Lannett Company, Inc.

NYSE:LCI

Analyst: Nils Weddig
Sector: Healthcare

BUY

Price Target: $59.52

Key Statistics as of 12/04/2015

Market Price:	$37.45
Industry:	Drugs - Generic
Market Cap:	$1.37 B
52-Week Range:	$33.13-72.44
Beta:	2.94

Thesis Points:

- Discount on LCI due to the acquisition of Kremers Urban Pharmaceuticals although acquisition will add value to Lannett and further diversify its product portfolio
- Fastest growing company of the year according to Fortune, with ability to create value and a promising product pipeline
- Market overreaction to negative macroeconomic news leading to current undervaluation

Company Description:

Lannett Company, Inc. is a specialty pharmaceuticals firm founded in 1942 and based in Philadelphia. Lannett is in the business of developing, manufacturing and distributing generic pharmaceutical products in the United States. Its products include tablets, capsules and drugs in oral liquid form, topicals as well as parenteral and ophthalmics. The company's more than 100 products are marketed for the treatment of migraine, glaucoma, anesthetic, thyroid deficiency, hypertension, dryness of the mouth, congestive heart failure, gout, bronchospasms and gallstone. In addition, Lannett manufactures active pharmaceutical ingredients (APIs) through its subsidiary Kremers Urban Pharmaceuticals, Inc. The company primarily sells its products to retail drug chains such as CVS, drug wholesalers, distributors and government agencies.

Thesis

Lannett Company, Inc. (NYSE: LCI) is a fast growing pharmaceutical firm with a promising product pipeline of 20 drugs pending approval and additional 42 drugs in development. In the past years the company focused on sales growth recently being ranked by Fortune as the fastest growing company in the United States in 2015 based on sales growth as well as earnings per share.

In addition, Lannett is heavily investing into diversifying their product portfolio. The company's recent acquisition of Kremers Urban Pharmaceuticals, Inc. added 18 high margin products to Lannett's product portfolio of now more than 100 products. LCI is currently being discounted in the market. Recent news of Kremers' loss of a customer and a potential loss of revenues for the subsidiary led to a decrease of Lannett's stock price of 34.26% to $34.38 although management is certain that the acquisition will add value to Lannett even with the loss of the customer. In addition, Lannett's stock price movement has similarities with all its competitors in the pharmaceutical industry. Lannett as well as the pharmaceutical sector have recently been seeing declines due to negative macroeconomic news.

A BUY of Lannett Company, Inc. (LCI) is therefore recommended with a one-year target price of $59.52. Currently trading at $37.45, it has an upside potential of 58.92% with a conservative valuation approach.

Industry Outlook

Lannett Company is primarily providing products for the generic drug industry. The outlook for the upcoming quarters and years is very positive and Lannett is expecting strong growth in the upcoming quarters.

As the company states there are many drivers for continued growth in the U.S. generic pharmaceutical industry. Generic pharmaceutical companies are able to produce its products at a cost of 80-85% lower than the brand which enables firms like Lannett to market their products at significantly lower prices. Generic drug companies usually incur lower costs since their main expenses are for the manufacturing process rather than development and testing. Generic drugs are comparable to brand listed drugs in their dosage form, quality, strength and performance as well as the usage of the drug. Generig drugs are usually available once the original patent of the brand drug expired. Therefore, the generic drug industry expects a large potential of growth in the upcoming years since through 2017 $86 billion of brand drug patents are expected to expire. The demand for generic drugs will continue to increase since aging baby boomers continue to fuel the market.

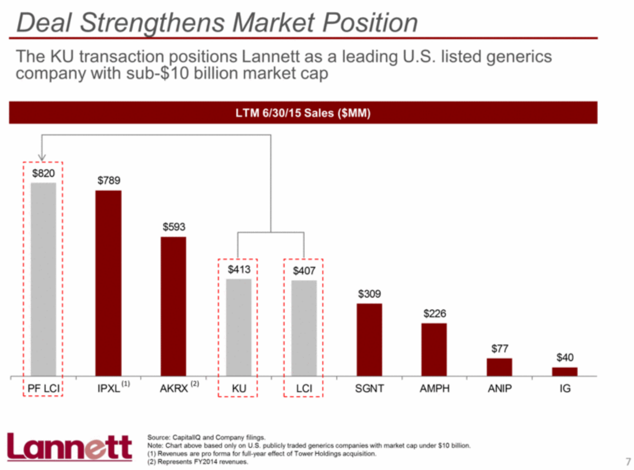
According to RNCOS "U.S. Generic Drug Market Outlook 2018", the U.S. generic drug market was valued at $43.5 billion in 2013. The market is expected to grow at a CAGR of 11% until 2018. Especially the market for drugs treating thyroid related illnesses will see significant growth in the upcoming years. Drugs for the treatment of thyroid deficiency currently make up 39% of Lannett's total sales. Currently, generic drugs account for 83% of prescriptions in the United States primarily due to their lower cost while providing the same results as brand products. Further driver of growth in the generic pharmaceutical industry is the advantageous product approval process. Abbreviated new drug applications (ANDAs) are being approved significantly faster compared to new drug applications (NDA). In general, there is no preclinical or clinical data required during the application process. Generic drug companies only need to provide characteristics of bioequivalence.

Lastly, Lannett has a strong customer base. The company's generics products are sold through third party distribution channels rather than directly to physicians and hospitals. Third party channels include chain drug stores such as Walgreens, CVS and RiteAid. Wholesale distributors including McKesson, Cardinal or AmerisourceBergen and mail-order pharmacies including Express Scripts/Medco, OPTUMRx and Caremark.

Acquisition Leading To Diversification

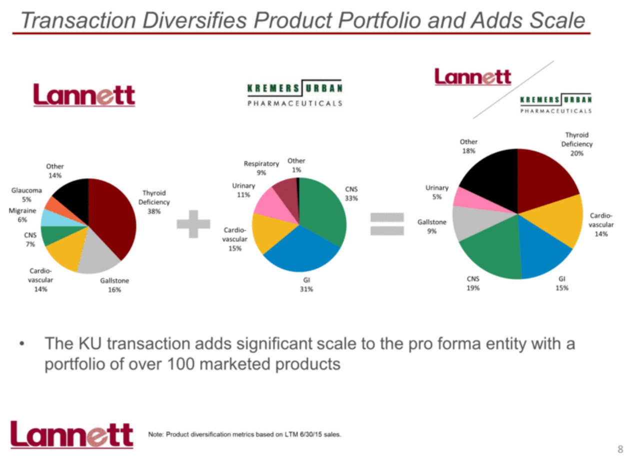
On November 27, 2015 Lannett Company, Inc. has completed its acquisition of Kremers Urban Pharmaceuticals, Inc. (KU) which is a specialty generic pharmaceuticals subsidiary of the global pharmaceutical firm UCB S.A. (Euronext:UCB). While previously being debt free, Lannett has issued a $1.16 billion term loan B as well as a $ 125 million undrawn revolving credit facility by Morgan Stanley and RBC in order to perform the $1.23 billion acquisition. The company's strong cash flow will enable Lannett to rapidly de-leverage the firm in the upcoming years.

The acquisition of Kremers transforms Lannett to the industry leader and largest company in the below 10 billion market cap range. Management is confident that the acquisition provides a broad product portfolio of now more than 100 products that will lead to future growth and an increase in profitability through economies of scale. The acquisition is expected to provide annual cost savings greater than $40 million after the third year. The acquisition also adds 18



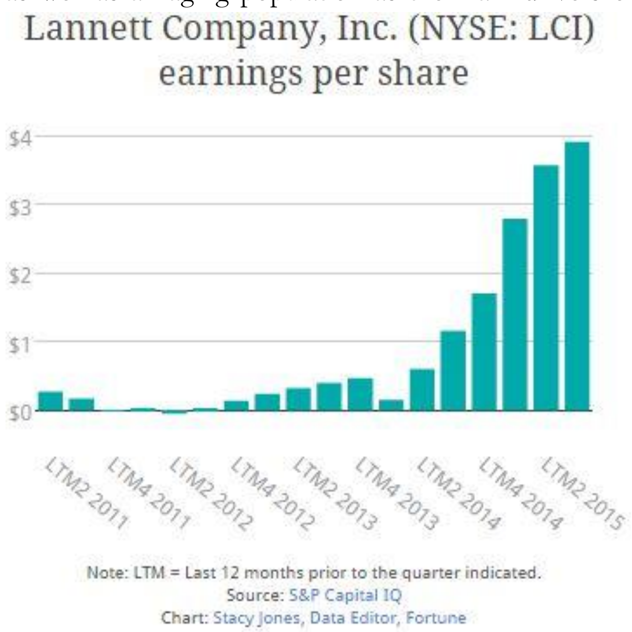
high margin products as well as 28 additional pipeline candidates, of which 11 are ANDAs currently filed with the FDA, to Lannetts product portfolio.

Kremers current strategy of marketing high barrier to entry generic drugs further improves the competitive advantage of Lennett. Especially Kremers product Methylphenidate XR has the potential to majorly contribute to Lannett's sales growth. The product has currently annual sales of approximately $70 million. The drug is Kremers' largest conbtributor to net sales and provides further upside potential due to the low number of competition in the market. Methylphenidate XR is prescribed for the treatment of several medical conditions. They include postural orthostatic tachycardia syndrome, attention deficit hyperactivity disorder and narcolepsy. The drug is also known under the name Concerta. The market for this drug is expected to further grow since more and more children are being prescribed ADHD and ADD medicine in order to treat hyperactive behavior. Overall, the acquisition of Kremers will significantly diversify Lannett's product portfolio which currently heavily relies on the company's thyroid deficiency and gallstone product segment with combined sales of 58% of Lannett's total sales. Besides improving Lannett's product portfolio, management expects a substantial tax benefit in excess of $100 million from the acquisition due to 338(h)(10) election.



Company growth and product pipeline

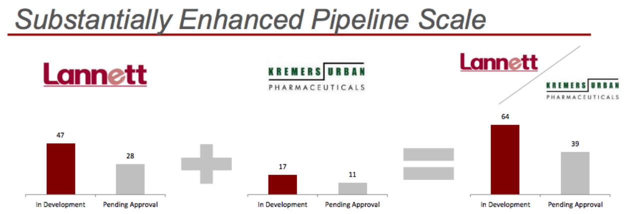
Fortune lists Lannett Company as the fastest growing company in the U.S. in 2015. The company achieved nine consecutive quarters of record sales combined with a three year annual earnings per share growth rate of 314%. Fortune states rising health care spending, growing prices in the generic pharmaceuticals industry as well as an aging population as the main drivers of



Lannett's growth.

After the acquisition of Kremers, Lannett's product pipeline has further improved. The company currently has 64 products in development of which 39 drugs pending approval. Nine of Lannett's ANDAs have Paragraph IV certifications pending at the FDA and are expected to be accepted shortly to start commercialization. In addition, Kremers adds eleven pipeline products with Paragraph IV certifications. Both

Lannett as well as Kremers have a strong record of regulatory compliance proving their ability to successfully bring new drugs to the market.



Management

Lannett Company is being managed by an experienced management team and run by CEO Arthur Bedrosian.

Mr. Bedrosian has been with the company for 13 years and has 46 years of experience in the industry. Overall, the entire executive team has experience in the industry of more than 20 years.

The management team is heavily invested into the company. Insider ownership ranges around 24%. This clarifies that the company management and shareholders of the company have the same interest of increasing the value of the firm and returning value to the shareholders since a large part of their compensation is coming from stock returns.

Financials

Lannett Company has positioned itself among industry leaders in the generic pharmaceutical industry and experienced large growth in the past quarters.

In the last 12 months the company had revenues of $419 million, net income of $148 million and EBITDA of $231 million.

The company's margins have significantly improved in the past years. Since 2012 Lannett's Gross Margin has increased from 31.7% to 74.4%. Lannett's EBITDA Margin has experienced similar growth. It improved from 10.3% to 56.5%. This demonstrates management's ability to improve the profitability of the company's core operations by decreasing the company's operating expenses relative to revenue. Lannett was able to decrease cost of goods sold as a percentage of revenue from 68.3% in 2012 to 25.6% in 2015. In the same period the firm's SG&A and R&D expenses as a percentage of revenue decreased from 16.4% to 12% and 9.6% to 7.3% respectively.

Lannett has had positive cash flow for the past four years. In 2015, cash from operations were $130 million, while the company has been investing into acquisitions leading to negative cash from investing of ($70) million, resulting in a net change in cash in 2015 of $70.4 million. The company's current cash and equivalents amount to $207 million.

Why The Market Is Wrong: Overreaction to negative macroeconomic news

Since September, Lannett's stock price has decreased by 70.42% due to a statement posted by Hillary Clinton as well as investors' negative sentiment regarding Lannett's recent acquisition of Kremers Urban Pharmaceuticals, Inc.

On September 21st 2015, Hillary Clinton criticized the trend towards high prices in the specialty drugs industry. She announced a plan to fight high prices on drugs which led to a sector wide stock price decrease in the pharmaceutical industry affecting pharmaceutical firms like Lannett. Her reaction was caused by a large price increase of $736.50 on one of Turing Pharmaceuticals' drugs. This price increase however is just a special case and can currently not be related to the entire pharmaceutical industry. In just one week after Clinton's tweet, the NYSE Arca Pharmaceutical Index (DRG) decreased by 7.33%. In the same time LCI has decreased by 41.16% and has yet to recover from the decline.

In addition, the market is discounting LCI due to issues regarding the recent acquisition of Kremers. Analysts believe that Lannett has overpaid for the acquisition since a key customer of Kremers, accounting for revenues of approximately $87 million, decided to end its relationship with Kremers. After this announcement LCI decreased by an additional 42.32% in just one week. This stock price decline is not justified since even without the partnership of that customer, the acquisition will still add value to the firm due to significant revenue growth as well as diversification of Lannett's product portfolio. Lannett's management is confident that the company's sales reps will find a customer for the product within 60-90 days due to the high demand for the product. In addition, when modeling the benefits of the deal Lannett's management accounted for a decline in the product segment that has been affected by the loss of the customer. Therefore, the current discount on LCI is not justified since the acquisition will add value to Lannett Company and provide future growth.

Valuation

The valuation of Lannett Company, Inc. (LCI) is based on a proforma that values the company with a discounted cash flow model and focus on the company's return on capital. A summary of the outputs of the valuation is attached to this report and can be found on the last page.
When valuing Lannett Company, a conservative approach has been utilized. The revenue growth rates for FY 2016 and FY 2017 are analysts' median estimates of 45.4% and 31.3% respectively. In the following years revenue growth has been set to decline year-over-year at a slow speed of reversion towards LT stability to reach a revenue growth for the long-term of 3%. This is a conservative approach, assuming revenue growth to follow long-term GDP growth.
Historically, the company's operating expenses as a percentage of revenue have been at 41.3%. The company plans to continue with their current strategy of acquiring target firms that they identify of being value adding. Therefore, the assumption of increasing operating costs up to a long-term ratio of 72.5% has been used when valuing Lannett Company. This ratio is in line with the sub-industry's convergence value of 72.5%. Currently, Lannett is not paying a dividend and does not plan to implement dividend payments in the short-term.

Summary

The recent decline in stock price caused by negative macroeconomic news led LCI to be undervalued. A BUY of Lannett Company, Inc. (LCI) is therefore recommended with a one-year target price of $59.52. Currently trading at $37.45, it has an upside potential of 58.92%.

Sources:

- Lannett Company, Inc. 10-K
- Lannett Company, Inc. Investor Presentations
- RNCOS Market Outlook
- Capital IQ
- Bloomberg
- SEC
- http://www.lannett.com/

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Lannett Company, Inc.	LCI	Analyst	Current Price	Intrinsic Value	Target Value	Divident Yield	1-y Return: 58.92%	BULLISH
		Nils Weddig	$37.45	$52.62	$59.52	0%		

General Info	
Sector	Healthcare
Industry	Pharmaceuticals
Last Guidance	October 28, 2015
Next earnings date	February 3, 2016
Market Data	
Enterprise value	$1,166.66
Market Capitalization	$1,387.97
Daily volume	0.91
Shares outstanding	37.06
Diluted shares outstanding	37.24
% shares held by institutions	74.99%
% shares held by insiders	24.09%
Short interest	30.73%
Days to cover short interest	9.87
52 week high	$72.44
52-week low	$33.13
5y Beta	1.82
6-month volatility	56.09%

Peers	Market Cap.
Impax Laboratories Inc.	$3,118.11
Sagent Pharmaceuticals, Inc.	$498.37
Akorn, Inc.	$4,097.85
Pernix Therapeutics Holdings, Inc.	$177.07
The Medicines Company	$2,789.57
Amphastar Pharmaceuticals, Inc.	$671.69
DepoMed Inc.	$1,098.95
ANI Pharmaceuticals, Inc.	$506.33
Allergan plc	$124,770.37

Current Capital Structure	
Total debt/Common Equity (LTM)	0.00
Cost of Borrowing (LTM)	22.00%
Estimated Cost of new Borrowing	2.63%
Altman's Z	32.26
Estimated Debt Rating	AAA
Current levered Beta	1.97
LTM WACC	14.90%

Management

Professional	Title	Comp. FY2013	Comp. FY2014	Comp. FY2015
Bedrosian, Arthur	Chief Executive Officer, Director and Chairma	$1,264,994	$3,134,061	$3,661,779
Bogda, Michael	President	$0	$0	$2,304,508
Galvan, Martin	Chief Financial Officer, Vice President of Fina	$733,715	$1,759,287	$1,522,474
Smith, Kevin	Senior Vice President of Sales and Marketing	$622,794	$1,348,416	$1,421,185
Landis, G.	Chief Accounting Officer and Director of Fina	$0	$0	$0
Ehlinger, Robert	Chief Information Officer and Vice President	$0	$0	$0

Past Earning Surprises

	Revenue	EBITDA	Norm. EPS	Standard Error of "Surprise"
Last Quarter	0.25%	3.55%	0.00%	1.14%
Last Quarter-1	1.70%	2.30%	8.05%	2.02%
Last Quarter -2	-1.75%	-1.42%	2.11%	1.23%
Last Quarter -3	-0.23%	0.00%	10.00%	3.37%
Last Quarter -4	0.16%	15.86%	16.05%	5.26%
Standard error	0.6%	3.1%	2.9%	1.53%
Standard Error of Revenues prediction	0.6%			
Imputed Standard Error of Op. Cost prediction	3.0%			
Imputed Standard Error of Non Op. Cost predictio	NM			

Industry Outlook (Porter's Five Forces)

Bargaining Power of Suppliers (50th Percentile), Bargaining Power of Customers (100th Percentile), Intensity of Existing Rivalry (67th Percentile), Threat of Substitutes (100th Percentile), Threat of New Competition (83th Percentile), and Overall (90th Percentile).

Proforma Assumptions

Convergence Assumptions

All base year ratios linearly converge towards the Sub-industry ratios over an explicit period of 10 years

General Assumptions	
Money market rate (as of today)	0.38%
Risk-Free rate (long term estimate)	3.07%
Annual increase (decrease) in interest rates	0.1%
Marginal Tax Rate	37.5%
Country Risk Premium	6.0%

Forecast Year	Revenue Growth Forecast	Revenue ($) Forecast
LTM		$419.88
FY2016	45.4%	$614.39
FY2017	31.3%	$826.45
FY2018	9.0%	$929.48
FY2019	8.5%	$1,049.83
FY2020	8.0%	$1,186.95
FY2021	7.0%	$1,333.97
FY2022	6.2%	$1,490.37
FY2023	5.4%	$1,652.99
FY2024	4.6%	$1,818.10
FY2025	3.8%	$1,982.41
Continuing Period	3.0%	$2,145.67

Items' Forecast Assumptions

	Base year (LTM)	Convergence period (Sub-industry)	Adjustment per year
Operating Cash/Rev.	0.00%	0.00%	0.0%
NWV/Rev.	32.78%	14.66%	-1.8%
NPPE/Rev.	23.49%	41.77%	1.8%
Dpr/NPPE	5.96%	15.40%	0.9%
NOPAT MARGIN	39.13%	19.58%	-2.0%
Op. Exp./Rev.	41.31%	72.50%	3.1%
SBC/Rev.	2.17%	1.62%	-0.1%
Rent Exp./Rev.	0.00%	0.83%	0.1%
R&D/Rev.	7.12%	11.33%	0.4%
E&D/Rev.	0.00%	0.00%	0.0%
SG&A/Rev.	10.22%	26.42%	1.6%
ROC	39%	13.29%	-2.55%
EV/Rev.	3.10x	2.47x	-0.06x
EV/EBITA	5.19x	7.90x	0.27x
Debt/Equity	0%	44%	4.4%
Unlevered beta	1.97	1.77	-0.02
Dividends/REV	0%	0%	0.0%

Other Assumptions

Tobin's Q	80%
Excess cash reinvestment	Cost of capital
Other claims on the firm's assets	$0.00

Capitalization

100% of all rent expenses are capitalized and amortized 'straightline' over 10 years
100% of all R&D expenses are capitalized and amortized 'straightline' over 10 years
E&P expenses are not capitalized
SG&A expenses are not capitalized

Valuation Focus

DCF Valuation	100%
Relative valuation	0%
Distress Valuation	0%

Monte Carlo Simulation Assumptions

Revenue Growth deviation	Normal (0%, 1%)
Operating expense deviation	Normal (0%, 1%)
Continuing Period growth	Triangular (5.82%, 6%, 6.18%)
Country risk premium	Triangular (2.91%, 3%, 3.09%)
Intrinsic value σ(ε)	$0.09
1-year target price σ(ε)	$0.10

Valuation

Forecast Year	ROC	WACC	Total Capital	Implied Enterprise Value	Other Claims on Assets and Dilution Costs	Shares Outstanding	Price per Share
LTM	38.8%	14.9%	$637.00	$1,740.74	$115.39	37.06	$51.32
FY2016	39.5%	14.4%	$889.83	$1,992.91	$117.49	37.06	$58.31
FY2017	33.7%	13.9%	$1,242.42	$2,322.35	$119.51	37.06	$64.78
FY2018	25.6%	13.4%	$1,575.41	$2,648.59	$118.18	37.06	$71.47
FY2019	21.4%	12.9%	$1,933.34	$3,011.47	$116.78	37.06	$78.91
FY2020	18.4%	12.4%	$2,315.64	$3,412.08	$115.26	37.06	$87.12
FY2021	16.0%	11.9%	$2,716.03	$3,848.44	$113.64	37.06	$96.21
FY2022	14.0%	11.4%	$3,129.83	$4,320.27	$113.26	37.06	$106.36
FY2023	12.3%	10.9%	$3,549.66	$4,825.46	$35.83	37.06	$118.88
FY2024	10.8%	10.4%	$3,966.37	$5,360.70	$0.00	37.06	$132.15
FY2025	9.4%	10.0%	$4,369.99	$5,927.27	$0.00	37.06	$143.70
Continuing Period	13.3%	10.0%	$3,160.87				

Monte Carlo Simulation Results

The 3σ(ε)-adjusted intrinsic value is $52.62; the 3σ(ε)-adjusted target price is $59.52; and the analysts' median target price is $50.6

Sensitivity Analysis

Revenue growth variations account for 95.9% of total variance
Risk premium's variations account for 2.5% of total variance
Operating expenses' variations account for 1.4% of total variance
Continuing period growth variations account for 0.2% of total variance