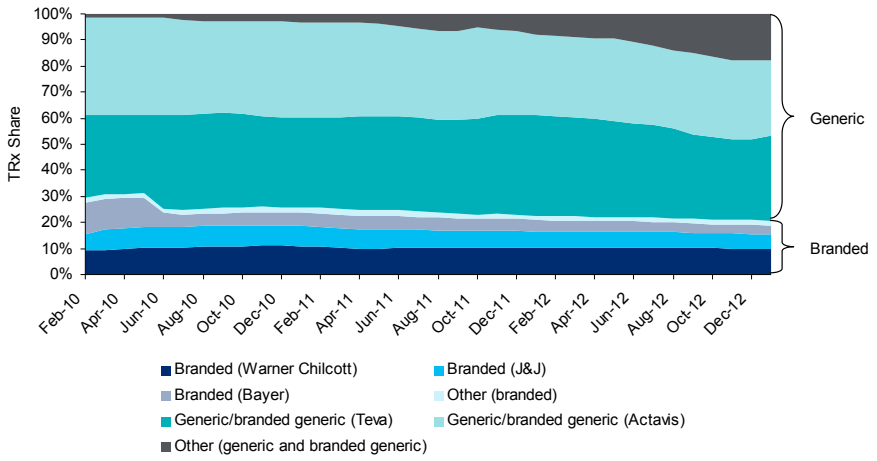
Asset	Indication	Phase of development	Launch year	Peak sales ($M)	Risk adjustment	Risk-adjusted peak sales ($M)	Partner
WC3055 (udenafil)	Lower UTI (U.S. and Canada)	Phase I	2015+	$100	15%	$15	Dong-A
Doryx (new formulation)	Severe acne (U.S.)	Potentially filed	2013	$200	83%	$166	
WC3036	Erectile dysfunction (U.S.)	Non-approvable letter	2015+	$150	54%	$81	Apricus
Asacol (next-generation products)	Ulcerative colitis	N/A	2015+	$100	0%	$0	

Source: Citi Research, Company filings.

Novel OCs, if approved, will compete in an increasingly generic market

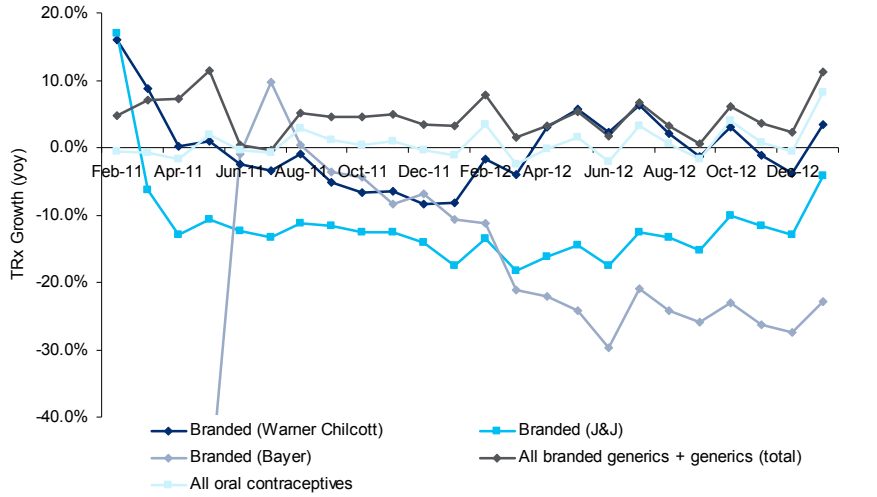
Novel oral contraceptive could be approved this year, but limited opportunities for material incremental market share gains in an increasingly generic market. While Warner Chilcott's branded oral contraceptive products have brought innovation to the OC market (by introducing the 24-day active pill cycle, as well as an oral contraceptive pill that offers women the lowest estrogen dosage on the market) and have enabled the company to maintain largely stable market share in an increasingly generic market (see Figure 20 and Figure 21), we see limited material upside to the company's overall OC scrip volumes going forward. We anticipate that the company's novel OC products will be aimed at lifecycle management of the "Loestrin 24" brand (which loses exclusivity in January 2014), however the ongoing genericization of the overall OC market (see Figure 20) will make it challenging for the company to materially increase overall market share over the foreseeable future, in our view.

Figure 20. Branded OC market share is gradually eroding over time as branded generics arrive in the market



Source: IMS Health

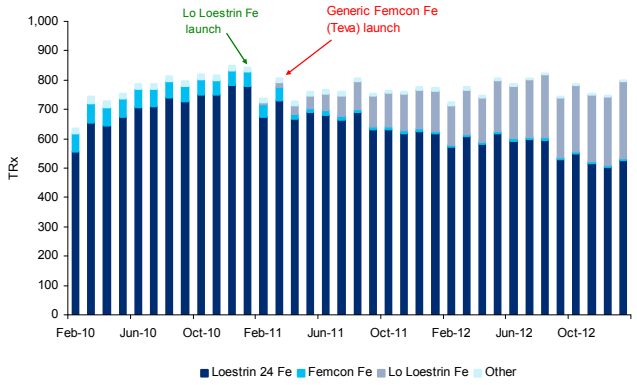
Figure 21. WCRX OC franchise script trends grew 1% in 2012, while overall brands declined by -9%



Source: IMS Health

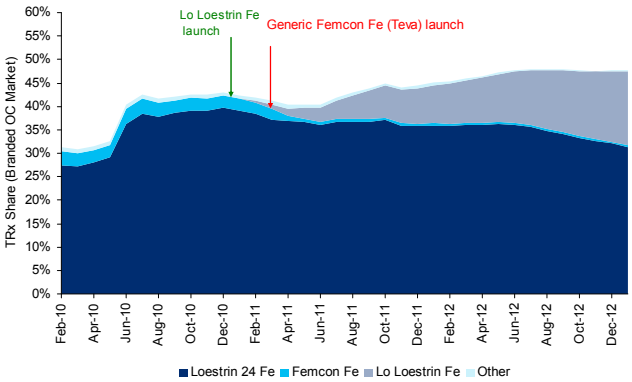
Physician feedback on WCRX's oral contraceptive products positive, but reimbursement in an increasingly generic market remains the key challenge for branded players. Conversations with multiple physicians in the women's health space indicate their satisfaction with WCRX's Loestrin 24 and Lo Loestrin, however the out-of-pocket cost of WCRX's products remains a barrier for the majority of women. (Loestrin 24 and Lo Loestrin are priced 5-6x higher than branded generic options available). Thus far, WCRX has successfully utilized its dedicated women's health salesforce (200 people), along with discounts through customer loyalty programs to maintain, and even slightly increase, market share in the overall OC market (see Figure 23).

Figure 22. Lo Loestrin Fe script growth has only partially cannibalized Loestrin 24 Fe scripts, resulting in relatively stable script trends



Source: Citi Research, IMS Health.

Figure 23. WCRX's OC franchise growth has allowed it to pick up 16% branded market share in the last 2 years



Source: Citi Research, IMS Health.

We anticipate WCRX will lose market share in the OC market following the genericization of "Loestrin 24" in early 2014

We see downside risk to the market share of the company's OC franchise following the launch of "Loestrin 24" generics in early 2014. Although the company's marketing efforts are focused on the promotion and continued market penetration of its successful branded "Lo Loestrin" oral contraceptive (25% of WCRX's total OC franchise in 2012), we anticipate a decline in overall OC scrip volumes following the anticipated launch of "Loestrin 24" generics onto the market in January 2014. Although some of this volume decline could be offset by the approval of a novel follow-on OC to Loestrin 24, we have limited visibility regarding the incremental benefits of the company's two oral contraceptive NDAs filed with the FDA, as well as the timing of a potential approval. Moreover, the approval of one of these filings could be delayed by the warning letter that the company received in March 2012 at its Fajardo (Puerto Rico) manufacturing facility. We understand that one of the novel OCs under development is manufactured at the Fajardo facility, though a potential backup compound could be manufactured at an alternate, unaffected facility.

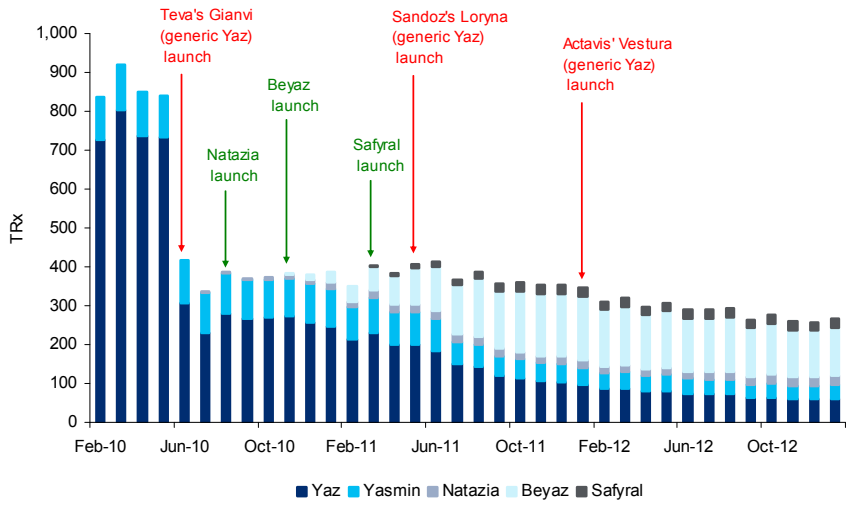
Figure 24. Loestrin 24 Fe and Ortho Tri-Cyclen Lo are next two major branded OC's to face loss of exclusivity

Company	Product	Patent Expiry	LOE	Generic Entrants at LOE
Warner Chilcott	Loestrin 24 Fe	Jul. 22, 2014	Jan. 22, 2014	Actavis (FTF exclusivity)
	Lo Loestrin Fe	Feb. 2, 2029	N/A	
Bayer	Yasmin	Aug. 31, 2020	N/A	
	Beyaz	Mar. 3, 2022	N/A	
	Natazia	Jan. 30, 2028	N/A	
	Safyral	Mar. 3, 2022	N/A	
Johnson & Johnson	Ortho Tri-Cyclen Lo	Dec. 9, 2019	Dec. 31, 2015	Teva, Mylan and Actavis (AG)

Source: Citi Research, Orange Book (FDA).

Case study: Bayer's OC franchise experienced significant overall script losses following the loss of its Yaz franchise. Immediately following Teva's launch of generic Yaz (Bayer's OC, with peak sales the Yaz/Yasmin franchise of $1.3B in 2009) in June 2010, the branded Yaz franchise experienced sequential monthly declines of ~58%, spilling over to declines in its Yasmin franchise as well. Over subsequent months, the company rebuilt some of its volume losses through two line extensions – Beyaz (Yaz with folate) and Safyral (Yasmin with folate), as well as an additional new product launch, Natazia. However, with the launch of subsequent branded Yaz generics (Sandoz's Loryna in May 2011 and Actavis' Vestura in January 2012), the gains were quickly reversed and the franchise experienced overall volume declines. Conservatively, we do not assume that WCRX will be able to continue to grow its total OC franchise revenue after Loestrin 24 Fe's loss of exclusivity.

Figure 25. Bayer's OC franchise declined significantly following branded generic Yaz launches despite new product launches



Source: Citi Research, IMS Health.

We forecast $250mn and $200mn in non-risk-adjusted peak sales for udenafil and serocycline. We anticipate these will only translate into revenue opportunities from 2015e, at the earliest

Late-stage erectile dysfunction and novel tetracycline assets will only impact top line growth from 2015, at the earliest. We view udenafil (for erectile dysfunction) and the novel tetracycline (for the treatment of acne) as more meaningful potential revenue opportunities for WCRX, and forecast $250mn and $200mn in non-risk adjusted peak sales for these assets, respectively.

(i) Phase III studies for udenafil have been completed. Based on a published meta-analysis of pooled data in patients across five clinical trials conducted with a South Korean patient population, the drug appears to show robust efficacy (statistical significance across its primary and secondary endpoints) and clean safety profile (most common adverse events were flushing and headache). Conversations we have conducted with urologists indicate a possible faster onset of action vs. other branded products currently on the market (Viagra, Cialis, Levitra). We anticipate an FDA filing in early 2014, with potential approval in early 2015.

(ii) The company's novel tetracycline (serocycline) is expected to enter Phase III clinical development in late 2013. The compound is a once-daily therapy for the treatment of acne, and could represent a material revenue opportunity for WCRX, due to the favorable economics associated with specialty dermatology products (lower than average pricing sensitivity, high margins) as well as the ability to leverage the company's presence in the dermatology market via its Doryx franchise and 60-person salesforce. We forecast peak non-risk adjusted sales of $200mn, however only anticipate potential FDA approval in 2016, at the earliest.

Business Development: The Key to Unlocking Value

Business development activities are necessary to boost the longer term growth profile of WCRX, in our view

Given Warner Chilcott's declining revenue profile over our projection period, as the company fully absorbs the upcoming US patent expiry of Actonel ($310mn revenues in 2012), the most material potential upside to the company's growth profile lies in potential business development activity, in our view. WCRX benefits from robust cash flow ($970mn in 2013e) and relatively modest gearing (2.8x debt/EBITDA as of the end of 2012), and has indicated its focus on business development, including company acquisitions, product acquisitions, and product in-licensing, as a driver of growth going forward. The company has a history of successfully executing on BD (see Figure 26), and we recognize the potential for value realization if/when additional business development takes place. Given the lack of visibility on the timelines and/or nature of future deal activity, we prefer to remain on the sidelines pending execution on this front.

Figure 26. WCRX business development has historically created significant value for the firm

($ in millions)

Deal	Closing Date	Drugs Involved	Annual Revenue (Time of Acquisition)	Annual Revenue (2012E)	Divestiture (Purchase) Price	Deal Value (Based on DCF)	Value Creation / (Destruction) - $
Acquisition of Exclusive U.S. Rights to Enablex	Oct. 18, 2010	Enablex (U.S.)	$180	$170	($400)	$204	($196)
P&G Pharma Acquisition	Oct. 30, 2009	Asacol (Global), Actonel (Global), Enablex (U.S.)	$1,900	$1,464	($2,919)	$4,133	$1,214
Divestiture of LEO Pharma Assets	Sep. 23, 2009	Dovonex (U.S.), Taclonex (U.S.)	$270	N/A	$1,000	$595	$405
Total			**$2,350**	**N/A**	**N/A**	**$4,933**	**$1,423**

Source: Citi Research, Company filings.

Note: Value creation/(destruction) calculated using a discounted cash flow analysis and Citi estimates.

The company's significant cash flow generation supports deal activity with an EV of $4-4.5bn

Actonel, although a declining asset, represents significant cash flow for WCRX and supports deal activity with an Enterprise Value in the range of $4-4.5bn. Warner Chilcott's cash flows fall into two categories:

(i) cash flows generated by **Actonel**, which represents 26%-27% of revenues and cash flows in FY12 and 16%-18% in FY13. Actonel loses IP protection in the US in June 2014 (EU patent protection was lost in 2H 2010).

(ii) cash flows generated by the **core business**, including the women's health, GI, dermatology and urology franchises. A potential acquisition would likely contribute to one or more of these asset classes, and thus has the potential to boost the growth potential of the company's core business, in our view.

Figure 27. Actonel generates a significant stream of profit, contributing to firm cash flows

Actonel vs. Core earnings profile
($ in millions)

	2010	2011	2012	2013E	2014E	2015E	2016E	2017E	3-Year CAGR ('12-'15E)	5-Year CAGR ('12-'17E)
WCRX revenue	$2,974	$2,728	$2,541	$2,392	$2,213	$2,033	$1,973	$1,944	-7.2%	-5.2%
Actonel revenue	$1,027	$771	$519	$329	$207	$124	$105	$90	-37.9%	-29.6%
Core revenue	**$1,947**	**$1,957**	**$2,022**	**$2,064**	**$2,005**	**$1,909**	**$1,868**	**$1,855**	**-1.9%**	**-1.7%**
WCRX net income	$890	$974	$1,024	$882	$830	$797	$804	$790	-8.0%	-5.1%
Actonel NOPAT	$509	$397	$276	$173	$110	$68	$58	$50	-37.4%	-29.1%
Core net income	**$381**	**$576**	**$748**	**$708**	**$720**	**$730**	**$746**	**$740**	**-0.8%**	**-0.2%**

Source: Citi Research

Note: Actonel calculations do not include Atelvia or any follow-on products.

According to our sum-of-the-parts valuation analysis, we estimate the value of the cash flows generated by Actonel at $529mn. This, coupled with the management's target debt/EBITDA multiple of 4.5x, supports our view that the company can very comfortably absorb an acquisition in the range of $4-4.5bn (EV).

Favorable operating cost and tax structures imply that most deals would be value accretive

Lean operating model leads to significant cash flow generation. WCRX's efficient cost structure (high gross margins, efficient sales infrastructure and frugal R&D spend) has allowed it to enjoy peer-leading operating margins (>50%). Its robust operating income, coupled with an attractive tax rate, has lead to significant free cash flow generation ($800M of operating cash flow, net of capex), with its free cash flow yield of ~25% outpacing its peer group (albeit partly attributed to its very modest valuation).

Tax structure implies that most acquisitions would be financially accretive. The company benefits from a low effective tax rate of 11-12% due to its Irish domicile. The company recently renewed its Advanced Pricing Agreement (APA) with the IRS, and we forecast that the current low tax structure will continue through 2017e, at least. The company's favorable tax structure increases the probability of earnings, and value, accretion for potential business development activities.

…but which asset classes would be the most value accretive, in our view? Business development activity will likely focus on leveraging the company's existing sales and marketing infrastructure, in our view. We see the greatest potential for bolt-on assets that add scale to its dermatology and/or urology platforms and that can leverage the company's primary care sales force currently detailing its osteoporosis franchise.

Management has significant expertise in operating a levered company. WCRX's management team has ample experience with executing deals that add significant leverage to its capital structure, both through asset acquisitions (most notably, the P&G Pharma deal) as well as through transactions to return shareholder capital (special dividends and share repurchase activities). We note that, the P&G Pharma acquisition tripled the size of the company (in terms of revenue). The company has historically chosen to make optional prepayments on debt with its significant excess cash flow, prepaying $350M in 2012. WCRX has also shown financial savvy in managing its debt by opportunistically refinancing to capitalize on the low financing environment (most notably refinancing its senior secured credit facility in March 2011). Given management's expertise in responsibly managing a levered business, we believe that the company could readily tap into the debt markets if it were required to borrow additional capital to fund an acquisition.

Special dividends remain an alternative, though not preferred, use of cash. WCRX management has had significant experience with dividend recapitalizations and (other capital structure changes) in the past. The company has utilized a special dividend twice over the past three years: (i) $4.00 per share in September 2012 ($1.00B in aggregate), and (ii) $8.50 per share in September 2010 ($2.14B in aggregate). We do not model a special dividend in 2013, but rather see the potential for a special dividend in the future as an alternative use of cash if management were not able to deploy capital towards other business development activities to add to its product portfolio.

Financials

Figure 28. Warner Chilcott Sales Model: 2010A – 2017E

USD mlns	2010A	2011A	2012A	2013E	2014E	2015E	2016E	2017E
Women's healthcare								
Osteoporosis								
Actonel (U.S.)	542.0	441.0	308.0	209.2	125.5	62.8	53.3	45.3
Actonel (North America ex-U.S.)	88.0	63.0	35.0	24.1	18.1	15.4	13.1	11.1
Actonel (ex-North America)	304.2	190.4	120.0	59.2	38.5	26.9	22.9	19.5
Total product net sales - Actonel	934.2	694.4	463.0	292.5	182.1	105.1	89.3	75.9
Actonel royalties	93.1	76.9	56.0	36.3	25.4	19.1	16.2	13.8
ACTONEL	1,027.2	771.3	519.0	328.8	207.5	124.1	105.5	89.7
ATELVIA	5.3	33.2	72.0	93.9	103.3	113.6	121.6	127.7
Total Osteoporosis	**1,032.6**	**804.4**	**591.0**	**422.7**	**310.8**	**237.7**	**227.1**	**217.3**
Oral contraceptives								
LOESTRIN 24 FE	342.3	396.2	389.0	349.3	122.3	61.1	45.8	39.0
LO LOESTRIN FE	-	63.1	137.0	236.1	342.3	393.7	452.8	475.4
Other oral contraceptives	63.4	19.4	18.0	15.0	14.2	13.5	12.8	12.2
Total Oral contraceptives	**405.7**	**478.7**	**544.0**	**600.3**	**478.8**	**468.3**	**511.4**	**526.5**
Hormone Therapy								
ESTRACE Cream	136.4	156.7	194.0	217.9	239.7	263.7	276.9	290.7
FEMHRT	51.4	20.3	-	-	-	-	-	-
Other Hormone Therapy	26.2	24.9	42.0	38.3	36.4	34.6	32.8	31.2
Total Hormone therapy	**214.1**	**201.9**	**236.0**	**256.2**	**276.1**	**298.3**	**309.7**	**321.9**
Other Women's healthcare products	63.2	64.2	55.0	47.4	47.4	47.4	47.4	47.4
Total Women's healthcare	**1,715.5**	**1,549.2**	**1,426.0**	**1,326.7**	**1,113.1**	**1,051.7**	**1,095.6**	**1,113.2**
Gastroenterology								
Asacol/HD (North America, ex-U.S.)	22.0	23.0	24.0	24.5	25.5	24.2	23.0	21.8
Asacol/HD/Delzicol (U.S.)	639.0	672.0	719.0	703.0	724.1	543.1	407.3	305.5
Asacol/HD (ex-North America)	53.7	48.3	50.0	50.0	47.5	45.1	42.9	40.7
Asacol HD	132.2	146.0	148.6	145.5	142.5	139.5	136.6	133.7
ASACOL	714.7	743.3	793.0	777.5	797.0	612.4	473.1	368.0
Dermatology								
DORYX	172.6	172.7	92.0	65.3	45.7	34.3	29.1	24.8
OTHER DERMATOLOGY	148.7	-	-	-	-	-	-	-
Total Dermatology	**321.3**	**172.7**	**92.0**	**65.3**	**45.7**	**34.3**	**29.1**	**24.8**
Urology								
ENABLEX	107.4	170.7	170.0	163.2	156.7	150.4	75.2	37.6
Other Product net sales	84.6	61.4	36.0	23.1	19.6	16.7	15.0	13.5
Contract manufacturing product sales	15.9	16.9	14.0	10.5	8.9	7.6	6.4	5.5
Product net sales	**2,959**	**2,714**	**2,531**	**2,366**	**2,141**	**1,873**	**1,695**	**1,563**
Other revenue	15.1	13.9	10.0	9.5	9.5	9.5	9.5	9.5
PIPELINE SALES	-	-	-	16.6	62.3	150.5	269.0	372.3
TOTAL REVENUE	**2,974**	**2,728**	**2,541**	**2,392**	**2,213**	**2,033**	**1,973**	**1,944**
% growth	*107.2%*	*-8.3%*	*-6.9%*	*-5.9%*	*-7.5%*	*-8.1%*	*-2.9%*	*-1.5%*
CORE REVENUE (excl. ACTONEL)	1,947.2	1,956.8	2,022.0	2,063.5	2,005.3	1,908.9	1,867.5	1,854.6
% growth	*60.4%*	*0.5%*	*3.3%*	*2.1%*	*-2.8%*	*-4.8%*	*-2.2%*	*-0.7%*
TAIL REVENUE (non-promoted CORE)	468.5	220.9	175.0	143.7	136.0	129.2	124.0	119.2
% growth	*-8.2%*	*-52.8%*	*-20.8%*	*-17.9%*	*-5.4%*	*-5.0%*	*-4.0%*	*-3.8%*

Source: Citi Research and Company reports

Figure 29. Warner Chilcott Non-GAAP P&L: 2010A – 2017E

$ mlns except per share data	2010A	2011A	2012A	2013E	2014E	2015E	2016E	2017E
Product net sales	**2,803.7**	**2,637.3**	**2,475.0**	**2,346.5**	**2,177.9**	**2,004.4**	**1,947.3**	**1,921.0**
YoY growth	*102.5%*	*-5.9%*	*-6.2%*	*-5.2%*	*-7.2%*	*-8.0%*	*-2.8%*	*-1.4%*
Other revenue	**170.7**	**90.8**	**66.0**	**45.8**	**34.9**	**28.6**	**25.7**	**23.3**
YoY growth	*233.4%*	*-46.8%*	*-27.3%*	*-30.6%*	*-23.8%*	*-18.2%*	*-10.0%*	*-9.5%*
Total Sales	**2,974.5**	**2,728.1**	**2,541.0**	**2,392.3**	**2,212.8**	**2,033.0**	**1,973.0**	**1,944.3**
YoY growth	*102.5%*	*-5.9%*	*-6.2%*	*-5.2%*	*-7.2%*	*-8.0%*	*-2.8%*	*-1.4%*
COGS	(440.5)	(325.1)	(311.0)	(311.0)	(287.7)	(264.3)	(236.8)	(233.3)
% of total sales	*14.8%*	*11.9%*	*12.2%*	*13.0%*	*13.0%*	*13.0%*	*12.0%*	*12.0%*
Gross Profit	**2,534.0**	**2,403.0**	**2,230.0**	**2,081.3**	**1,925.1**	**1,768.7**	**1,736.3**	**1,711.0**
Gross Margin	*85.2%*	*88.1%*	*87.8%*	*87.0%*	*87.0%*	*87.0%*	*88.0%*	*88.0%*
SG&A	(1,090.4)	(923.9)	(759.0)	(766.5)	(686.0)	(575.2)	(554.1)	(565.4)
% of Total revenue	*36.7%*	*33.9%*	*29.9%*	*32.0%*	*31.0%*	*28.3%*	*28.1%*	*29.1%*
R&D	(146.5)	(107.8)	(103.0)	(122.0)	(121.7)	(132.1)	(138.1)	(136.1)
% of Total revenue	*4.9%*	*4.0%*	*4.1%*	*5.1%*	*5.5%*	*6.5%*	*7.0%*	*7.0%*
EBITDA	1,279.5	1,379.6	1,417.0	1,203.8	1,135.1	1,085.6	1,075.1	1,047.2
EBITDA margin	43.0%	50.6%	55.8%	50.3%	51.3%	53.4%	54.5%	53.9%
Depreciation and Amortization (incl. intangibles)	(34.7)	(39.4)	(35.0)	(41.0)	(47.7)	(54.3)	(61.0)	(67.7)
Amortization of Intangibles	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-
Operating income	**1,297.1**	**1,371.2**	**1,368.0**	**1,192.8**	**1,117.5**	**1,061.3**	**1,044.1**	**1,009.5**
Operating Margin	*43.6%*	*50.3%*	*53.8%*	*49.9%*	*50.5%*	*52.2%*	*52.9%*	*51.9%*
Net Interest expense	(219.5)	(229.9)	(200.0)	(173.7)	(158.0)	(144.8)	(125.3)	(112.2)
Income before taxes	**1,077.7**	**1,141.3**	**1,168.0**	**1,019.1**	**959.5**	**916.5**	**918.8**	**897.3**
Tax	(188.0)	(167.7)	(144.0)	(137.6)	(129.5)	(119.2)	(114.8)	(107.7)
Effective Tax Rate	*17.4%*	*14.7%*	*12.3%*	*13.5%*	*13.5%*	*13.0%*	*12.5%*	*12.0%*
Adjusted cash net income	**889.7**	**973.7**	**1,024.0**	**881.5**	**830.0**	**797.4**	**803.9**	**789.7**
Numerator for diluted EPS	**889.7**	**973.7**	**1,024.0**	**881.5**	**830.0**	**797.4**	**803.9**	**789.7**
Shares Outstanding (basic)	251.3	252.0	248.3	250.2	250.2	250.2	250.2	250.2
Shares Outstanding (diluted)	253.9	254.3	250.5	251.5	251.5	251.5	251.5	251.5
Adjusted cash net income per share	**$3.50**	**$3.83**	**$4.09**	**$3.50**	**$3.30**	**$3.17**	**$3.20**	**$3.14**

Source: Citi Research and Company reports

Figure 30. Warner Chilcott Balance Sheet: 2010A – 2017E

$ mlns	2010A	2011A	2012A	2013E	2014E	2015E	2016E	2017E
Cash and cash equivalents	401.8	616.3	474.0	726.8	906.5	1,055.4	1,028.8	1,182.8
Accounts receivable	368.5	265.8	195.0	196.6	181.9	167.1	162.2	159.8
Inventories	119.5	118.7	113.0	115.0	106.4	97.7	87.6	86.3
Deferred income taxes	134.4	121.1	130.0	95.7	88.5	81.3	78.9	77.8
Prepaid income taxes, net	49.4	37.4	51.0	23.9	22.1	20.3	19.7	19.4
Prepaid expenses and other current assets	103.4	72.7	63.0	71.8	66.4	61.0	59.2	58.3
Total Current Assets	**1,177.0**	**1,231.9**	**1,026.0**	**1,229.8**	**1,371.8**	**1,482.9**	**1,436.4**	**1,584.5**
PPE	235.7	214.7	216.0	235.0	247.3	253.0	252.0	244.3
Intangibles	3,016.7	2,420.3	1,817.0	1,408.0	1,069.0	808.0	642.5	586.1
Goodwill	1,028.6	1,028.6	1,029.0	1,029.0	1,029.0	1,029.0	1,029.0	1,029.0
Deferred tax asset	27.9	30.6	43.0	-	-	-	-	-
Other assets	166.1	103.9	87.0	95.7	88.5	81.3	78.9	77.8
Total Long Term Assets	**4,474.9**	**3,798.1**	**3,192.0**	**2,767.7**	**2,433.8**	**2,171.3**	**2,002.4**	**1,937.2**
TOTAL ASSETS	**5,652.0**	**5,030.0**	**4,218.0**	**3,997.5**	**3,805.6**	**3,654.2**	**3,438.8**	**3,521.7**
Trade Accounts Payable	98.5	53.7	29.0	39.3	36.4	33.4	32.4	32.0
Accrued exp and other current liabilities	730.8	817.0	668.0	550.2	508.9	467.6	453.8	447.2
Income taxes payables	23.0	44.4	17.0	35.9	33.2	30.5	29.6	29.2
Deferred income taxes	1.2	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Current portion of long-term debt	269.9	185.0	179.0	400.0	400.0	600.0	400.0	525.0
Total Current Liabilities	**1,123.4**	**1,101.2**	**894.0**	**1,026.4**	**979.5**	**1,132.5**	**916.8**	**1,034.3**
Long-term debt	4,408.8	3,677.8	3,796.0	3,175.0	2,775.0	2,175.0	1,775.0	1,250.0
Deferred tax liabilities	70.3	58.1	32.0	47.8	44.3	40.7	39.5	38.9
Other long-term liabilities	115.1	123.8	96.0	95.7	88.5	81.3	78.9	77.8
Total Long Term Liabilities	**4,594.2**	**3,859.7**	**3,924.0**	**3,318.5**	**2,907.8**	**2,297.0**	**1,893.4**	**1,366.7**
TOTAL LIABILITIES	**5,717.6**	**4,960.9**	**4,818.0**	**4,345.0**	**3,887.3**	**3,429.5**	**2,810.2**	**2,401.0**
Total Stockholders' equity	**(65.6)**	**69.1**	**(600.0)**	**(347.4)**	**(81.7)**	**224.7**	**628.6**	**1,120.7**
TOTAL LIABILITIES & EQUITY	**5,652.0**	**5,030.0**	**4,218.0**	**3,997.5**	**3,805.6**	**3,654.2**	**3,438.8**	**3,521.7**

Source: Citi Research and Company reports

Figure 31. Warner Chilcott Cash Flow Statement: 2010A – 2017E

$ mlns	2010A	2011A	2012A	2013E	2014E	2015E	2016E	2017E
CASH FLOWS FROM OPERATING ACTIVITIES								
Net Income	**171.0**	**171.1**	**403.0**	**397.7**	**414.7**	**459.1**	**560.6**	**653.0**
Depreciation	34.7	39.4	42.0	41.0	47.7	54.3	61.0	67.7
Write-off of fair value step-up on acquired inventories	105.5	-	-	-	-	-	-	-
(Gain) on sale of assets	-	-	(20.0)	-	-	-	-	-
Provision for inventory obsolescence	13.0	35.2	28.0	-	-	-	-	-
Deferred income taxes	(21.0)	0.7	(47.0)	93.2	3.6	3.6	1.2	0.6
Amortization of deferred loan costs	65.0	110.0	36.0	-	-	-	-	-
Stock-based compensation expense	21.5	22.1	24.0	-	-	-	-	-
Accretion on preferred stock of subsidiary	-	-	-	-	-	-	-	-
Changes in operating assets and liabilities:								
Accounts receivable, prepaid and other assets	9.6	92.5	102.0	(1.6)	14.8	14.8	4.9	2.4
Inventories	(8.4)	(46.3)	(21.0)	(2.0)	8.6	8.6	10.2	1.3
Accounts payable, accrued expenses & other current liabilities	(66.2)	91.1	(172.0)	(107.4)	(44.2)	(44.3)	(14.8)	(7.1)
Income taxes and other, net	(30.1)	41.8	(82.0)	28.2	4.5	4.5	1.5	0.7
Cash flows from operating activities	**947.4**	**1,177.1**	**897.0**	**887.9**	**818.6**	**791.6**	**820.2**	**804.8**
CASH FLOWS FROM INVESTING ACTIVITIES								
Purchase of intangible assets	(402.9)	-	-	-	-	-	-	-
Purchase of business, net of cash acquired	-	-	-	-	-	-	-	-
Proceeds from the sale of assets	-	-	-	-	-	-	-	-
Capital expenditures	(95.0)	(46.2)	(63.0)	(60.0)	(60.0)	(60.0)	(60.0)	(60.0)
Cash flows from investing activities	**(497.9)**	**(46.2)**	**(63.0)**	**(60.0)**	**(60.0)**	**(60.0)**	**(60.0)**	**(60.0)**
CASH FLOWS FROM FINANCING ACTIVITIES								
Dividends	(2,137.8)	-	(1,052.0)	(125.1)	(128.9)	(132.7)	(136.7)	(140.8)
Net borrowings (repayments) of debt	1,555.5	(865.6)	98.0	(400.0)	(400.0)	(400.0)	(600.0)	(400.0)
Proceeds from share capital issue	-	-	-	-	-	-	-	-
Retirement of preferred stock	-	-	-	-	-	-	-	-
Redemption of Ordinary Shares	-	(55.7)	(32.0)	(50.0)	(50.0)	(50.0)	(50.0)	(50.0)
Proceeds from the exercise of non-qualified options to purchase c	7.8	4.9	8.0	-	-	-	-	-
Purchase of treasury stock	-	-	-	-	-	-	-	-
Other	(0.3)	2.4	-	-	-	-	-	-
Cash flows from financing activities	**(574.8)**	**(914.0)**	**(978.0)**	**(575.1)**	**(578.9)**	**(582.7)**	**(786.7)**	**(590.8)**
FX effect	(11.9)	(2.3)	2.0	-	-	-	-	-
Change in cash and cash equivalents	**(137.2)**	**214.5**	**(142.0)**	**252.8**	**179.7**	**148.9**	**(26.5)**	**154.0**

Source: Citi Research and Company reports

Warner Chilcott PLC

Company description

Warner Chilcott is a specialty pharmaceutical company whose therapeutic footprint includes women's health, gastroenterology, urology and dermatology. The company primarily operates in North America.

Investment strategy

We rate Warner Chilcott Neutral (2) on concerns about its negative growth outlook, while noting its modest valuation. We model 5-year sales and earnings CAGR's of -5%, reflecting the incremental generic and/or competitive pressures that the company faces going forward. We see limited upside to current valuation levels in the absence of business development activities that could unlock value.

Valuation

Our target price of $14.50 is based on a 2014e non-GAAP P/E multiple of ~4.4x. We believe that the stock's discount to the peer group is warranted given its negative earnings growth profile due to significant reimbursement and/or generic competition risk to its pharmaceutical portfolio. Our DCF analysis indicates an intrinsic value of $20 per share.

Risks

Several key downside risks associated with the name include: (i) earlier-than-modeled generic entry on key marketed products (particularly Asacol 400 and Estrace Cream), (ii) pipeline failures or setbacks, and (iii) an inability to execute business development opportunities.

Several key upside risks associated with the name include: (i) longer period of exclusivity on Asacol, (ii) pipeline successes or disclosure on previously unannounced pipeline assets, and (iii) any material business development that materially enhances the company's growth profile.

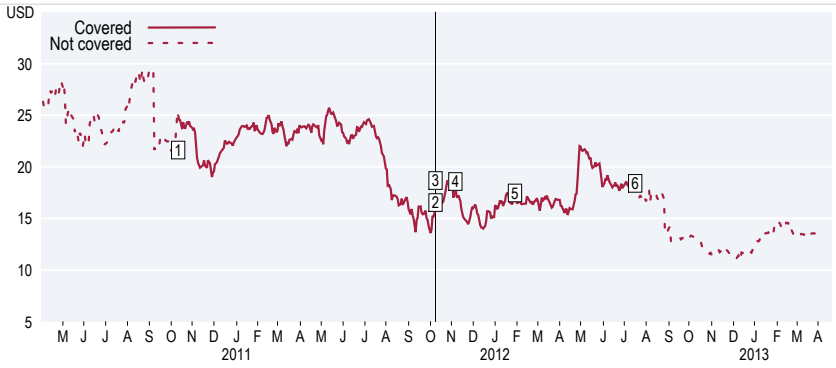
Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

Warner Chilcott PLC (WCRX)
Ratings and Target Price History
Fundamental Research



	Date	Rating	Target Price	Closing Price
1	12-Oct-10	*1H	*29.00	25.00
2	8-Oct-11	Stock rating system changed		

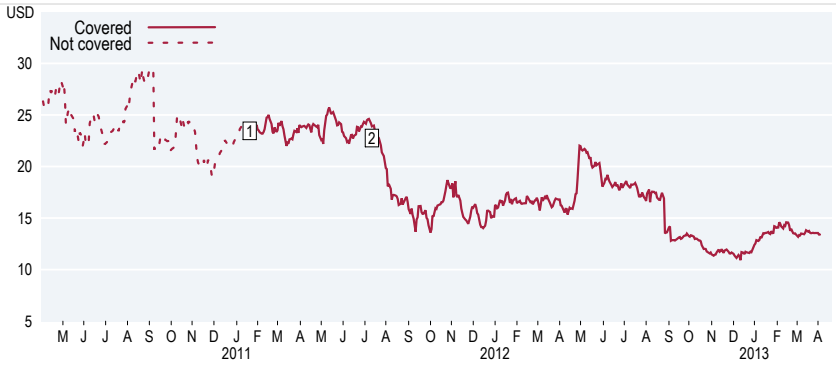
	Date	Rating	Target Price	Closing Price
3	8-Oct-11	*1	29.00	15.14
4	7-Nov-11	1	*24.00	18.58

	Date	Rating	Target Price	Closing Price
5	29-Jan-12	1	*22.00	16.69
6	17-Jul-12	Coverage terminated		

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Warner Chilcott PLC (WCRX)
Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)



	Date	Rating	Target Price	Closing Price
1	20-Jan-11	*ADD MP	-	23.68

	Date	Rating	Target Price	Closing Price
2	12-Jul-11	*REM MP	-	23.89

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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Citigroup Global Markets Inc. or its affiliates has received compensation for investment banking services provided within the past 12 months from Warner Chilcott PLC.

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