Standpoint Research

Weekly Investment Research

Gilead Sciences (GILD)

HEALTHCARE - *Biotechnology*

Stock Statistics

Ticker	GILD
Exchange	NASDAQ
Financial Year End	December

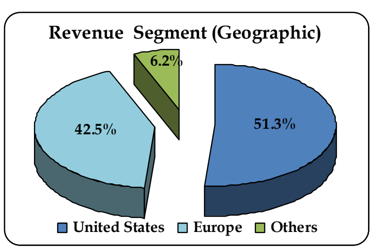
Market Price *	$33.43
Market Cap *	$29.48 bln
52-Week High / Low	$50 / $31
Average Daily Volume	> 10,000,000

** As of previous day close*

Source: Reuters

Company Description

Gilead Sciences, founded in 1987 and incorporated in Foster City, California, is a Biotech-pharmaceutical company that discovers, develops and commercializes innovative medicines for HIV/AIDS, liver disease, serious cardiovascular and respiratory conditions. GILD products include Truvada, Atripla, Viread and Emtriva, all for HIV; Hepsera (hepatitis), AmBisome (invasive fungal infections), Letairis (pulmonary arterial hypertension), Ranexa (angina), Vistide (retinitis) and Cayston (for enhancement of respiratory systems). On April 17, 2009, Gilead acquired CV Therapeutics, a Biopharmaceutical company, primarily focused on the discovery, development and commercialization of small molecule drugs for the treatment of cardiovascular diseases.



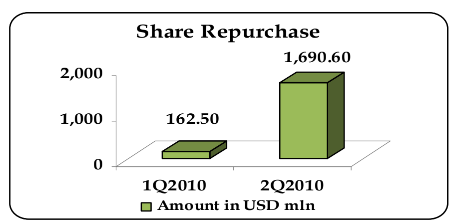
Gilead has ~ 4,000 employees around the world and operations in North America, Europe, and Australia. The company competes with GlaxoSmithKline, Abbott Laboratories, Merck, Pfizer, Roche, Enzon Pharmaceuticals, Novartis, Zeneus, Shire Pharmaceuticals, United Therapeutics Corporation and King Pharmaceuticals.

Investment Recommendation -- **Buy / 2011-2012 price target: $44**

In our S&P-500 report from four weeks ago, the Biotechnology industry ranking was # 5 out of 134 industries according to our 155-variable computer model. The biotech ETF [BBH] has jumped 6% since then. In the S&P report **GILD** ranked # 3 out of 500 stocks according to our computer model é BIIB was # 27 é AMGN was # 37 é CEPH was # 43 and CELG was # 57. From that group, we have an open recommendation out on BIIB é GILD was added on July 13, 2010 after passing our subjective and fundamental overlays[1]. GENZ, up on its pending takeover bid from SNY (actually) scored in the bottom third at # 373 (and that was before the recent price spike). Several GILD drugs will go off patent, but that wonôt be until 2017-2018. This stock should be good for at least one more (40%) run between now and then **even if the company does not diversify into other areas** as we expect they will. Gilead owns all four of the *QUAD* components and would pocket all of the profits if that four-drug AIDS combo is successful. If Phase III trials go according to plan, the launch would most likely be in 2011 (or 2012). The price for *QUAD* will be > $15,000 and margins are expected to be high as the marketing and distribution channels are already in place. This is a stock with concerns, and GILD has most of its eggs in one (HIV) basket. That being said, near its five-year low, and at < 10X earnings, those concerns are more than priced in. **GILD ranked # 1 (out of 200 stocks) in our Q3 Healthcare sector report according to our computer model –** *see page 5*.

Investment Summary

- **Focus on product diversification --** GILD has unique expertise and a line of products in anti-viral drugs for HIV treatment. **It generates more than two-thirds of its revenue from this product category**. With an objective to minimize the business risk, GILD is diversifying its product portfolio into other areas, such as cardiovascular diseases, oncology and inflammatory diseases. During 2Q10, the revenue from these products has grown 36% to ~ $210 mln from $154 mln in 2Q09. In FY09, the company acquired CV Therapeutics which has expertise in the field of discovery, development and commercialization of small molecule drugs for the treatment of cardiovascular diseases. Apart from this, GILD management's recent initiative and strategic hires indicate an increased focus on Hepatitis C drug development. GILD, with its competitive advantages of a strong selling and distribution infrastructure, drug manufacturing expertise, existing market and experienced researchers, will look toward M&A in order to increase its product portfolio.
- **Advanced key pipeline programs --** GILD plans to utilize its strong cash balance for enhancing its pipeline. Gilead invests heavily on research and development. During FY09, its total expense for R&D was ~ $850 mln, and the company expects FY10 R&D cost to remain in the range of $850 mln-$870 mln. GILD possesses promising phase III programs for the HIV portfolio via Quad and the cobicistat pill, TMC278, offering potential safety advantages over Atripla and other anti-viral regimens. These drugs are expected to continue to secure Gilead's dominating position in the HIV space. GILD also has Phase II programs for liver disease and cardiovascular disease. Apart from this, GILDôs advanced pipeline includes Phase I & II programs in HCV, inhaled antibiotics and Ranexa follow-on molecules.
- **Share repurchase programs --** In an effort to return value to the stockholders and minimize dilution from stock issuances, GILD is leveraging its strong cash position and continuing with its stock repurchase program. During Q2, 2010, GILD bought and retired 44 mln shares of its common stock for $1.7 bln. In addition to this, GILD initiated a $5.0 bln share repurchase program which it expects to complete by 2013. If GILD is able to fully execute the planned $5.0 bln stock repurchase at the current price, this would be quite significant as a percent (17%) of its market cap.

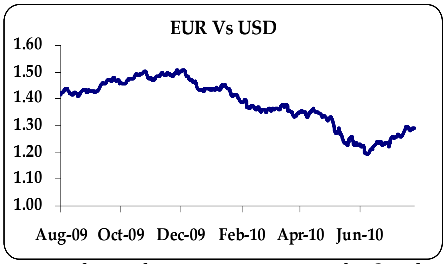


Peer Benchmarking ï see page 6 for additional comparisons

Tick / Mkt Cap	5-yr. ROE	P / E	P / Sales	EV/EBITDA
GILD / $29B	49.3%	09.4 X	3.8 X	6.5 X
BMY / $42B	36.6%	11.3 X	2.2 X	8.4 X
GSK / $95B	62.6%	09.2 X	2.0 X	6.4 X
NVS / $112B	16.9%	10.2 X	2.8 X	7.6 X

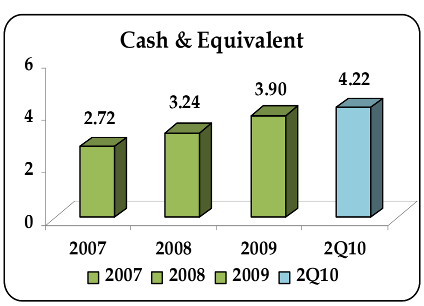
[1] We dropped AZN from the healthcare sector on July 29, 2010. If you did not receive the pre-market note on AZN from July 29, it is pasted at the end of this report.

Global expansion and recovery in Europe will lead to growth -- During 2Q10, Europe contributed $601 mln in antiviral product sales. It increased 9% y/y and declined 4% sequentially. The decline in Europe was caused primarily because of strength in the US$ relative to the Euro and cost containment measures in light of budget deficits in many European countries. The slowdown in Europe has forced companies to look for other markets. Gilead is looking at increasing its presence in the Asian market for Hepatitis B Virus (HBV), where the infection rate is relatively high compared to the U.S. and Europe. Apart from this, GILD has entered into a number of collaborations related to access for its products in the developing world. In one such arrangement it has entered into a non-exclusive license agreement with 13 Indian generic drug manufacturers. It granted them the right to produce and distribute generic versions of Viread (also known as tenofovir disoproxil fumarate), used for treatment of HIV infection (for 95 low income countries covered under the Gilead Access Program). The Purchasing Managers Index (PMI) rose to 56.7 in July, from 56.0 in June and positive movement in the Euro in comparison to the US$ (gained 5.8% since the beginning of 3Q10) indicates that growth across the 16-nation euro-zone may see an up-tick in the near-term.



Growth through collaborations and acquisitions -- As part of its business strategy, GILD establishes collaborations with corporate partners for selling & distribution and research & development programs. In September 1996, GILD entered into a licensing agreement with Roche to treat and prevent viral influenza (with Tamiflu). In December 2004 it entered into collaboration with Bristol Myers Squibb for the development and commercialization of Atripla in the United States, Europe and Canada. In March 2006 it sub-licensed to GSK the rights to market ambrisentan in territories outside of the United States. In addition to licensing and collaborating activities, GILD has a strong acquisition strategy. Acquisitions include Myogen and Corus Pharma in 2006; Navitas assets related to its cicletanine business in 2008; and the acquisition of CV Therapeutics to further expand into the cardiovascular therapeutics area in 2009.

Strong cash balance – GILD maintains a strong cash position. In the second quarter, GILDôs cash, equivalents and marketable securities grew 8.0% to $4.2 bln versus $3.9 bln at the end of the first quarter. Its cash flow from operations was at $699 mln versus $671 mln in 1Q10 and $623 mln in 2Q09. During FY09, despite spending $1.13 bln on the acquisition of CV Therapeutics and completion of its share repurchase program (21.8 mln shares for an aggregate purchase price of $998 mln through open market transactions), GILD is able to show an impressive cash balance of $1.7 bln.



Mixed reaction to TMC-278 data -- On July 22, 2010, at the International AIDS Society meeting, Phase III TMC-278 data and Phase II-b GSK-572 data was presented. The meeting highlighted GSK-572 from GlaxoSmithKline and its potential to be the best-in-class integrase inhibitor and that it could be used as a first-line therapy. Secondly, TMC-278 data was a disappointment -- the virological failure rate was somewhat higher compared to Sustiva and the tolerability, while significantly better than Sustiva, was not impressive. Despite all that, it is expected that Gilead's HIV franchise is likely to be unchallenged for the next few years. Maintaining their leadership position beyond then will be challenging, as generic Sustiva and new branded competition (GSK-572, once-daily Intelence, and once-daily raltegravir) come to market.

Competition to increase going forward -- GILD is enjoying market dominance in the manufacturing, selling and distribution of HIV infection drugs. But JNJ's rilpivirine and GSK's integrase inhibitor are likely to be the new drugs in HIV (in the next few years). GILD has already developed a fixed dose combination of rilpivirine and Truvada which is expected to replace Atripla, but GILD's incremental value from this product is expected to be modest at best. Similarly, GSK's new drug, GSK-572 could signal the re-emergence of Gilead's biggest and oldest rival in HIV. These competitors could both disrupt Gilead's current market dominance and also undermine the future value of Gilead's combination line extensions.

Credit risk from European markets -- GILD generates 42% of its revenue from European countries. Due to government funding and reimbursement practices, GILDôs European product sales to government owned or supported customers in Greece, Italy, Portugal and Spain are subject to significant payment delays. The companyôs accounts receivable in these countries totaled ~ $753.6 mln as of December 31, 2009, of which $289.4 mln was more than 120 days past due. **Note**: for GILD, $175 mln = $0.25 per share. Any significant changes in the reimbursement practices of the European governments or unavailability of government funding would create a credit risk and will adversely impact the company.

Dependence on HIV related products -- More than two-thirds of the companyôs total revenue is derived from HIV products. In FY09, Truvada and Atripla product sales together were $4.87 bln, or 69% of GILDôs total revenues. Any discontinuity in production or inability to market the HIV products would adversely impact the companyôs revenue as well as its operations and R&D effort.

Adverse currency move to impact top line and bottom line -- GILD markets its products mainly in the United States, Europe and Australia. A significant portion of its sales volume, approximately 45%, occurs outside the United States. A substantial percentage of product sales are denominated in foreign currencies, primarily in Euros. Ongoing strengthening of the US$ against the Euro has already impacted the value of the companyôs top and bottom lines. The foreign currency fluctuations in FY09 had an unfavorable impact of ~ $98 mln on total revenues and ~ $34 mln (or $0.05 per share) on pre-tax income. The current European sovereign debt crisis led to a 13% rise in the US$ since July 2009 including 10% this year.

Gilead Sciences reported Q2 on July 20. Earnings of $0.85 per share were $0.02 worse than the Thomson Reuters consensus of $0.87; revenues increased 17.0% y/y to $1.93 bln versus the $1.96 bln consensus. Q2 drug sales and consensus: Truvada $641 mln vs. $675 mln consensus; Atripla $716 mln vs. $727 mln consensus, Viread $176 mln vs. $185 mln consensus, and Ambisome $78 mln vs. $76 mln consensus. The shares have tracked the S&P index since this news (at +1%), but under-performed the biotech ETF [BBH].[2]

[2] BBH would be + 2% if we excluded the move in GENZ on takeover speculation and its impact; + 3% if it was included.

Industry Outlook

The growth in the biotech and pharmaceutical industries has been in line with the overall trend seen in the healthcare sector over the past few quarters. Recent performance of the biotech and pharmaceutical has been tied to the impact of healthcare reform, general market conditions, austerity actions in Europe, future direction of the Euro, prescription trends and intensifying generic competition ï these factors will have an impact in the near-term as well. According to IMS Health, global pharmaceutical market growth will remain in the mid-single digits (5%-8%), through 2014.

The impact from U.S. healthcare reform - The introduction of rebates on drugs sold through the Medicaid program in healthcare reform legislation is impacting pharmaceutical and biotech companies in the U.S. Large cap companies such as Bayer, Sanofi-Aventis, Novartis and Roche will be more insulated from healthcare reform because of their relatively low focus on the U.S. market. **Companies which are expected to face the most exposure are Amgen and Gilead**. Recently, Gilead projected that U.S. healthcare reform will have a negative impact on its FY10 and FY11 U.S. product sales and will result in a $200 mln decline in FY10 and 5%- 6% in FY11. Smaller companies having the majority of their sales in the U.S. will have to weather the storm before reform law measures that benefit the industry [by increasing the number of insured individuals] will start to have a positive impact [in FY14].

The European debt crisis, declining Euro and pricing pressure will impact growth -- The European debt crisis is forcing many governments to increase austerity measures. Most Europeans receive healthcare that is government funded. The turn of events is forcing governments to cut expenses, healthcare expenses included. These cuts are hurting the sector, pressuring volumes, revenues, margins and profits. Pharmaceutical companies will be unable to command price increases ï it is the governments who now have the negotiating leverage. Drug pricing is at the high risk of being targeted for cuts in the near-term. Global pharmaceutical companies with manufacturing bases in the U.S. (or elsewhere) who sells to Europe have been impacted by the steep decline in Euro. By the end of 2Q10, the Euro had declined 15% versus the US$. That being said, there has been a 6% move off the 2Q low. The slowdown in Europe has forced the many industry players to look to new markets in order to increase market share. These markets have been less impacted by recent events. Recent indications suggest that recovery in Europe may not be far off. Once there is stability in Europe, companies who have weathered the storm by growing their global footprint will have an edge.

Rising M&A activity -- Mergers and acquisition activity has increased significantly over the last few quarters. The economic crisis hit the small players significantly relative to their size, and they have become soft acquisition targets. Drug manufacturers, with the objective of widening their product portfolio -- instead of developing a product from the initial stage, which requires huge funds -- are exploring for deals including drugs that are in the mid-to-late stages/phases and that look promising. Deals such as Abbott Laboratoriesô acquisition of Advanced Medical Optics; Johnson & Johnsonôs acquisition of Cougar Biotech; Pfizer's acquisition of Wyeth; Roche's acquisition of Genentech and Bristol-Myers Squibbs' acquisition of Medarex are just a few that show this trend. The current M&A trend is expected to continue going forward if recent headlines in the biotech industry are any indication. Additionally, it is to be expected that there will be a significant increase in licensing activities and collaborations with regards to pipeline development.

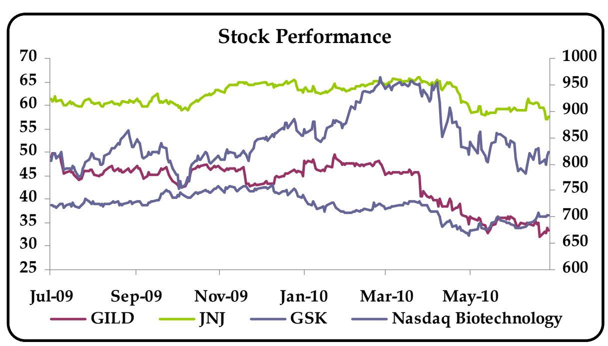
Positives for the industry going forward -- Large-cap Biopharmaceutical stocks have offered [relative to other sectors in the economy] reliable revenue and earnings growth despite the economic downturn. That being said, if we look at these names on a stand alone basis, revenue growth is in many cases flat or down marginally. Most of the companies have resorted to cost-cutting and share buybacks in order to drive bottom-line growth.

Still, we maintain a positive outlook for the industry. The recent events and current environment has forced companies to improvise -- that is encouraging if we look out a few years. With assistance from recent acquisitions, strong business segments and impressive late-stage pipelines, the good companies should be able to deal with the current obstacles and pressures. We expect growth to come from FDA approvals for key drugs, emergence of promising Phase II programs, and continued demand growth for recently launched products.

Key Industry player's highlights --

GlaxoSmithKline (GSK) is engaged in the creation and discovery, development, manufacture and marketing of pharmaceutical products, including vaccines, over-the-counter medicines and health-related consumer products. The Company's segments include Pharmaceuticals and Consumer Healthcare. On July 22, 2009, it acquired Stiefel Laboratories. On October 30, 2009, it acquired Pfizer Inc.ôs HIV business and combined it with its own HIV business to form ViiV Healthcare. On November 10, 2009, it acquired an Algerian pharmaceutical, manufacturing and distribution company. On December 18, 2009, it acquired NovaMin Technology. The companyôs revenue has grown at a rate of 7.2% for five yrs, while its EPS has grown at a 9.8% rate.

Johnson & Johnson (JNJ) operates in three business segments: Consumer, Pharmaceutical, and Medical Devices and Diagnostics. In July 2009, Johnson & Johnson completed the acquisition of Cougar Biotech. In September 2009, Elan Corporation and Johnson & Johnson announced that JANSSEN Alzheimer Immunotherapy, a newly formed subsidiary of Johnson & Johnson, has completed the acquisition of all of the assets and rights of Elan related to its Alzheimer`s Immunotherapy Program (AIP). **Note**: we initiated coverage on JNJ with a ôBuyô recommendation on April 29, 2009. We dropped the name to ñHoldò on July 1, 2009, closing the position out with a 20% gain +300 bps versus our S&P-500 benchmark. The downgrade note can be re-sent on request. In March 2010, Hypermarcas SA acquired 100% of Versoix Participacoes from JNJ. The companyôs revenue has grown at a rate of 5.5% for five yrs, while its EPS has grown at a 9.9% rate. The industry figures are 6.6% and 7.1% respectively. Its 2Q10 sales grew 0.6% to $15.3 bln versus 2Q09. Operational results increased 0.1%. Domestic sales declined 2.8%, while international sales increased 4.1%, reflecting operational growth of 3.0% and a positive currency impact of 1.1%. Net earnings were $3.4 bln and EPS were $1.21, representing increases of 5.4% and 5.2%, respectively. JNJ updated its earnings guidance for FY10 to $4.65-$4.75 per share, which excludes the impact of special items.



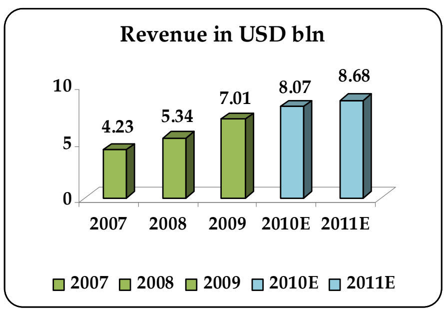
Financial Analysis

Management Guidance -- Gilead lowered its FY10 revenue guidance to $7.3-$7.4 bln from $7.4-$7.5 bln due to the impact of foreign exchange rate changes. The effective tax rate was also increased to 26.5%-27.5% from 25.0%-26.0%. GILD estimates its R&D and SG&A expenses will remain unchanged at $850-$870 mln and $900-$920 mln, respectively.

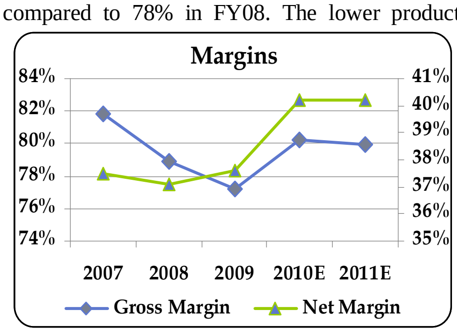
Reuters estimates -- Reuters estimates FY10 revenue at $8.0 bln, EBITDA at $4.5 bln, Capex at $215 mln and EPS at **$3.60**. For FY11, revenue is estimated at $8.6 bln, EBITDA at $4.8 bln, Capex at $236 mln and EPS at **$3.87.** For FY12, revenue is estimated at $9.4 bln, EBITDA at $5.2 bln, and EPS at **$4.31. GILD is currently trading at 9.3X FY10 EPS estimates.**

Note: The estimates in this *Reuters* section will not always match estimates on the right side, as those are from an independent forecasting service.

Stable revenue growth — GILDôs top line has shown 36% (annualized) growth on CAGR basis since FY05. During FY09, GILD grew its business significantly and achieved a 31.4% rise in its net revenue to $7.0 bln from $5.3 bln in FY08. Most of this gain came from a 125% increase in royalty revenue to $492 mln in FY09 versus $218 mln in FY08. The rollout of Atripla in the European Union and continued use of Atripla and Truveda in the U.S. and Canada was also a factor. In FY09 Atripla generated 37% of total product sales as revenues rose 50% to $2.4 bln versus $1.6 bln in FY08. GILDôs net profit grew ~ 33% to ~ $2.60 bln versus ~ $1.95 bln during FY08. EPS increased by 35.3% to $2.91 versus $2.15. During 2Q10, GILD reported revenue growth of 18% to ~ $1.9 bln versus ~ $1.6 bln in 2Q09. Most of the increase was due to the 53.8% increase in royalty income to $121.16 mln versus $78.78 mln in the corresponding quarter in FY09. During the quarter, GILD diluted EPS grew 29.5% to $0.79 from $0.61 in 2Q09.



Margin trends – During FY09, GILDôs gross profit margin declined 163 basis points to 77.24% compared to 78.87% in FY08, primarily due to the drop in GILDôs product gross margin which registered 75% compared to 78% in FY08. The lower product gross margin in FY09 was primarily due to the higher proportion of Atripla sales, which include the favirenz portion with a ózeroô product gross margin, as well as the amortization associated with the intangible assets acquired in its acquisition of CV Therapeutics. Operating profit margin and net profit margin registered improvements of 14 bps and 50 bps respectively versus FY08 levels. During 2Q10 the companyôs gross profit margin declined 39 bps to 76.36% from 76.75%. Net margin improved significantly by 225 bps to 36.775% versus 34.550% in 2Q09 mainly due to greater operating leverage and the increase in Tamiflu royalties.



Financial Summary

	FY 2009A	FY 2010E	FY 2011E	FY 2012E
Summary Income Statement				
Revenue	7,011.38	8,072.90	8,683.21	9,473.39
Gross Profit	5,523.78	6,478.42	6,938.41	7,605.90
EBITDA	3,697.50	4,520.99	4,796.35	5,313.15
Interest Expense	69.66	66.32	66.33	66.33
Pre-tax Income	3,501.96	4,460.96	4,814.62	5,424.15
Net Income	2,635.75	3,247.25	3,489.64	3,916.75
EPS	2.91	3.61	3.88	4.35
Summary Balance Sheet				
Cash and Equivalent	1,656.97	4,061.95	7,113.35	10,529.21
Short-term Debt	5.59	6.34	6.34	6.34
Long-term Debt	1,155.44	1,170.10	1,170.10	1,170.10
Total Debt	1,161.03	1,176.44	1,176.44	1,176.44
Share holders Equity	6,367.06	9,733.99	13,343.30	17,379.73
Total Assets	9,698.55	13,028.30	16,802.85	21,044.24
Summary Cash Flow				
Cash from Operations	3,080.05	2,713.18	3,378.32	3,768.25
Capex	(1,477.87)	(157.93)	(167.11)	(198.78)
Capex, net	(1,477.87)	(60.76)	(64.06)	(89.54)
Free Cash Flow	1,157.88	3,186.49	3,425.58	3,827.21
Key Ratios				
Revenue Growth Y/Y	31.40%	15.14%	7.56%	9.10%
EPS Growth Y/Y	35.35%	24.00%	7.50%	12.20%
Gross Margin	78.8%	80.2%	79.9%	80.3%
EBITDA Margin	52.7%	56.0%	55.2%	56.1%
EBIT/Interest exp.	51.5	66.4	70.5	78.1

$million, except EPS
NM: Not Meaningful; NA: Not Available

Significant Developments

(07/26/2010) **Gilead to Offer $2.2 bln of Convertible Senior Notes –** GILD announced its intention to offer ~ $1.1 bln principal amount of convertible senior notes due 2014 and ~ $1.1 bln principal amount of convertible senior notes due 2016 to qualified institutional buyers.

(07/20/2010) **2Q10 Financial Results –** GILD announced its results of operations for the quarter ended June 30, 2010. See bottom of page 2.

(07/14/2010) **Gilead Sciences Files Lawsuit against Lupin** – GILD filed a lawsuit against Lupin Ltd. for infringement against Gilead's patents for Ranexa.

(06/25/2010) **GILD to Acquire CGI Pharmaceuticals** – Gilead acquired CGI for up to $120 mln, the majority as an upfront payment and the remaining based on clinical development progress, all of which will be financed through available cash on hand.

(05/11/2010) **Announced $5 bln Share Repurchase Program** – The Board of Directors of GILD has authorized the repurchase of up to $5 bln of the Company's common stock through May 2013. This is a significant repurchase representing ~ 15% of GILDôs market capitalization.

(02/22/2010) **FDA Approved GILD's Cayston (Aztreonam for Inhalation Solution)** – The U.S. Food and Drug Administration (FDA) has granted marketing approval for Cayston (Aztreonam for inhalation solution) as a treatment to improve respiratory symptoms in cystic fibrosis patients with Pseudomonas aeruginosa.

(01/29/2010) **Gilead Sciences Share Repurchase Program –** Board of Directors of GILD has authorized the repurchase of up to $1.0 bln of its common stock through January 2011.

Standpoint Research 155-Variable Model / Quantitative Analysis with Fundamental & Subjective Overlay

We recently ran 200 Healthcare stocks through our 155-variable computer model. Refer to the *Legend* sheet in our Excel reports for the color code and description of all 155 variables used in our model. The 155-variable scoring is summarized in the 32 categories below (from roe through peg). The number in each of the cells, is the rank out of **200** stocks in the recent run. The seven cells to the right of the peg cell are coded and for internal use. For example -- a weak score for return on equity (roe) can be offset by a strong score on price-to-book (pbk). A weak score on technical indicators (**especially at the extremes**), is looked at positively if it is combined with strong scores on fundamentals and valuation. Below is the color-coded profile generated by the computer for # 1 ranking Gilead Sciences **GILD**.

rank	ticker	roe	roa	roc	ebitda	npm	acct	eps m	rev gr	eps gr	beta	debt	stab gr
1 / 200	GILD	3	2	1	5	2	58	31	34	28	38	78	46

div I	pbk	base	rel-ma	inside	safe	pcf I	pcf II	fcf	div II	rel str	pr mo	ps	rel ps	off hi-lo
23	98	91	11	25	55	174	8	66	52	197	194	146	1	8

pred	pertix	perhis	blend	peg	deducts	t val	t fund	t prop	t misc	t tech	total score
145	13	9	22	5	3389	926	934	527	600	402	77.10%

We are currently slightly overweight in this sector with 11 open recommendations (out of 79 overall). That is a 13.9% weight versus 11.3% in healthcare for the S&P-500. Our current open recommendations are: BIIB, GILD, CMED **China**, SYK, ZMH, CVH, HWAY, ENDP, PFE, SNY **France** and TEVA **Israel**. GILD was added on July 13, 2010; JNJ was dropped on July 1, 2010; AZN **United Kingdom** was dropped on July 30, 2010.

When French drug maker Sanofi-Aventis **SNY** approached biotech firm Genzyme **GENZ** expressing its interest in an acquisition last week, several biotech stocks jumped on speculation over who would be the next target. This reaction was rational. *Big Pharma* has struggled with the problem of expiring patents for years, and many companies are now becoming desperate to replenish their drug pipelines. With several pharmaceutical firms set to lose a significant share of revenues to generics in the next three-to-five years as a result of patent expiration, we must consider how desperate each firm is now or will be in the near-term; which companies have the resources to make an M&A deal, and what deal would make the most sense for their respective businesses.

Sanofi-Aventis seems determined to carry out the acquisition of Genzyme. The companyôs board has already approved a $70 per share bid ï which amounts to an $18.6 bln offer. According to Dr. Mark Schoenebaum, an analyst at ISI Group, the deal makes sense (although we feel SNY may end up overpaying for a company now trading at 35X 2010 earnings). This would provide Genzyme founding CEO with a ñgraceful exitò as the company recently had manufacturing problems as well as problems with activists on its board. The addition for SNY, while contributing a healthy drug pipeline would also allow the company to greatly expand its biopharmaceuticals division. British pharmaceutical giant GlaxoSmithKline (also) feels Genzyme might fit well with its operations. While the company has not yet made a formal offer to the # 4 biotech firm, it has casually approached -- creating speculation of a potential bidding war. Others have thrown Johnson & Johnson **JNJ**, AstraZeneca **AZN**, Merck & Co. **MCK**, and Novartis **NVS** into play, and while the first two are contenders, the last two are unlikely because of their recent (and significant) acquisitions. That leaves four likely players in a potential bidding war. Johnson & Johnson is the player best equipped to win such a war. The company was holding $14 billion on its balance sheet as of the end of the first quarter, twice the size of that held by any of the other three companies. However, because of the diversification of its operations, JNJ is not in as dire need as the other three.

AstraZeneca, GlaxoSmithKline, and Sanofi-Aventis all face near and medium-term generic competition. AstraZeneca holds eight patents that are all set to expire within the next eight years on drugs that contribute ~ 60% of the companyôs revenue. The company does have another eight products near the end of their pipeline, but it is unclear how many of those will be approved by the FDA. The outlook for GSK and SNY is grimmer. By as early as next year, 40% of GSK revenues will be under threat from generics, and by 2015 that figure will top 50%. While next year SNY will only have 25% of its revenues exposed to generic competition, by 2015 that figure will top 60%. This information seems to suggest that Sanofi faces greater trouble in the next five years than its competitors. This may imply that SNY would be more willing to purchase a biotech firm sooner as opposed to later and perhaps at a premium to what others are willing to pay. SNY circumstances may have forced it to act more hastily than its peers. Those peers will have to move quickly in order to increase the drugs in their respective pipelines, and there are a few targets with which they could move forward. In addition to GILD, the peers we focus on here are Biogen Idec BIIB, Celgene CELG, Cephalon CEPH, Amgen AMGN and Genzyme GENZ.

Before we compare the biotech peers it is important to discuss the clinical research process. On average, it takes ~ twelve years for a drug to reach the patient population. Phase I can take from several months up to a year, and approximately 70% of drugs pass this phase. Phase II can take from several months up to two years and ~ 30% of drugs pass to the next phase. Phase III will generally last a few years and 70%-90% of drugs pass through this phase to request approval by the FDA or other regulatory agencies around the world. In total, only 20% of drugs that pass through the clinical trial process and receive approval for patient use.

Amgen is a biotech peer with a substantial pipeline. The company holds the most total drugs in its pipeline out of these peers. However, the majority of these drugs (85%) are in the first and second phases in the clinical testing process, and considering the low success rate of the second phase, the size of its pipeline is not as impressive as it sounds. Amgenôs primary focuses are on nephrology, inflammation, and supportive cancer care. Because of its presence in the field of oncology, Johnson and Johnson ï its biggest competitor ï would be a more likely acquirer. Amgen actually sells one of its best-selling drugs, Epogen, to JNJ which markets the drug under the name Procrit.

While Johnson & Johnson would have the greatest source of cash to make such a deal, the company is more prone to acquire (much) smaller firms that it can easily absorb into its existing businesses. While SNY has expressed interest in expanding its focus on cancer drugs, Amgen is a deal that may be too pricey for the companyôs budget. Amgen has a market capitalization of $51.1 billion, more than twice the size of its peer, Celgene, which analysts say could be an attractive target.

How Relative Pipeline Strength was calculated in the table below –

Each company was ranked 1-6, (with 6 being the best) by the number of drugs that were in each phase of clinical testing (according to data on the company web sites). Thus the company with the greatest number of drugs in phase one would get a ñ6ò, and the company with the least number of drugs in the phase would get a ñ1ò. This was done for each phase. Then each ranking was weighted by order of its proximity to being passed. So rankings in Phase III received a weight of 0.5, rankings in Phase II received a weight of 0.3, and rankings of Phase I received a weight of 0.2. Thus, companies with more drugs in Phases II & III would have greater ñpipeline strengthò than companies with a majority of their drugs going through Phase I of clinical trials. The figure was intended to emphasize pipelines as a whole that were closer to being approved by regulatory authorities, as these big pharma companies are looking for new drugs to replenish expiring patents and timing is certainly an issue.

Note: This simple exercise does not take into consideration what the market size for each drug is. An assumption is made that all markets are the same size. In most cases, the law of averages would have these numbers evening out.

	GILD	GENZ	BIIB	AMGN	CELG	CEPH
Price	$33.42	$68.00	$55.92	$53.76	$52.85	$57.62
Market Cap	$29.5 bln	$18.1 bln	$13.7 bln	$51.1 bln	$24.8 bln	$4.27 bln
Beta	0.70	0.53	0.61	0.45	0.80	0.64
Revenue (ttm)	$7.85 bln	$4.29 bln	$4.57 bln	$14.93 bln	$2.88 bln	$2.27 bln
Quarterly Revenue Growth y/y	17%	-12.10%	10.90%	8.60%	30.80%	14.70%
Profit Margins (ttm)	38.77%	-1.76%	23.95%	31.84%	29.50%	17.39%
Relative Pipeline Strength (out of 6.0)	2.3	5.2	3.8	5.4	1.5	1.7
R&D Spending as a % of revenue	12.4%	20.5%	26.8%	19.3%	28.4%	17.5%

Source: Yahoo! Finance, Thomson Reuters

Celgene and Cephalon both have pipelines that compare poorly to those of peers. Celgene has only six drugs going through clinical testing, and only one of those is in phase three. Cephalon has eight drugs going through trials. None of those are in the last phase of testing. About a quarter of Cephalonôs revenues come from treatments for pain relief. The company, which has a $4.27 billion market capitalization, competes directly with JNJ in this segment. Considering JNJ (usually) only seeks to acquire rather small firms, this would be a more likely match should the company take part in the M&A wave.

Regardless of its prospects going forward, Celgene was said to be a candidate for acquisition by Sanofi because of its strong presence in the therapeutic area of oncology. A majority of the companyôs revenues come from treatment for multiple myeloma and other blood cancers. Sanofi had articulated its target price at around $20 billion, close to that of CELG market capitalization. Because the company is seeking a new pipeline, though, it will likely focus on a target that is better positioned to provide new drugs.

Biogen is another company that has a notable pipeline. It has eight drugs in phase three of clinical trials. The therapeutic areas that it focuses on are oncology, neurological diseases, and autoimmune diseases. Analysts have speculated that Biogen would be an even better takeover candidate for Sanofi than Genzyme. According to analysts, BIIB does not have the regulatory issues that GENZ has had to manage. In addition, the company has had more financial success, bringing in more revenue and higher profit margins than Genzyme. The company also has a smaller market capitalization. Over 80% of its revenues come from its treatment for multiple sclerosis, an autoimmune disease, which Sanofi has no investment in. We initiated coverage on BIIB January 19, 2010. BIIB **remains** an open recommendation of ours and is + 580 basis points versus the S&P-500 since the recommendation was made. The shares dropped 1.1% on Friday, July 30 (analyst downgrade at Bernstein).

Genzymeôs most attractive feature is its pipeline and **that is why it trades at a high multiple relative to others in the industry**. The company placed second behind Amgen with ten drugs now in phase three of the testing process. However, its financial figures are far from impressive. The company experienced negative revenue growth in its second quarter from a year earlier. It also produced negative profit margins over the last twelve months. These figures price the company at a discounted multiple **relative to historical multiples** for GENZ which may serve well for a potential bidder. This discount should be attractive to an acquirer considering such an appealing pipeline, although the shares are expensive based on trailing earnings and 2010-2011 estimates.

With regard to relative pipeline strength, **Gilead** placed fourth out of the six firms and that is one reason it trades at 9X. Its pipeline is small compared to other firms ï **that being said, six of its thirteen drugs that are in clinical testing are in the third phase** which is encouraging. Still, the company already has profit margins that far exceed those of its peers, and holds a solid revenue base bringing in billions more than competitors GENZ, BIIB, CELG, and CEPH. Approximately 80% of Gileadôs revenue comes from marketing antiviral treatments for HIV. GlaxoSmithKline has a substantial presence in anti-virals as well. In fact, Gilead partners with GSK to commercialize its products all over the world and to perform clinical research. For this reason, a combination of the two firms would make sense.

Last but not least, **GILD ranks # 1 versus 200 healthcare names** according to our 155-variable computer model. This rank is up from # 58 in May, 2009 (Q2 HC sector report) when it traded at $45. We attach an 11X multiple to $4.00 in earnings potential to arrive at a $44 target for 2011-2012 -- 31% above the current quote.

Partial list of sources

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End of Report

For whoever did not receive our note on AZN from 8am, Thursday, July 29, it is pasted below --

From 8am, July 29, 2010 …

Downgrading AstraZeneca AZN from Buy to Hold

We recommended AstraZeneca AZN on February 25, 2007 -- Adjusted for dividends, the shares are + 2800 basis points for us versus the S&P since AZN was recommended. There is still value here and our price target remains $60 for 2011-2012, but we can no longer leave our highest rating attached to this name. AZN will hit a three-year high today and is ahead of the S&P-500 by 2000 bps since late May.

The good news from after-the-close on Wednesday -- earnings beat, raised guidance and FDA approval for blood thinner drug Brilinta -- is already priced in. We are over-weight in healthcare and see this as an opportunity to lighten up ï selling on the news and boost to the sector from the SNY-GENZ news, takeover speculation surrounding other names and the shift to lower beta names in a rough market by risk averse investors.

The raised buyback to $2 bln is positive, but not very significant relative to the size of this $75 bln market cap company. Additionally, expected *annual* sales from Brilinta of ~ $1-$2 bln will be positive, but not very significant relative to total sales of $32 bln. All this news does is offset and reduce concerns going forward -- AZN needs to replace revenue that will be lost from Seroquel (schizophrenia) and Nexium (stomach) -- hurt by generic competition. Revenues for each of those drugs for the *quarter* reported this morning were ~ $1.3 bln. Revenue growth in the U.S is actually negative for AZN at this point offset by gains in emerging markets.

This reported second quarter may be the last impressive earnings we see before key drugs from AZN go off-patent. Furthermore, there is not any additional good expected news coming now that the Brilinta story is out. Brilinta will compete with Plavix and Lipitor. AZN is based in the United Kingdom and its dividend yield is > 6%.

Note: the gain in London as of 8am [EST] is currently 4.8%, but all that did was get the UK price a bit higher than where AZN traded here yesterday on the Brilinta news, so the gain here at the open may not be more than 2%-3%.

Updated Report Schedule

July 04: S&P-500 _ # 263
July 08: Individual write-up **ADBE**
July 12: Special Report _ # 264
July 16: Energy-150 _ # 265
July 20: Healthcare-200 _ # 266
July 24: Individual write-up **TEO**
July 27: Industrials-300 _ # 267
July 31: Individual write-up **GILD**

Aug 04: Russell-1000 _ # 268
Aug 07: Cons Disc-300 _ # 269
Aug 11: Individual write-up **WDC**
Aug 15: Short Interest-1000 _ # 270
Aug 19: Cons Staples-100 _ # 271
Aug 23: Individual write-up **CVX**
Aug 27: ADR-Int'l-200 _ # 272
Aug 30: Individual write-up TBD

Disclaimer:

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