

PDL BioPharma

Downgrading to Underweight; Range of Strategic Options All Point to Downside

We are downgrading shares of PDLI to Underweight from Neutral. We see downside from current levels based on the range of strategic outcomes on the table including: 1) status quo; 2) an outright sale of the royalty stream; or 3) securitization of the royalty stream. This is based on our analysis of the operating structure as well as the tax and debt implications of a potential transaction. The last 12 months have been volatile for PDLI shares, which declined to just above \$9 in May, but rallied ~30% since. We believe this rally is unjustified, and expect PDLI shares to trade lower as investor expectations for the value of the royalty stream and the biotech spin-off reflect the true value of these entities. **Join us for a conf call at 11am ET today to discuss this and other SMid cap ratings changes (US: 888-606-5716; Int'l: 517-308-9288; Pass: BIOTECH).**

- **Royalty company requires unique valuation.** We believe the royalty stream, given its defined duration and predictable cash flow, should not be valued like a typical equity investment, but rather like a fixed income asset. In valuing the royalty stream, the Street in our view has not fully considered: 1) the tax implications; 2) the continued operating expense associated with a royalty company; 3) the remaining obligation to service and redeem the \$500M in debt before the 2014 "Queen" patent expiration; and 4) the discount rate (e.g., the required IRR for an acquirer) used in calculating the NPV. We view a mid-teens discount as appropriate, not a WACC discount normally used as the nature of the entity requires no premium.
- **Tiered royalty diminishes optionality from adjuvant.** A key catalyst for PDL is data from the trial of Avastin in adjuvant colon cancer, which we estimate could add \$1.4B in US Avastin sales by 2012. Importantly though, as Genentech sales increase, the tiered royalty that PDL is paid continues to decline. Indeed, we believe that a positive Avastin trial could lead royalties on Genentech products to decline to the mid-1% range, which is well below the 2% range that many investors assume.

PDL BioPharma (PDLI;PDLI US)

	2007A	2008E	2009E
EPS Reported (\$)			
Q1 (Mar)	0.09	(0.15)A	
Q2 (Jun)	0.31	0.29A	
Q3 (Sep)	0.16	0.14	
Q4 (Dec)	0.04	0.05	
FY	0.61	0.35	0.89

Source: Company data, Reuters, JPMorgan estimates.

Downgrade Underweight

Previous Rating: Neutral

\$11.62

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US Biotechnology

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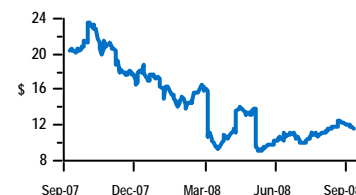
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Price Performance



Company Data

Price (\$)	11.62
Date Of Price	10 Sep 08
52-week Range (\$)	23.95 - 9.00
Mkt Cap (\$ mn)	1,383.88
Fiscal Year End	Dec
Shares O/S (mn)	119

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See page 6 for analyst certification and important disclosures.

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- **Ascribe minimal value to pipeline.** We have very little conviction in PDL's pipeline, with its most advanced programs being daclizumab (ph 2: MS, asthma – partnered with Biogen), volociximab (ph 2: solid tumors – partnered with Biogen), and elotuzumab (ph 1: multiple myeloma – partnered with Bristol). Data available thus far have shown undifferentiated product profiles, and point to limited commercial potential if late-stage studies are successful.
- **Biotech spin-off should trade at discount to cash.** Given our pessimistic view on the potential of PDL's biotech pipeline, which will require continued cash output, a potentially dilutive financing within 3 years, and little R&D success historically, we believe it should trade at a discount to cash. PDL has indicated it will invest \$375M upfront to fund the pipeline, and we believe a 10% discount to this investment is reasonable, which places the value at under \$3/share.
- **Total NPV suggests ~\$9 is more reasonable.** We revised our NPV analysis based on what the entire company is worth currently. We now assume that the fully taxed (less NOLs) royalty company that will remain following the biotech spin-off, discounted to the present at 15%, plus net cash, less \$20M in advisory and legal fees, would be worth over \$6/share. Couple this with a little under \$3/share in value for the biotech spin-off, and we arrive at an NPV for PDL of a little over \$9/share for PDL.
- **Unlikely to securitize full value of future royalties.** PDL has indicated an option to monetize the royalty stream could also include securitization. Based on our analysis, we believe PDL would have difficulty securitizing more than \$1B for the royalty stream. Indeed, the Sensipar precedent suggests the securitization value could be worth only 20% of the future royalty value. Given that Sensipar was yet to be launched and thus faced greater market risk, we believe PDL could receive ~40% of estimated future royalty payments, which based on our estimates is roughly \$1B.
- **Securitization unlikely to increase value.** We conducted a separate NPV on the potential distribution if PDL does securitize \$1B of the future royalty stream. In this case, we assume the \$500M in debt would be required to be repaid (or the cash would need to be set aside), and after fees we estimate \$4/share could be distributed immediately to shareholders. Once the debt is repaid (likely before the royalty stream disappears), PDL shareholders would have access to any remaining royalty payments, which including cash would be worth under \$2.50/share. Adding these with the biotech spin-off at under \$3.00/share, and we arrive at an NPV of a little over \$9.00/share.
- **Outright sale of royalty stream still implies value below current levels.** In the event of an outright sale of the royalty stream based on a modest 10% discount of future top-line royalty revenue, the value of the company would still be below current levels (see Table 3). The proceeds would still be taxed (less NOLs), advisory fees would need to be paid, and the debt would still need to be serviced. Importantly, we view this outcome as unlikely, and suspect an acquirer will apply a higher discount and consider operating costs.
- **Downgrading PDLI shares to Underweight.** Following our analysis of the value of PDL under several scenarios, we see a meaningful disconnect from the current price of PDLI shares and the true value of the company. As a result, we are downgrading PDLI shares to Underweight from Neutral, and will wait for more attractive levels to revisit the story.

Table 1: PDL Valuation – Current Value as of Today

PDL NPV Analysis - Value Today	2H08E	2009E	2010E	2011E	2012E	2013E	2014E	1H15E	Total
IP: Expires Dec 2014 and paid 1 quarter in arrears									
Royalty revenues	118	316	336	356	382	398	420	42	2,368
Operating Expense	5	12	13	13	14	15	15	4	90
Operating Profit	113	304	324	343	368	383	405	38	2,278
Net Interest	2	4	4	12	17	20	20	5	84
Pretax Income	115	308	328	355	385	403	425	43	2,362
Total Tax Paid (Less NOLs)	2	54	125	135	146	153	161	16	793
Net to PDL	113	253	203	220	239	250	263	27	1,569
Discount rate	15%								
Years to discount	0	0	1	2	3	4	5	6	
Royalty Stream NPV	113	253	177	166	157	143	131	12	1,152
Net Cash (less \$375M for biotech spin-off)	(368)								
Less Fees	20								
Royalty Company NPV	764								
Royalty Company NPV/Share	6.43								
Biotech Company Value (assume 10% discount to cash)	341								
Biotech Company Value/Share	2.87								
PDL NPV	1,105								
PDL NPV/Share	9.30								

Source: Company data and JPMorgan estimates.

Table 2: PDL Valuation –Securitization of Royalty Stream

PDL NPV Analysis - Securitization	2H08E	2009E	2010E	2011E	2012E	2013E	2014E	1H15E	Total
Royalty revenues	118	316	336	356	382	398	420	42	2,368
Operating Expense	5	12	13	13	14	15	15	4	90
Operating Profit	113	304	324	343	368	383	405	38	2,278
Net Interest	(15)	(60)	(60)	(60)	(60)	(45)	0	0	(300)
Pretax Income	98	244	264	283	308	338	405	38	1,978
Total Tax Paid (Less NOLs)	1	24	100	108	117	129	154	15	647
Net Revenue	97	220	163	175	191	210	251	24	1,331
Less Debt Obligation Amortization	97	220	163	175	191	153	0	0	1,000
Debt Balance	903	683	520	344	153	0	0	0	2,604
Net to PDL	0	0	0	0	0	56	251	24	331
Discount rate	15%								
Years to discount	0	0	1	2	3	4	5	6	
Royalty Stream NPV	0	0	0	0	0	32	125	10	167
Security Value	1,000								
Debt Repayment	500								
Less Fees	35								
Net Proceed From Security	465								
Net Security Value Per Share	3.91								
Net Cash (less \$375M for biotech spin-off)	132								
Remaining Royalty Company NPV	299								
Royalty Company NPV/Share	2.51								
Biotech Company Value (assume 10% discount to cash)	341								
Biotech Company Value/Share	2.87								
PDL NPV	1,105								
PDL NPV/Share	9.30								

Source: Company data and JPMorgan estimates.

Table 3: PDL Valuation – Complete Sale of Royalty Stream

PDL Royalty - Complete Sale of Royalty	2H08E	2009E	2010E	2011E	2012E	2013E	2014E	1H15E	Total
Royalty revenues	118	316	336	356	382	398	420	42	2,368
Discount rate	10%								
Years to discount	0	0	1	2	3	4	5	6	
Royalty Stream NPV	118	316	306	294	287	272	261	24	1,877
Sale Price	1,877								
Less Fees	35								
Gross Proceeds from Sale	1,842								
Tax Paid (Less NOLs)	595								
Available to shareholders	1,247								
Net Cash (less \$375M for biotech spin-off)	(368)								
Net Proceeds from Sale	879								
Royalty Company NPV/Share	7.39								
Biotech Company Value (assume 10% discount to cash)	341								
Biotech Company Value/Share	2.87								
PDL NPV	1,219								
PDL NPV/Share	10.26								

Source: Company data and JPMorgan estimates.

Valuation and Rating Analysis

We rate PDLI shares Underweight. In our view, the risk-reward in PDLI shares is not compelling given uncertainty over upside potential from either pipeline development or strategic alternatives. The failure of Nuvion leaves PDL's pipeline without a late-stage candidate, although we view M200 and daclizumab as promising phase II assets. Monetization of assets through strategic alternatives could also be a challenge given the company's stepwise approach of reviewing its options for maximizing shareholder value, and our NPV analysis suggests the value from strategic alternatives would be below current valuation.

Risks to Our Rating

As a development-stage biotechnology company, our Underweight rating comes with several investment risks that could cause share prices to increase. Upside risks to PDL's current share price include: (1) appreciation of PDLI shares through acquisition or through take-out expectations above what we view as the value of its assets; (2) a resolution of legal disputes with Alexion on royalties PDL may be entitled to for Soliris; (3) further business development deals that increase PDL's cash position; and (4) positive clinical data for pipeline candidates.

PDL BioPharma: Summary of Financials

Income Statement - Annual	FY07A	FY08E	FY09E	FY10E	Income Statement - Quarterly	1Q08A	2Q08A	3Q08E	4Q08E
Revenues	406	302	342	360	Revenues	57	112	76	56
Cost of products sold	(60)	0	0	0	Cost of products sold	0	0	0	0
Gross profit	345	302	342	360	Gross profit	57	112	76	56
SG&A	(133)	(59)	(32)	(35)	SG&A	(20)	(17)	(13)	(9)
R&D	(236)	(170)	(142)	(157)	R&D	(48)	(40)	(42)	(39)
Operating Income	(35)	104	166	147	Operating income	30	52	18	5
Note: EBITDA	(3)	120	174	155	Note: EBITDA	-	-	-	-
Net interest income / (expense)	6	3	4	4	Net interest income / (expense)	1	0	1	1
Other income / (expense)	-	-	-	-	Other income / (expense)	-	-	-	-
Pretax income	(30)	107	171	171	Pretax income	31	52	19	6
Income taxes	0	4	51	51	Income taxes	1	1	1	1
Net income - GAAP	(21)	(6)	120	120	Net income - GAAP	(62)	34	18	5
Net income - recurring	72	52	136	136	Net income - recurring	(22)	45	21	8
Diluted shares outstanding	119	150	151	152	Diluted shares outstanding	141	152	153	153
EPS - excluding non-recurring	0.61	0.35	0.89	0.88	EPS - excluding non-recurring	(0.15)	0.29	0.14	0.05
EPS - recurring	0.61	0.35	0.89	0.88	EPS - recurring	(0.15)	0.29	0.14	0.05

Balance Sheet and Cash Flow Data	FY07A	FY08E	FY09E	FY10E	Ratio Analysis	FY07A	FY08E	FY09E	FY10E
Cash and cash equivalents	341	374	529	435	Sales growth	23.2%	(100.0%)	0.0%	0.0%
Accounts receivable	-	-	-	-	EBIT growth	(73.7%)	(394.4%)	59.9%	(11.5%)
Inventories	-	-	-	-	EPS growth	27.9%	(42.7%)	156.2%	(1.4%)
Other current assets	308	10	10	10	Gross margin	85.1%	100.0%	100.0%	100.0%
Current assets	720	431	561	442	EBIT margin	(8.7%)	34.4%	48.6%	40.9%
PP&E	331	200	220	242	EBITDA margin	(0.8%)	39.8%	50.9%	43.1%
Total assets	1,192	703	853	756	EBITDA margin				
					Tax rate	40582.8%	30173.8%	34153.6%	35956.2%
Total debt	563	564	566	66	Net margin	17.8%	17.4%	39.7%	37.8%
Total liabilities	685	681	684	186	Debt / EBITDA	(181.3)	4.7	3.3	0.4
Shareholders' equity	508	21	169	570	Debt / Capital (book)	52.6%	96.4%	77.0%	10.3%
Net income (including charges)	(21)	(6)	120	120	Return on assets (ROA)	(0.6%)	1.5%	15.9%	18.0%
D&A	32	16	8	8	Return on equity (ROE)	(4.1%)	(26.3%)	71.0%	21.1%
Change in working capital	(6)	(5)	1	1	Return on invested capital (ROIC)	(0.7%)	1.8%	18.5%	21.4%
Other	-	-	-	-	Enterprise value / sales	2.9	3.7	2.8	3.0
Cash flow from operations	67	8	130	131	Enterprise value / EBITDA	(93.3)	2.3	1.4	1.7
Capex	(95)	(10)	(10)	(10)	Free cash flow yield	0.0%	(79.1%)	360.8%	(160.7%)
Free cash flow	162	34	155	(94)					
Cash flow from investing activities	73	15	15	15					
Cash flow from financing activities	22	11	10	(240)					
Dividends	-	-	-	-					
Dividend yield	-	-	-	-					

Source: Company reports and JPMorgan estimates.

Note: \$ in millions (except per-share data). Fiscal year ends Dec

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PDL BioPharma (PDLI) Price Chart



Date	Rating	Share Price (\$)	Price Target (\$)
08-Oct-05	OW	28.00	--
29-Aug-07	N	23.60	--

Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
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