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P.O. Box 133, Redding, CT 06875

September 28, 2011

Year 31, No. 7

DJIA- 10,771
S&P 500- 1,136

Questcor Pharmaceuticals

(QCOR \$25.15, NGS)

<u>Year ending December 31,</u>	<u>2009</u>	<u>2010</u>	<u>2011E</u>	<u>2012E</u>
Net Revenue (\$ millions)	88	115	185	260
Adjusted Net Income (\$ millions)	29	39	59	89
Adjusted EPS, Diluted (\$/share)	.44	.60	.91	1.35
Avg. Diluted Shares (millions)	66.3	64.7	65.5	66

With signs this past week increasingly pointing to a double dip recession, the healthcare sector seems a good place to snag our latest recommendation. Questcor is a specialty, niche biopharmaceutical company which helps patients with serious, difficult-to-treat medical conditions, such as multiple sclerosis, nephrotic syndrome and infantile spasms. In addition entry into the lupus market is being actively explored.

Now, let me turn this recommendation upside down and start with some of the more quantitative things that attracted me to this story, which I usually put at the end. Questcor has the third best 5-year sales growth rate in the pharmaceutical space (68%), and among those 20 companies the highest EPS growth rate over the past five years (192%) and looking forward the highest projected 3-5 year EPS growth rate (>30%). Furthermore, the Company is projected to grow EPS 52% this year to \$.91 and 48% next year to \$1.35. Questcor has no debt and \$170 million in cash and a 40% operating margin. Investor's Business Daily gives the shares a 99 composite rating, including 93 for relative earnings strength and 99 for relative strength. Of the 4 analysts actively following Questcor there

are 3 Strong Buys and one Buy, with an average target price of \$36. Also, Zacks ranks it 1 for future performance. There was an insider buy by an officer in August at \$30. Questcor has beaten estimates by about 16% in the past two quarters. Indeed Q2 results sparked a 25% stock surge.

The Company

Questcor is a biopharmaceutical company whose products help patients with serious, difficult-to-treat medical conditions. Its efforts are currently focused on the fields of neurology and nephrology, areas of medicine which have significant unmet medical needs. Questcor's flagship product is H.P Acthar® Gel (repository corticotropin injection), a naturally-derived formulation of adrenocorticotrophic hormones used in a variety of disorders having an inflammatory component. Acthar has been around for 60 years and is approved by the FDA for the treatment of 19 indications. Of these 19 indications, Questcor currently generates substantially all of its net sales from just 3 indications: the treatment of acute exacerbations of multiple sclerosis in adults, the treatment of nephrotic syndrome, and the treatment of infantile spasms in children under two years of

age. These three have a combined market opportunity estimated to exceed \$1.6 billion. Questcor is also exploring the use of Acthar to treat systemic lupus erythematosus, for which Acthar is approved as both a maintenance therapy and to treat exacerbations. Questcor is also exploring the possibility of developing markets for other on-label indications and the possibility of pursuing FDA approval of additional indications not currently on the Acthar label where there is high unmet medical need. Their strategy, put simply, is “grow Acthar sales”; more specifically by expanding penetration in each of its current three markets and developing an on-label lupus market. With just 3 of the existing 19 indications for this drug currently being marketed, and still low penetration rates in many of those, there is a rich pipeline of growth potential.

With Acthar being by far its most important product and sole emphasis for growth, and having been on the market for 60 years, we need to address this gorilla in the room that nearly side railed me from this company until I looked into it more closely. For starters in 60 years nobody has duplicated this drug, nor is this likely. Why’s that? First and foremost, its formulation is biologic, proprietary, and has never been disclosed ... like Coke, but much harder to copy. The manufacturing process is complex, unique and proprietary, with the composition tied to the process. Since the formula is not out there anywhere a generic is virtually impossible, as is a biosimilar pathway. In any event clinical trials would be needed and if somehow something got through all this unlikelihood, it would likely be for just one indication (of the 19 Questcor has for Acthar). Now, while you can never say never, for these reasons I’m at peace with this, in fact the gorilla and I are holding hands right now. Instead I prefer to look at each of the 19 indications as separate products.

So let’s take a look at the three existing markets. Multiple sclerosis is a neurodegenerative disorder primarily being treated with steroids. However when steroids are not suitable, relapses can be treated with a 1-2 week treatment with Acthar. Through Q3 of 2010 there were 38 reps out there making calls for this indication generating 323 paid prescriptions. In Q4 Questcor doubled that to 77 reps and prescrip-

tions shot up from 354 in Q4 to 508 in Q1 and 751 in Q2, with Q3 on track to grow another 10% sequentially. August was a record month. In Q2 400 doctors wrote scripts out of a total population somewhere between 5,000-8,000. Of these only 60 wrote more than one per month. So there is tremendous potential to increase this single digit penetration and increase the number of scripts per doctor. Interesting that doubling the sales force doubled the number of scripts. Now the rate of surge from that Q4 2010 rep increase is slowing ... though what company would hang its head over 10% sequential growth over the previous quarter! By the way, this is an expensive drug with an MS regimen costing \$40,000 - \$50,000, so each prescription goes a long way. MS accounts for about 60% of sales, has a market potential in excess of \$500 million and is the primary emphasis of selling efforts.

However the nephrotic syndrome market is twice that size, estimated to be over \$1 billion. This disease is characterized by excessive spilling of protein from the kidneys into the urine which can result in end stage renal disease, dialysis or transplant. Here the treatment is 4-6 months costing \$150,000 - \$250,000. Up until the end of 2010 there weren’t *any* reps selling for NS and it was still averaging eight scripts per Q. However, much like they are looking at entering lupus now, they entered the NS market in Q1 of 2011 with a whopping 5 reps and by Q2 new paid scripts had shot up to 45. An estimated 20-25,000 patients would benefit from this treatment, so a lot of blue sky ahead. Now they have signed on another 23 reps for a total of 28 and they will hit the street in October. Questcor notes that Q3 may suffer a bit because the 5 existing reps spent a lot of time hiring and especially training the new 23. I can live with it. Its third product/market is for infantile spasms. Acthar is very efficacious for curing this so that patients can lead a normal life, which is otherwise unlikely. This market is “only” \$100 million with 1,500 - 2,000 patients annually and is mature. So ... there you have it. Please reread the second paragraph which I’d normally put here. Questcor has a rich pipeline to fuel its growth ... and an excellent BI Rank of 11.2 making QCOR a Buy near current levels. There is an excellent presentation at Morgan Stanley on their web site under the IR section and another scheduled for 9/28. www.questcor.com

“It’s just a big fat mess ...”

At the Fed’s recent two day meeting, specifically on 9/21, Bernanke’s comment that there are “significant downside risks to the economic outlook, including strains in global financial markets” indicated the Fed was now bracing Americans for what investors (this one included) have been increasingly fearing as the summer wore on. Stocks and commodity prices, which already had a foot on the floor, promptly fell completely out of bed. Resource-related stocks were hit especially hard as fear of a double dip recession became all that much more certain. However, if the truth be told...though GDP bounced back for a while (now flagging) and corporate profits enjoyed a real period of prosperity, 9 million unemployed Americans, and perhaps an equal number of underemployed, would argue the recession never ended! And housing starts remain in a depression. A heart-breaking % of recent college graduates haven’t been able to find a job (25% did I hear?). Looking ahead I don’t see what will cause any of this to improve let alone resolve itself anytime soon, including the sovereign debt issues in Europe.

The fear there is a contagion (like the Lehman bankruptcy caused in the U.S. in 2008) due to the amount of debt issued by these troubled countries that is held by European banks and others. The Fed’s last rusty bullet on its ammo belt to try to help, “Operation Twist,” dribbled out of the gun and rattled across the floor. Obama’s plan might help somewhat if it can get past a gridlocked Congress. Our credit rating was downgraded. As my mother would say, “It’s just a big fat mess.” We are moving from a period of economic stimulus for the past two years, to a period where cuts in government spending (at the state level also) to trim the deficit seem mandatory and will only exacerbate matters. I expect forward looking cautionary statements to be common in Q3 conference calls. In this environment I can’t see keeping more than 50% of my stock market money in the market, about as low as I go being a longer term investor and given the uncertainty of knowing *when* to get back in. Currently most attractive are Questcor, MAPTX, Mylan, PetroBakken, and with limits- Ceragon, Brigham and Taseko. The next issue mailing date is 11/7.

DIAMOND FOODS* (DMND \$90. NGS, +217%); BI Rank = 6.7 – See Text/Hold 50%

www.diamondfoods.com CA (415) 912-3180 (11/08) (sold 25% 4/5/11 @\$63, +123%; sold 15% 9/16/11 & 10% 9/25/11@ \$90, +217%)

Diamond Foods, sells snack nuts and nut mixes under the Emerald line, culinary nuts under the Diamond brand, and owns Pop Secret, the #2 popcorn brand commanding a 25% market share. In 2010 the Company purchased Kettle Foods, a maker of those crispier potato chips and in 2011 is in the process of acquiring Pringles which is expected to close by December. A rapidly growing consumer staple stock, less likely to be impacted as much by any pending recession, is in high demand in this market. The shares are UP \$20 a share since our mid-August issue... wish I had more staples like that (and I’ve looked).

On September 15th Diamond released fiscal Q4 results for the quarter ending 7/31. They trounced analysts’ estimates registering non-GAAP EPS of \$.53, beating by \$.09 a share and exceeding last year’s EPS by 53%. This marks at least 8 consecutive quarters of results beating expectations. Full year adjusted EPS

weighed in at \$2.61 for a 37% increase. Full year adjusted EBITDA grew a huge 72% to \$146 million on a 42% increase in revenues to \$966 million. Snack sales grew 16%, all organic, and full year snack sales surged 72%, including three quarters of Kettle not in prior year results. In U.S. measured channels, Emerald snack nuts grew 16% while the nut category was up only 3% industry-wide, gaining Emerald 100 basis points of market share. Within this, Emerald’s new *Breakfast on the go!* has proven to be Diamond’s best launch ever, creating a significant subcategory for Emerald/Diamond in a new market that is 45% bigger than the nut category. In fact, Breakfast on the go! contributed 40% of the total convenient breakfast category growth during the period. They will add two more flavors this fall and an oatmeal version next year. Pop Secret grew 5% in sharp contrast to the popcorn category which declined 4% industry-wide. Accordingly, Pop Secret gained 210 basis

points of market share. Meanwhile, Kettle's U.S. sales were up 11% while the overall category grew just 2%, gaining 10 basis points of market share. Diamond is in the process of rapidly expanding chip capacity to meet demand. In short these guys know what they are doing and have a knack for creating a new brand (Emerald), or buying a tired/undernurtured brand (Pop Secret and Kettle) and turning them into winners.

Now they expect to do the same with the pending \$2.2 billion acquisition of Pringles, which hasn't gotten much love from P&G lately as it exits its food products to focus on its core products. The deal should close in December. It cleared its last important anti-trust hurdle in August and it sounds like integration is already underway. No cash is involved. Diamond will pay about 29 million shares initially valued at \$51.45, or \$1.5 billion, at the time the deal was put together and assume \$700 million in debt (down from \$850 due to the higher stock price). Note how smart P&G was to take shares in this excellent Company rather than *any* cash. The shares alone are worth \$2.6 billion today for a tidy \$0.9 billion profit ... so far. Pringles is

IPG PHOTONICS* (IPGP \$55.66 NMS, +203%); BI Rank = 8.3 – See Text

www.ipgphotonics.com MA(10/08)(Sold 40% 2/10 @\$46,+150%;Sold 20% 5/4/11 @\$66.18, +260%; Sell 20% 9/25/11 \$55.66,+203%)

IPG manufactures high, medium and low-powered lasers, especially fiber lasers, used in a wide range of applications such as materials processing (cutting, welding, etc.- by far IPG's biggest market), telecommunications and advanced applications (such as cool laser weapons, like for shooting drones and missiles out of the sky). IPG continues to benefit from the continuing migration from conventional lasers to its fiber lasers. The shares marked time not going anywhere in the last six weeks until the market fell out of bed in the past week on worries that there were no more silver bullets left to fight off an increasingly likely double dip recession. Note the economy in terms of unemployment and housing

expected to add \$1.5 billion annually to sales. Assuming 7 months, sales are now forecasted to double from \$966 million in FY7/11 to a range of \$1.85 - \$1.95 billion in FY7/12 and EPS guidance was bumped up a nickel to \$3.05 - \$3.15. Note that with the Company's knack for beating its own estimates and raising guidance along the way \$3.15 or better is probably a safe bet, though there is always some commodity risk.

The shares remain a solid Holding for long term appreciation. However, they are not particularly cheap for current purchase at 28 times next year's earnings, perhaps even a bit exuberant on the recent news given 20.7% EPS growth forecasted for FY7/12 at the high end. You always have to pay up for a good stock. Indeed, having now more than tripled for us, taking a bit of this oversized position off the table seems prudent diversification. In an Update Line on 9/16 after a \$10 per share positive reaction to Q4, I advised selling another 15%, and given the BI Rank and lofty PEG sell another 10% for 217% profit, leaving 50% of this position which after a triple is still more than 1.5 times the dollar amount initially invested back at \$28.20.

starts never really came out of the last recession. GDP growth started to come back but has stalled out as 2011 unfolds. Meanwhile, corporate profits came *zooming* back and cash stashes soared. In this environment IPG's results were kicking butts and taking names. However, with another recession of some sort increasingly likely, plus worries about European defaults having a contagion effect much like the Lehman effect here in 2008 (due to all the banks and other entities that own debt issued by these trouble countries) ... I don't see the resolution of issues on either side of the pond anytime soon. In this environment those ordering lasers may grow cautious and delay orders. So be cautious also- Sell another 20% for a 203% profit.

CERAGON* (CRNT \$9.74 NGS, +52% Avg.); BI Rank = 9.4 – A Buy under \$9

www.ceragon.com Israel (5/07) (Sold 40% at \$16.15, +100%)

Ceragon supplies the high-capacity "pipes" that move data via microwave radio from tower to tower in the part of the network called

backhauling. This refers to routing your cell phone call back to the main switching station once it has reached the cell tower. In this niche

Ceragon has leading edge products. With 3G migrating to 4G and LTE, Internet and video over cell phones, Ceragon is at the right place at the right time to offer its short haul and long haul solutions to operators struggling to address their capacity bottlenecks. Earlier this year the Company acquired Nera beefing up its long haul capability and also evening out its global presence. This has temporarily dragged down profitability, especially during the cost trimming and rationalization period. However, this is coming along nicely and ultimately Ceragon sees this as very accretive with estimates for 2012

now at \$1.00. Not much new here. The shares were marching in place little changed in the past six weeks until the market collapsed this past week and even then have given a fairly good accounting of themselves, off just \$.50 since our last update. Here I don't see the state of the economy impacting this global company's fortunes as much as others (like IPG) as the need to add capacity is more technology-related than related to any usage that would be reduced by a weak economy ... in theory anyway. Nonetheless all things tend to go down in a bear market, but in this case I'll just grin and bear it-A Buy under \$9.

BRIGHAM EXPLORATION* (BEXP \$25.10 NGS, -27%); BI Rank = 10.8 – Buy Under \$24
www.bexp3d.com (3/11) TX (512) 427-3300

Brigham is an independent exploration, development and production company that utilizes advanced exploration, drilling and completion technologies to systematically explore for, develop and produce domestic onshore oil (84% and climbing) and natural gas (16%). In particular, the Company is dedicated to drilling in the Williston Basin in western North Dakota and more recently eastern Montana where its current emphasis is on the Bakken formation. Brigham believes it has as many as 1,299 net drilling locations with each well estimated to have a net present value (NPV10) of \$10.9 million. A nice kicker here is that below the Bakken formation is the Three Forks with equally exciting potential accounting for 500 of these drilling locations, basically a two-for. In fact on Friday Brigham announced another Three Forks well with an initial 24-hour flow rate of 2,906 boe. This is the highest of the 6 Three Forks wells completed to date. Two more are scheduled for completion shortly. Brigham was one of the first to see the potential of the Williston and started acquiring land rights early. As a result it now has one of the best land positions there consisting of 378,000 net acres, of which it believes 235,200 have been “derisked.” It has also been on the leading edge of rapidly evolving drilling and

development techniques (like using proppants, walking drilling platforms and zipper fracturing). As a result, some of its wells have achieved *rock star* status in the Basin. The Company noted that it is currently rigging up for an unheard of 4 well zipper frack. Brigham has drilled 88 horizontal wells into the Bakken so far with an average initial 24-hour flow rate of 2,797 boe.

On Friday Brigham announced that Q3 production would likely come in at or beyond the upper end of its production guidance of 15,000 - 16,200 boepd. In Q1 two walking rigs will be added to generate additional efficiencies via batch drilling. The Company hopes to drill as many as five wells per producing horizon per spacing unit. In total it expects to generate 10 to 20% in capital cost savings from its various efficiency efforts. You have to read their September 23 release. It is just amazing what they are doing. Amidst a rout of metal and energy commodities in the past week, oil has backed off to \$80 a barrel. It had been trading in the upper \$80's in recent weeks. While Brigham has dropped off in sympathy I think this is an excellent, leading edge company in one of the hottest U.S. oil plays and the stock should do very well over the longer term- Buy under \$24.

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Well, I don't want to give away all the stocks we are holding but you get the idea. The remaining 7 pages of the (12 page) newsletter are also entirely filled with detailed updates like the above on every stock we are currently following... every stock... updated in detail in every issue. That's our niche for over 30 years and we're sticking with it.