Allergan Plc [AGN] – Bridging the GAAP

Target Price Analysis
Expected Return from $236 PPS (as of 4/17/17) = $117/Share
50% Expected Downside Risk
(See Section I.D herein for calculations)

Summary

- ***Allergan's So-Called "Performance Net Income" Is A Cash-Flow Measure, Not A Net Income Measure.***
- ***Allergan Has Thumbed its Nose At The SEC, Which Has Warned Against This Type of Misleading Non-GAAP Metric.***
- ***To Bridge the GAAP (Pun Intended), We Propose a Realistic Calculation of Allergan's True Economic Earnings.***
- ***Even Using Extremely Generous Assumptions, Based on Our Non-GAAP Earnings Calculations We Estimate Allergan's Valuation to be $117 Per Share, Indicating 50% Expected Downside For Its Common Shares.***

In our prior write-up on Allergan (AGN), we summarized the SEC's rules on permissible non-GAAP financial metrics, specifically the guidance promulgated by the Commission in May 2016 regarding the same, concluding that Allergan's preferred "non-GAAP EPS" metric did not comply in form or spirit with the SEC's rules and would need to be either substantially revised or jettisoned altogether. In this write-up, we first follow up on what has transpired with respect to this issue since our initial publication. Second, we more closely examine the add-backs Allergan uses in calculating its non-GAAP numbers to determine whether such add-backs are justified. Finally, we propose a non-GAAP EPS calculation for the company that we believe reflects economic reality, rather than wishful thinking.

Based on our analysis, Allergan shares at current price levels are a danger to an investor's financial health. Since they topped out at around $330/share in July 2015, the shares have fallen precipitously to a recent quote of $236/share. We believe that there is approximately 50% more downside before the shares reach a fair value of around $117. This valuation is based on a generous multiple of 50 times our conservatively calculated 2016 non-GAAP economic net income of $2.34/share.

Table of Contents

I. Investment Discussion

A. Allergan's (Mis)Use Of Non-GAAP Financial Metrics

Warren Buffett, 2001 Shareholder Letter – "*When stocks are rising…both questionable accounting and management chicanery often go undetected*."

To recap, we previously asserted that Allergan was in violation of the SEC's rules regarding permissible non-GAAP performance metrics because the company included in its "non-GAAP EPS" calculation add-backs for amortization of intangibles and other (mostly non-cash) items in such a way as to transform this metric into a per-share cash flow, or "liquidity", measure. SEC rules, however, specifically state that "non-GAAP liquidity measures that measure cash generated must not be presented on a per share basis in documents filed or furnished with the Commission". The rationale for this rule is that the SEC does not want investors to confuse per share cash flow or liquidity measures with per share net income or earnings measures; i.e., the commonly-accepted earnings per share, or EPS, metric. Unfortunately, this is precisely the confusion that Allergan has created with its "non-GAAP EPS" calculation (now known as "performance net income per share"). As we demonstrated in our prior article, investors, analysts and data providers alike, not to mention the company, refer to the company's non-GAAP cash flow measure as if it accurately represents real economic net income per share (indeed, the company's chosen title for the metric refers to "net income", rather than "cash flow" or "liquidity").

In early January of this year, the SEC stated the following in a letter to the company (source):

> We note…that you continue to view your non-GAAP adjusted net income attributable to shareholders, including its presentation on a per share basis, as solely a performance measure. While *we do not agree and believe that the measure you present is clearly and closely related to cash flows*, we recognize that how you characterize it is a matter of significant judgment. While we also recognize that other companies, particularly in your industry, make these types of significant adjustments, *it does not suggest that the magnitude of your departure from GAAP results nor the resulting similarity to cash flows is at all common*. In light of our observations, we suggest that you carefully consider Question 102.05 of the updated Non-GAAP Compliance and Disclosure Interpretations and *consider ending your practice of providing the per share data*. If you choose to continue providing this per share data, please make the following changes:
>
> - Retitle the measure to more clearly reflect the extent of its departure from the concept of earnings. For example, the title should be consistent with the fact that you typically exclude more than half of all operating expenses;
> - Quantify the cumulative excluded cost of acquiring the intellectual property associated with revenue recognized (e.g., accumulated amortization for products currently being sold); and
> - Clearly state that your non-GAAP results have not been, and never will be, burdened with any of the costs to acquire the underlying products that are currently generating revenue.

> Finally, in light of our discussions about this matter, we will evaluate the industry practices you described to us and consider whether additional comprehensive non-GAAP staff guidance is appropriate. [*emphases added*]

So how did Allergan attempt to address these instructions when it issued its Q4 2016 financial results press release on February 8, 2017? The company made a minor cosmetic alteration to their terminology, changing "non-GAAP EPS" to "non-GAAP Performance Net Income", but leaving all of the underlying calculations exactly as they had been previously. In addition, nowhere in their press release did Allergan follow the SEC's instructions to (1) "(c)learly state that (the company's) non-GAAP results have not been, and never will be, burdened with any of the costs to acquire the underlying products that are currently generating revenue" or (2) "(q)uantify the cumulative excluded cost of acquiring the intellectual property associated with revenue recognized" (Allergan only shows the amortization for the applicable period in its non-GAAP reconciliation, not the cumulative amortization to date for its revenue generating products). Finally, it is highly debatable whether tweaking the name of the metric to "non-GAAP Performance Net Income" "more clearly reflect(s) the extent of its departure from the concept of earnings", since the company still includes the words "net income" in the nomenclature used—and "net" income, under any reasonable interpretation, means gross income "net of" (or "minus") all normal expenses.

The following exchange regarding the issue took place near the end of Allergan's Q4 2016 earnings call (see full transcript here):

> *Umer Raffat - Evercore Group LLC* - I just wanted to get more color on the change in accounting nomenclature to the performance net income. And I was just curious why the change if metrics are identical and whether SEC had feedback on the accounting for upfronts for R&D payments or something else. Thank you.
>
> *Maria Teresa Hilado - Allergan Plc* - So our discussions with the SEC really have been limited towards the change on nomenclature and additional disclosures. There was no other conversation, and so therefore there was no change in the calculation methodology.
>
> *Umer Raffat - Evercore Group LLC* - Got it. Tessa, so why change it then from non-GAAP net income?
>
> *Brenton L. Saunders - Allergan Plc* - We could debate this, if you want, for hours.
>
> *Maria Teresa Hilado - Allergan Plc* - I think the simple answer is we wanted to provide clarity that in fact this is a performance measure and this is the measure that we use as a management team. If you look at the industry, there really isn't any one standard in our conversations with them. We wanted to comply with a change in the name, so it was easy.

Easy indeed. Apparently the company decided to roll the dice and do virtually nothing, daring the SEC to stop them. Perhaps they view the likelihood of any enforcement or other action as low, given that the SEC, as stated above, now intends to do a full review of "the industry practices you described to us and consider whether additional comprehensive non-GAAP staff guidance is appropriate". Allergan could thus argue that it would be premature to drastically change their non-GAAP disclosures. However, despite this theoretical defense we continue to believe that sooner or later the company will be forced to comply with the SEC's rules substantially as previously promulgated.

B. Scrutinizing Allergan's "Adjusted Performance Net Income" Metric

Allergan has asked investors to ignore over $5.1 billion in 2015 GAAP charges and $5.5 billion in 2016 GAAP charges to arrive at its "performance net income" of $13.20/share and $13.51/share for those years, respectively. Indeed, if one accepts these non-GAAP add-backs, one could reasonably conclude that the company's shares are fairly valued at current levels. Analysts have adopted Allergan's metrics as valid; however due to their conflicts of interest (their employers stand to reap large fees from Allergan's dealmaking), extreme skepticism is warranted. We believe a reasonable investor should independently examine each of the add-backs in Allergan's GAAP metrics to determine whether they represent "real" costs to the company or simply "one-off or unusual items" that can be safely ignored in determining the company's normal earnings power. Below is (1) Allergan's reconciliation for "performance net income" from its Q4 2016 earnings press release and (2) our analysis of the reasonableness of each of the items added back in the reconciliation.

	Three Months Ended		Twelve Months Ended	
	December 31,	December 31,	December 31,	December 31,
	2016	2015	2016	2015
GAAP (loss) from continuing operations attributable to shareholders	-$41.90	-$790.20	-$941.10	-$2,945.80
Adjusted for:				
Amortization	1,638.50	1,584.80	6,470.40	5,443.70
Acquisition and licensing charges	800.4	517.2	1,593.60	3,673.10
Accretion and fair-value adjustments to contingent consideration	-143.5	8.4	-64.2	95.7
Impairment/asset sales and related costs	456	282.9	748.9	783.6
Non-recurring (gain) / losses	-9.5	10.7	8.9	52.9
Legal settlements	17.3	10.6	117.3	31.1
Income taxes on items above and other income tax adjustments	-1,242.20	-229.3	-2,432.20	-2,029.60
Non-GAAP performance net income attributable to shareholders	$1,475.10	$1,395.10	$5,501.60	$5,104.70
Diluted (loss) per share from continuing operations attributable to shareholders- GAAP	-$0.12	-$2.00	-$2.45	-$8.01
Non-GAAP performance net income per share attributable to shareholders	$3.90	$3.36	$13.51	$13.20
Basic weighted average ordinary shares outstanding	356.8	394.2	384.9	367.8
Effect of dilutive securities: Dilutive shares	21.8	21.5	22.3	18.8
Diluted weighted average ordinary shares outstanding	378.6	415.7	407.2	386.6

1. Amortization of Intangibles

In the above reconciliation, Allergan begins with the aforementioned large add-back for amortization of intangible assets, adding back the entire GAAP amount for this line item. What the company is basically saying is that amortization is not a "real" expense, presumably because it is a non-cash expense. However, we strongly disagree with this viewpoint. Under GAAP accounting, the value of these assets is assumed to decline over time because this reflects economic reality for must companies. Therefore, unless the "real" economic value of Allergan's intangible assets actually is *not* depreciating, then it would be incorrect to add-back the entire amortization figure in the non-GAAP calculations. Instead, the proper way to calculate the add-back would be to include only that portion of the amortization of intangibles that does not reflect a "real cost" to the company. For example, if a company purchases a valuable trademark and establishes an intangible asset on its balance sheet for it, it would be incorrect to consider the amortization of this asset as a true cost, so long as the company was spending enough on product quality, customer service and advertising and other promotion to preserve the value of the trademark.

But what do Allergan's intangibles represent? They represent intellectual property and other product rights, licenses and customer relationships acquired via acquisitions. Generally speaking, they represent the present and future right of the company to sell certain branded drugs in various jurisdictions. However, common knowledge tells us that branded drugs enjoy limited lifespans before their patents expire and they succumb to generic competition. Thus, the right to sell such drugs must be a depreciable and depreciating asset—i.e., a "real cost" to the company. Much as an oil producer drills new wells to make up for the limited productive life of its existing wells, a drug company such as Allergan must spend money to develop new drugs to replenish its existing branded drug portfolio, otherwise its revenues will inevitably dry up over time. This cost under GAAP accounting is the depreciation of intangible assets. Therefore, Allergan's implicit message in its "non-GAAP Performance Net Income" metric that people should ignore this cost because it is "non-cash" does not reflect economic reality. Cash must be spent roughly in line with the annual amortization figure or the company's revenues will erode.

Indeed, Allergan's 2016 Form 10-K (page 91) specifically states that the company establishes intangible assets on its balance sheet and depreciates them in a way that is expected to match the (declining) underlying cash flows of the assets over time:

> Our product rights and other definite-lived intangible assets are stated at cost, less accumulated amortization, and are amortized using the economic benefit model or the straight-line method, if results are materially aligned, over their estimated useful lives. *We determine amortization periods for product rights and other definite-lived intangible assets based on our assessment of various factors impacting estimated useful lives and cash flows.* Such factors include the product's position in its life cycle, the existence or absence of like products in the market, various other competitive and regulatory issues, and contractual terms. [*emphasis added*]

There is one caveat to the above argument regarding amortization of intangibles, however. Theoretically, one could argue that, at least with respect to the combination of Actavis and Allergan in 2015, the intangibles placed on the balance sheet represent in significant part those attributable to Botox, which (again, at least in theory) might be considered a highly "durable" asset which is largely immune from the "depleting oil well" comparison above. In essence, Allergan could argue that Botox represents an asset with no decline curve, hence there should be no amortization of its intangibles—at least, if GAAP didn't mandate such a charge. However, investors should note first that legacy Allergan's portfolio was not simply Botox for cosmetic use, but also included Botox used for therapeutic use. The latter should be subject to depreciation, since generics should inevitably encroach on these indications as patents expire over time. Legacy Allergan also had many branded drugs, such as Restasis. In fact, almost half of legacy Allergan's 2014 revenues were attributable to its eye care segment (see page 46 of the company's 2014 Form 10-K filing), so at a bare minimum half of the intangible amortization that can be traced to the Actavis / Allergan combination should not be added back when calculating Allergan's non-GAAP performance net income. Given that Botox's cosmetic and therapeutic revenues represented just one-third of Allergan's Q4 2016 overall revenues, we believe that the maximum amount of intangible amortization a reasonable investor should add back in determining a non-GAAP EPS number for the company going forward should be one-third of the total amount. Even this is pushing the envelope, since as stated above Botox therapeutics revenues should be open to patent challenges over time, and hence should have depreciation charged against the assets producing such revenues.

2. Acquisition and Licensing Charges

Next we examine Allergan's exclusions for "acquisition and licensing charges" in the non-GAAP reconciliation. Presumably these items are not considered "real" costs to the company because they are supposedly nonrecurring. However, Allergan's "Open Science" business model depends on substantial recurring acquisition activity. On its website, the company describes its business model as follows [source]:

> Allergan has sought to follow a different R&D path than other companies. We embrace an Open Science model. It defines [Allergan's] position in this new ecosystem—as a magnet for game-changing ideas and innovation. *A large percentage of our pipeline is sourced by partnering with biotech companies, academia and other pharmaceutical companies globally.* Through this Open Science model, we drive strong R&D productivity by delivering innovative therapies that create long-term shared value for Allergan, for customers and for patients.

Thus, acquisition and licensing charges are clearly recurring in nature and should be expected to be large as a percentage of non-GAAP net income. In Q4 2016, for example, such acquisition and licensing charges amounted to $800 million, a significant increase year-over-year over the already substantial $517 million in Q4 2015. Such charges should not be added back in determining Allergan's "performance net income per share".

3. Accretion and Fair-Value Adjustments to Contingent Consideration

The line item for accretion and fair-value adjustments to contingent consideration appears reasonable to exclude from a non-GAAP reconciliation, since the amounts can arbitrarily swing in either direction and do not appear to reflect the underlying performance of Allergan's business.

4. Impairment/Asset Sales and Related Costs

Impairment/asset sales and related costs should not in our opinion be added back to obtain the non-GAAP net income since these amounts have been significant and seem to recur. In both 2015 and 2016, for example, these costs amounted to well over $2/share. In any event, if these were truly non-recurring expenses, there would be no real need to exclude them since, by definition, they would go away over time on their own.

5. Non-Recurring Gains and Losses

The line item for non-recurring gains and losses appears reasonable to exclude from a non-GAAP reconciliation, however Allergan does not disclose enough information to make an informed decision on this point.

6. Legal Settlements

Legal settlements should not be excluded, as these amounts appear to recur. However, to give Allergan the benefit of the doubt we will nevertheless add them back in our calculation of "real" non-GAAP net income below.

C. A Realistic Method of Calculating Allergan's True Economic Earnings

Given the above discussion, we believe that the following items from Allergan's non-GAAP performance net income calculation are acceptable to add back:

- 1/3 of the company's amortization of intangible assets;
- all of the company's accretion and fair-value adjustments to contingent consideration;
- all of the company's self-described non-recurring gains and losses; and
- all of the company's expenses for legal settlements.

Thus, we obtain the following result for Allergan's true "adjusted" economic earnings:

	Three Months Ended		Twelve Months Ended	
	December 31,	December 31,	December 31,	December 31,
	2016	2015	2016	2015
GAAP (loss) from continuing operations attributable to shareholders	-$41.90	-$790.20	-$941.10	-$2,945.80
Adjusted for:				
Amortization	545.62	527.74	2,154.64	1,812.75
Accretion and fair-value adjustments to contingent consideration	-143.5	8.4	-64.2	95.7
Non-recurring (gain) / losses	-9.5	10.7	8.9	52.9
Legal settlements	17.3	10.6	117.3	31.1
Total Add-Backs	409.92	557.44	2,216.64	1,992.45
Income taxes on items above and other income tax adjustments (using 20% tax rate)	-81.98	-111.49	-443.33	-398.49
Non-GAAP performance net income attributable to shareholders	$286.04	-$344.25	$832.21	-$1,351.84
Diluted (loss) per share from continuing operations attributable to shareholders- GAAP	-$0.12	-$2.00	-$2.45	-$8.01
Non-GAAP performance net income per share attributable to shareholders	$0.76	-$0.83	***$2.04***	-$3.50
Basic weighted average ordinary shares outstanding	356.8	394.2	384.9	367.8
Effect of dilutive securities: Dilutive shares	21.8	21.5	22.3	18.8
Diluted weighted average ordinary shares outstanding	378.6	415.7	407.2	386.6

Based on our revised, more realistic calculations, Allergan's non-GAAP net income would have been just $2.04/share for 2016, which means that Allergan would currently be trading at over 115X trailing adjusted EPS, an extremely high earnings multiple. If one factors in Allergan's recent share repurchases and thereby reduces the diluted share count to just 355 million, the non-GAAP net income figure for 2016 would have been a ***still anemic $2.34/share*** and Allergan would currently be trading at over ***100X trailing adjusted non-GAAP EPS***.

Moreover, even if we were to add back *all* of Allergan's acquisition and licensing charges, non-GAAP net income would only have been $5.17/share for 2016, which means that Allergan would currently be trading at over 45X trailing adjusted non-GAAP EPS, as evidenced by the following calculations:

	Three Months Ended		Twelve Months Ended	
	December 31,	December 31,	December 31,	December 31,
	2016	2015	2016	2015
GAAP (loss) from continuing operations attributable to shareholders	-$41.90	-$790.20	-$941.10	-$2,945.80
Adjusted for:				
Amortization	545.62	527.74	2,154.64	1,812.75
Acquisition and licensing charges	800.4	517.2	1,593.60	3,673.10
Accretion and fair-value adjustments to contingent consideration	-143.5	8.4	-64.2	95.7
Non-recurring (gain) / losses	-9.5	10.7	8.9	52.9
Legal settlements	17.3	10.6	117.3	31.1
Total Add-Backs	1,210.32	1,074.64	3,810.24	5,665.55
Income taxes on items above and other income tax adjustments (using 20% tax rate)	-242.06	-214.93	-762.05	-1,133.11
Non-GAAP performance net income attributable to shareholders	$926.36	$69.51	$2,107.09	$1,586.64
Diluted (loss) per share from continuing operations attributable to shareholders- GAAP	-$0.12	-$2.00	-$2.45	-$8.01
Non-GAAP performance net income per share attributable to shareholders	$2.45	$0.17	***$5.17***	$4.10
Basic weighted average ordinary shares outstanding	356.8	394.2	384.9	367.8
Effect of dilutive securities: Dilutive shares	21.8	21.5	22.3	18.8
Diluted weighted average ordinary shares outstanding	378.6	415.7	407.2	386.6

D. Our Valuation of Allergan's Common Shares

Having determined above a realistic calculation for Allergan's true economic net earnings using what we believe are fairly generous add-backs for non-cash and other supposedly nonrecurring items, we now can calculate a realistic valuation for Allergan's common shares. Again, erring on the side of being generous, we apply a fulsome 50X multiple to Allergan's trailing $2.34/share non-GAAP earnings (including the effect of share buybacks) and we obtain a ***valuation of $117/share***

as our base case. The 50X multiple is more than ample to account for the touted superiority of Allergan's "Growth Pharma" business model. Note that even if we bend over backwards completely and credit Allergan with $5.17/share trailing non-GAAP earnings by adding back all acquisition and licensing charges (even though they are substantial and recurring), the company's shares still trade at a nosebleed valuation, leaving extremely little room for error in an environment where the government and third-party payors are pushing back more and more on aggressive drug pricing practices in the United States.

II. Historical Financials and Analyst Estimates

A. Allergan's Historical Financial Data

For reference, below please find past 5-year financial data for Allergan:

ALLERGAN PLC
FINANCIAL HIGHLIGHTS
($ in millions, except per share amounts)

	Years Ended December 31, 2016(4)(5)	2015(4)(5)(7)	2014(4)(5)(10)	2013(4)(5)(11)	2012(4)(5)
Operating Highlights:					
Net revenues	$ 14,570.6	$ 12,688.1	$ 4,676.5	$ 1,025.7	$ 665.0
Net (loss) from continuing operations, net of tax	(935.0)	(2,941.6)	(2,484.6)	(569.1)	(269.2)
Net income/(loss) attributable to ordinary shareholders	14,695.0	3,683.2	(1,630.5)	(750.4)	97.3
Basic earnings/(loss) per share from continuing operations	$ (3.17)	$ (8.64)	$ (11.31)	$ (4.00)	$ (2.14)
Diluted earnings/(loss) per share from continuing operations	$ (3.17)	$ (8.64)	$ (11.31)	$ (4.00)	$ (2.14)
Basic earnings/(loss) per share	$ 38.18	$ 10.01	$ (7.42)	$ (5.27)	$ 0.77
Diluted earnings/(loss) per share	$ 38.18	$ 10.01	$ (7.42)	$ (5.27)	$ 0.76
Weighted average shares outstanding:					
Basic	384.9	367.8	219.7	142.3	125.8
Diluted	384.9	367.8	219.7	142.3	128.4

	At December 31, 2016(1)(2)(3)(4)(5)	2015(4)(5)(6)(7)	2014(4)(5)(8)(9)(10)	2013(4)(5)(11)	2012(4)(5)
Balance Sheet Highlights:					
Total assets	$ 128,986.3	$ 135,583.3	$ 52,758.0	$ 22,725.9	$ 14,114.8
Total debt and capital leases	32,768.7	42,530.4	15,531.1	9,052.0	6,433.3
Total equity	76,200.5	76,589.3	28,335.5	9,537.1	3,856.4

(1) On November 1, 2016, Allergan plc completed the Tobira Acquisition. The acquisition had the impact of increasing the Company's intangible assets and lowering working capital.

(2) On October 25, 2016, Allergan plc completed the Vitae Acquisition. The acquisition had the impact of increasing the Company's intangible assets and lowering working capital.

(3) During the year ended December 31, 2016, the Company repurchased equity of $15.0 billion as part of its cumulative share buyback programs.

(4) On October 3, 2016, we completed the divestiture of the Anda Distribution business to Teva. We completed the divestiture of our Anda Distribution business, which distributes generic, brand, specialty and OTC pharmaceutical products from more than 300 manufacturers to retail independent and chain pharmacies, nursing homes, mail order pharmacies, hospitals, clinics and physician offices across the U.S.

(5) On August 2, 2016, Teva acquired our global generics business, including the U.S. and international generic commercial units, our third-party supplier Medis, our global generic manufacturing operations, our global generic R&D unit, our international OTC commercial unit (excluding OTC eye care products) and certain established international brands to Teva.

(6) On October 1, 2015, Allergan plc completed the Kythera Acquisition. The acquisition increased the Company's intangible assets.

(7) On March 17, 2015, Allergan plc completed the acquisition of Legacy Allergan. Legacy Allergan was a leading, fully integrated, specialty pharmaceutical company that specialized in ophthalmology, neurosciences and medical/aesthetics/dermatology/plastic surgery. Beginning March 17, 2015, the following items were included in our operating results:

- total revenues and related cost of sales for Legacy Allergan products;
- selling, general and administrative expenses and research and development expenses;
- amortization expense for intangible assets acquired;
- impairment losses on select assets; and
- increased interest expense from the senior secured notes assumed and the indebtedness incurred.

(8) On November 17, 2014, Allergan plc completed the Durata Acquisition. The acquisition had the impact of increasing the Company's intangible assets and lowering working capital.

(9) On July 2, 2014, the Company completed the Furiex Acquisition. The acquisition had the impact of increasing the Company's intangible assets and lowering working capital.

(10) On July 1, 2014, the Company completed the Forest Acquisition. Forest was a leading, fully integrated, specialty pharmaceutical company largely focused on the United States market. Forest marketed a portfolio of branded drug products and developed new medicines to treat patients suffering from diseases principally in the following therapeutic areas: central nervous system, cardiovascular, gastrointestinal, respiratory, anti-infective, and cystic fibrosis. Beginning July 1, 2014, the following items were included in our operating results:

- total revenues and related cost of sales for Forest products;
- selling, general and administrative expenses and research and development expenses;
- amortization expense for intangible assets acquired;
- impairment losses on select assets; and
- increased interest expense from the senior secured notes assumed and the indebtedness incurred.

(11) On October 1, 2013, we completed the Warner Chilcott Acquisition. Warner Chilcott was a leading specialty pharmaceutical company focused on women's healthcare, gastroenterology, urology and dermatology segments of the branded pharmaceuticals market, primarily in North America. Beginning October 1, 2013, the following items were included in our operating results:

- total revenues and related cost of sales for Warner Chilcott products;
- selling, general and administrative expenses and research and development expenses;
- amortization expense for intangible assets acquired; and
- increased interest expense from the senior secured notes assumed and the $2.0 billion aggregate term loan indebtedness assumed, and subsequently refinanced, in connection with the Warner Chilcott Acquisition.

Notably, while total revenues increased from $12.7B to $14.6B, or approximately 15%, from 2015 to 2016, the Actavis / Allergan merger did not close until just two weeks prior to the end of the first quarter of 2015, therefore Allergan's revenues for 2015 through the date of closing are excluded from the $12.7 billion figure for 2015 above. Moreover, since legacy Allergan never filed a Form 10-Q for the first quarter of 2015, we do not have an exact amount to add to the above $12.7 billion figure in order to arrive at a *pro forma* revenue amount for the combined Allegan / Actavis entity for fiscal 2015. We can roughly estimate that revenues on a *pro forma* basis would likely have been approximately $1.5 billion to $2 billion higher on a combined *pro forma* basis, given that the first quarter of any fiscal year is usually seasonally slow. Therefore actual revenue growth during 2016 on a *pro forma* basis would likely have been minimal at beset. So much for the "Growth Pharma" model that Allergan CEO Brent Saunders loves to tout.

On a positive note, GAAP net loss for 2016 came in at slightly under $1 billion, a significant improvement from the nearly $3 billion GAAP net loss in 2015. Nevertheless, on a combined basis in 2016 Allergan was still far from profitable. The only way Allergan is able to justify its current market valuation is to contort its GAAP net loss into non-GAAP net income for 2016 of over $13 per share. As we further discuss herein, however, we do not believe that Allergan's non-GAAP net income calculations are reasonable or logical.

B. Analyst Estimates

Below are current analyst estimates for earnings and revenues for Allergan for this fiscal year and next fiscal year [source]:

Earnings Estimate	Current Qtr. (Mar 2017)	Next Qtr. (Jun 2017)	Current Year	Next Year
No. of Analysts	18	18	14	12
Avg. Estimate	3.32	4.07	16.03	17.9
Low Estimate	3.2	3.85	15.93	17.33
High Estimate	3.55	4.26	16.2	18.48
Year Ago EPS	2.99	3.35	13.51	16.03

Revenue Estimate	Current Qtr. (Mar 2017)	Next Qtr. (Jun 2017)	Current Year	Next Year
No. of Analysts	16	16	12	10
Avg. Estimate	3.53B	3.93B	15.61B	16.54B
Low Estimate	3.5B	3.84B	15.43B	15.93B
High Estimate	3.57B	4.05B	15.76B	17.1B
Year Ago Sales	3.8B	3.68B	14.57B	15.61B
Sales Growth (year/est)	-6.90%	6.70%	7.20%	5.90%

Here again we note that the investment community has swallowed whole Allergan's fictional non-GAAP net income guidance (or if one prefers, "performance net income" guidance), expecting the company to deliver over $16/share in "earnings" this year. In order to do this however, one must also accept without questioning Allergan's add-backs to its GAAP financial numbers as if such add-backs made sense, which we believe they clearly do not. Note how all fourteen analysts have pegged their 2016 earnings estimates within the company's guided range of $15.80 - $16.30/share, which was issued in their Q4 2016 earnings press release. The financial press has also drunk the Kool-Aid offered by Allergan on this front. In short, we are not aware of any reputable analyst or financial journalist who has seriously questioned the integrity of Allergan's non-GAAP numbers.

III. Bull Case

To be fair to the bulls, Allergan's valuation would be reasonable if analysts' non-GAAP net income estimates were realistic and rational. At $16/share forward non-GAAP earnings, the company's shares would only be trading at a 14.75X P/E multiple, well below the multiple of the overall market. Of course, we do not accept these earnings estimates as realistic and rational, and therein lies the rub.

In addition, Allergan has engaged in a number of transactions recently, any of which could potentially pay off in a large way for the company. For reference, below is a list of the acquisitions the company has made in just the past seven months, per its 2016 10-K filing:

- ZELTIQ® Aesthetics, Inc. – On February 13, 2017 Allergan entered into a definitive agreement to acquire ZELTIQ® Aesthetics, Inc. ("ZELTIQ") for a price of $56.50 per share, or $2.475 billion. ZELTIQ is focused on developing and commercializing products utilizing its proprietary controlled-cooling technology platform. The transaction is expected to close in the second half of 2017 and is subject to customary closing conditions.
- LifeCell Corporation – On February 1, 2017, Allergan completed the acquisition of LifeCell Corporation ("LifeCell"), a regenerative medicine company, for approximately $2.9 billion in cash. The acquisition combines LifeCell's novel, regenerative medicines business, including its high-quality and durable portfolio of dermal matrix products with Allergan's leading portfolio of medical aesthetics, breast implants and tissue expanders.
- Lysosomal Therapeutics, Inc. – On January 9, 2017 Allergan entered into a definitive agreement to acquire Lysosomal Therapeutics Inc. ("LTI"). LTI is focused on innovative small-molecule research and development in the field of neurodegeneration, yielding new treatment options for patients with severe neurological diseases. LTI-291, LTI's lead program, aims to stimulate the activity of glucocerebrosidase in the brain. Under the option agreement, Allergan purchased an option right directly from LTI shareholders to acquire LTI following completion of a Phase 1b trial for LTI-291. In addition, Allergan provided a separate upfront research and development payment. The net payment of $145 million will be recorded as a component of R&D expense in the year ended December 31, 2017. Allergan and LTI will establish a joint development committee to oversee the development activities for LTI-291.
- Tobira Therapeutics, Inc. – On November 1, 2016, Allergan acquired Tobira Therapeutics, Inc. ("Tobira"), a clinical-stage biopharmaceutical company focused on developing and commercializing therapies for non-alcoholic steatohepatitis ("NASH") and other liver diseases, for an acquisition accounting purchase price of $570.1 million, plus contingent consideration of up to $49.84 per share in contingent value rights ("CVR"), or up to $1,101.3 million, that may be payable based on the successful completion of certain development, regulatory and commercial milestones (the "Tobira Acquisition"). The CVR had an acquisition date fair value of $479.0 million. The Tobira Acquisition adds to Allergan's pipeline Cenicriviroc and Evogliptin, two differentiated, complementary development programs for the treatment of the multi-factorial elements of NASH, including inflammation, metabolic syndromes and fibrosis.
- Vitae Pharmaceuticals, Inc. – On October 25, 2016, Allergan acquired Vitae Pharmaceuticals, Inc. ("Vitae"), a clinical-stage biotechnology company, for an acquisition accounting purchase price of $621.4 million (the "Vitae Acquisition"). The Vitae Acquisition strengthens Allergan's dermatology product pipeline with the addition of a Phase II orally active RORyt (retinoic acid receptor-related orphan receptor gamma) inhibitor for the potential treatment of psoriasis and other autoimmune disorders. In addition, as a result of the Vitae Acquisition, Allergan expanded its pipeline with the acquisition of a Phase II atopic dermatitis drug candidate.
- ForSight VISION5, Inc. – On September 23, 2016, Allergan acquired ForSight VISION5, Inc. ("ForSight'), a privately held, clinical-stage biotechnology company focused on eye care, in an all cash transaction of approximately $95.0 million (the "ForSight Acquisition"). Under the terms of the ForSight Acquisition, Allergan acquired ForSight for an acquisition accounting purchase price of $74.5 million plus the payment of outstanding indebtedness of $14.8 million and other miscellaneous charges. ForSight shareholders are eligible to receive contingent consideration of up to $125.0 million, which has an

initial estimated fair value of $79.8 million, relating to commercialization milestones. The Company acquired ForSight for its lead development program, a peri-ocular ring designed for extended drug delivery and reducing elevated intraocular pressure ("IOP") in glaucoma patients.

In addition, the company has entered into a number of licensing agreements recently, which could also boost revenues and earnings going forward.

Finally, as shown by the fact that Pfizer was willing to pay well over $300/share in its own stock in order to acquire Allergan, a deep-pocketed suitor could attempt to take over the company at a premium, especially if the Treasury Department's rules regarding tax inversions are relaxed and/or comprehensive corporate tax reform in the U.S. is delayed due to partisan gridlock.

IV. Conclusion

If price is what you pay and value is what you get, we believe that Allergan investors today are getting just $117/share of value for stock recently trading at $236/share. Our valuation is based on a generous multiple of 50 times our conservatively calculated 2016 non-GAAP economic net income of $2.34/share, which gives effect to recent share repurchase activity. While Allergan has decided to ignore the SEC's instructions regarding permissible non-GAAP financial metrics by continuing to present a per share liquidity / cash flow measure as if it were an acceptable non-GAAP per share net income measure, we believe that eventually the company will be forced by the SEC to adjust its non-GAAP figures drastically downward to comport with economic reality (and be more in-line with our calculations). Assuming our $117/share valuation is reasonable, this implies that Allergan's common shares currently have an expected downside risk of approximately 50%, which should make any prudent investor cautious.

V. Disclaimer

As of the publication date of this report, Seven Corners Capital Management and its affiliates (collectively, "Seven Corners") have short positions in the shares of Allergan Plc ("Allergan"). In addition, others that contributed research to this report and others that we have shared our research with (collectively with Seven Corners, the "Authors") likewise may have short positions in, and/or own options on, Allergan. The Authors stand to realize gains in the event that the price of the stock decreases. Following publication of the report, the Authors may transact in the securities of the company covered herein. All content in this report represent the opinions of Seven Corners. The Authors have obtained all information herein from sources they believe to be accurate and reliable. However, such information is presented "as is," without warranty of any kind—whether express or implied. The Authors make no representation, express or implied, as to the accuracy, timeliness, or completeness of any such information or with regard to the results obtained from its use. All expressions of opinion are subject to change without notice, and the Authors do not undertake to update or supplement this report or any information contained herein.

This document is for informational purposes only and it is not intended as an official confirmation of any transaction. All market prices, data and other information are not warranted as to completeness or accuracy and are subject to change without notice. The information included in this document is based upon selected public market data and reflects prevailing conditions and the Authors' views as of this date, all of which are accordingly subject to change. The Authors' opinions and estimates constitute a best efforts judgment and should be regarded as indicative, preliminary and for illustrative purposes only.

Any investment involves substantial risks, including, but not limited to, pricing volatility, inadequate liquidity, and the potential complete loss of principal. This report's estimated fundamental value only represents a best efforts estimate of the potential fundamental valuation of a specific security, and is not expressed as, or implied as, assessments of the quality of a security, a summary of past performance, or an actionable investment strategy for an investor.

This document does not in any way constitute an offer or solicitation of an offer to buy or sell any investment, security, or commodity discussed herein or of any of the affiliates of the Authors. Also, this document does not in any way constitute an offer or solicitation of an offer to buy or sell any security in any jurisdiction in which such an offer would be unlawful under the securities laws of such jurisdiction. To the best of the Authors' abilities and beliefs, all information contained herein is accurate and reliable. The Authors reserve the rights for their affiliates, officers, and employees to hold cash or derivative positions in any company discussed in this document at any time. As of the original publication date of this document, investors should assume that the Authors are short shares of Allergan and may have positions in financial derivatives that reference this security and stand to potentially realize gains in the event that the market valuation of the company's common equity is lower than prior to the original publication date. These affiliates, officers, and individuals shall have no obligation to inform any investor or viewer of this report about their historical, current, and future trading activities. In addition, the Authors may benefit from any change in the valuation of any other companies, securities, or commodities discussed in this document. Analysts who prepared this report are compensated based upon (among other factors) the overall profitability of the Authors' operations and their affiliates. The compensation structure for the Authors' analysts is generally a derivative of their effectiveness in generating and communicating new investment ideas and the performance of recommended strategies for the Authors. This could represent a potential conflict of interest in the statements and opinions in the Authors' documents.

The information contained in this document may include, or incorporate by reference, forward-looking statements, which would include any statements that are not statements of historical fact. Any or all of the Authors' forward-looking assumptions, expectations, projections, intentions or beliefs about future events may turn out to be wrong. These forward-looking statements can be affected by inaccurate assumptions or by known or unknown risks, uncertainties and other factors, most of which are beyond the Authors' control. Investors should conduct independent due diligence, with assistance from professional financial, legal and tax experts, on all securities, companies, and commodities discussed in this document and develop a stand-alone judgment of the relevant markets prior to making any investment decision.