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In This Issue

Healthcare Market Review & Outlook
Page One.

Consolidation in the Generics Industry is set to continue
Page Three.

About Sectoral Asset Management
Page Ten.

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Healthcare Market Review and Outlook

The summer turned out to be a hot one for biotech and generics/specialty pharma. While the Nasdaq Biotech Index rose by 13.7%, our generics/specialty pharma universe gained approximately 7.7%. The main drivers behind this strong performance (in an otherwise rather uninspired market with the Nasdaq Composite Index up a mere 3.1%) were not only the generally strong Q2 results, particularly Amgen and Genzyme, among the biotech firms, and Allergan and Alpharma, in the generics industry, but also sustained intense M&A and deal making activity in the sector. Large pharma, increasingly under pressure to find new growth opportunities, stepped into the vaccine business with Glaxo's offer to buy out ID Biomedical and Novartis's bid to acquire the part in Chiron it does not already own. On the generics side, the consolidation trend continued with Teva acquiring Ivax in a bid to reclaim its number one position in the industry. In the same generics space, several deals between patent challengers and "challengees" may be the signal of a new trend. Indeed, the Barr/Kos settlement on Niaspan signaled an important shift away from courtroom dramas to a more stable, risk-balanced approach to managing product portfolios on both the brand and generic sides. On the side of large cap pharma, performance was lackluster, the sector being virtually flat for the quarter (MSCI World Pharma Index +0.6%). While European pharmaceutical stocks benefited from improvements in fundamentals, e.g. positive pipeline news at Glaxo and Novartis, their US counterparts continued to suffer from threats to their core franchises and liability claims. Pfizer suffered as key trials related to Lipitor patent challenges are drawing close, while Merck lost ground on negative rulings in the first Vioxx cases.

Since this spring, regulatory worries have subsided as investors responded to the wake up call sent by the industry through a series of M&A transactions as early as April. Fundamentals have, rightfully so, taken the front seat, so much so, that the confirmation of Dr. Lester Crawford as permanent FDA Commissioner in July and his abrupt resignation in September went almost unnoticed. The latter event is of no particular consequence to industry since Dr. Crawford was perceived by most FDA observers as a "lame" leader with no vision. His appointment by President Bush in February

Overall Market Results

Index	Close 9/30/2005	Return 1 Month	Return 3 Month	Return 6 Month	Return 9 Month	Return 12 Month	Annualized Volatility 3 Month	Annualized Volatility 6 Month	Average Volume (m) 3 Month	Average Volume (m) 6 Month
MSCI World Index	1224.3	2.5%	6.6%	6.4%	4.7%	16.8%	7%	8%	6135	6111
S&P 500	1228.8	0.7%	3.1%	4.1%	1.4%	10.2%	9%	10%	1187	1217
Nasdaq Composite	2151.7	0.0%	4.6%	7.6%	-1.1%	13.4%	11%	13%	877	906
Nasdaq Biotech Index	784.9	1.3%	13.7%	20.6%	2.1%	9.8%	17%	18%	75	75
Philadelphia Drug Index	188.62	0.0%	1.1%	2.8%	1.7%	5.3%	9%	10%	54	55
S&P Pharmaceutical Index	302.73	-1.9%	-5.0%	-3.2%	-4.3%	-3.2%	10%	12%	50	53

had come as the US administration was under pressure to appoint a permanent FDA Commissioner following the Vioxx withdrawal. The choice of Crawford was thought to be better than no choice at all. His background as a veterinarian, his long tenure as a civil servant and his age (66 at the time), never made him the right man for the job. His inability to lead was recently evidenced by the fact that he refused to rule on the plan B contraceptive despite clear scientific and clinical evidence and against the recommendation of his senior staff.

The new acting Commissioner, Andrew von Eschenbach, has a more relevant background as a urologic surgeon and as ex-head of the University of Texas M.D. Anderson Cancer Center before moving to the National Cancer Institute, where he acted as director until his appointment at the FDA. In his first statements he appears to have a clearer vision than his predecessor, in that he namely wants to make drugs available to patients to turn cancer into a chronic disease. From that perspective, von Eschenbach is probably better than Crawford, although it is admittedly too soon to tell. The only mild negative, is that the abrupt departure of Crawford once again highlights the difficulty of finding a stable and competent candidate for this position, which has been vacant for too long in the last ten years. The fact remains, however, that the feared slowdown in regulatory activity and increase in pre-approval requirements have not (yet) materialized, and that is a source of legitimate relief to investors.

Outlook

We are sticking to our guns: big pharma is cheap (17x 2006E EPS, 5 year EPS growth: 5% p.a.) for a reason, and cheapness alone is not reason enough to justify any broad exposure in these stocks. We continue to have a preference for European based pharmaceuticals, which have a better pipeline and are less exposed to patent expiries or liability suits. Novartis is our preferred pick, while Roche, which has been one of our long time picks is probably running out of steam with most (anticipated) good news behind it and a valuation, which is double that of its peers. Among the US based companies, we have a hard time finding a stock we like. We would propose Lilly for the same reason as the European pharmaceuticals – no significant patent expirations or challenges and an attractive valuation. We feel the stage is set for further solid performance in the biotech sector. While some large caps may look stretched on valuation, e.g. Genentech at 49x 2006E EPS or Gilead at 34x 2006E EPS, others remain attractively valued, e.g. Amgen at 23x 2006E EPS and offer upside in line with estimated earnings growth (> 20% p.a.). With the improvement in investor sentiment we also feel that less well know issuers could start to perform handsomely. Indeed, several companies in the later stages of development are quickly moving towards commercialization of their first or second products. Despite solid recent runs in certain cases, valuation leaves room for significant upside. Situations we like include Alexion, CoTherix and CV Therapeutics. Lastly, with the worst now behind us in terms of price erosion in the generics market and a clear consolidation trend in place (see following article), further price appreciation is in the cards for the next 12 months. Here our preference goes to the industry leaders and selected niche players.

Michael Sjöström, CFA
Chief Investment Officer

Consolidation In The Generics Industry Is Set To Continue

Introduction

The generic drug industry is fertile hunting ground for would-be acquirers, and 2005 year-to-date has been no exception. The acquisition of Hexal, and its U.S. subsidiary Eon Labs, by Sandoz (announced February 21st, 2005) was a significant deal for the generic industry, positioning Sandoz—albeit temporarily—as the largest generic manufacturer worldwide. This deal was quickly trumped by Teva's acquisition of Ivax (announced July 25th, 2005), which put Teva firmly back in the number one spot in terms of size. Among the commodity pharma players, size provides economies of scale, and importantly, the ability to offer a broad range of products in sufficient quantities and in a reliable fashion. When pricing becomes competitive, leading companies achieve better margins through more efficient cost structures, and thereby gain the status of "preferred suppliers." This in turn enables them to dominate in terms of market share. Yet size is not the only driving force behind mergers and acquisitions. Particularly in other subsectors of the generics industry, deals occur for many different reasons, including access to new technologies (Teva/Sicor) and a desire to gain an important strategic product (Shire/TKT), to name a few. With 160 listed companies in the S.A.M. Global Generics Universe, and many more private players, the industry is highly fragmented thus leaving ample room for further consolidation.

Pure Generics Players

The most obvious companies for which further mergers are inevitable are the pure generic, commodity pharma players, which collectively represent 30% of the generics universe. Companies in this universe include Teva, Sandoz, Mylan, Watson and Dr. Reddy's, among several other mid- and smaller-sized players. At the recent Generic Pharmaceutical Association's (GPhA) first annual policy conference, Bernie Hampl, CEO of Sandoz U.S., noted that USD27bn worth of products will be off patent by 2007, with USD318bn worth of products going off patent by 2015. Competition for these opportunities, particularly over first-to-file exclusivities, has increased in recent quarters. As a result, the business of copying simple molecules is becoming fully exploited. A telling measure is the number of generic drug filings (ANDAs) as compared with the total brand sales of the drugs they target. According to the Office of Generic Drugs, there will be over 700 ANDAs filed in 2005. This is at least 10% higher than 2004's 635 filings and up 46% from 2003. Between 2004 and 2005, the brand sales of products coming off patent for the ensuing 5 year period increased 8%, while the comparison for 2005 vs. 2003 is a 15% increase. Combined with the actual slowdown in patent expirations witnessed in 2004, many generic drug companies have found themselves fighting over the same scraps, leading to rapid price erosion of easy-to-manufacture oral dosage products.

U.S. generics manufacturers, particularly the mid-sized players, are under pressure from cheap manufacturers—most notably from the Indian companies. For example, Dr. Reddy launched citalopram (the generic equivalent to Celexa from Forest Laboratories) at a >90% discount to the brand price. This virtually flooded the market with cheap, low-margin product, squeezing U.S. players between a rock and hard place. The often-touted solutions for keeping an edge on the competition, then, were to focus on difficult-to-manufacture products with high barriers to entry or streamline the manufacturing process.

The end result of the aforementioned competitive dynamics will be to accelerate consolidation in the industry. As such, it is not difficult to envision an oligopolistic situation in the future, wherein the pure generics business is home to but a few, dominant players with little incentive to compete on price. No matter how one looks at it, the sector is in the early innings of a consolidation trend.

Specialty Pharmaceutical Transactions - Branded

(Figures in USDm, except for multiples)

Acquiror/Target	Date Ann'd	Consideration	Transaction Value	Enterprise Value	Enterprise Value/LTM Revenue	EBITDA	EBIT	EBIT Margin	LTM P/E	Premium 1 Day	1 Month
MGI Pharma/Guilford Pharmaceuticals *Polymer-based cancer therapeutics + drug delivery technology*	21-Jul-05	Cash/Stock	177.5	168.4	3.3x	NM	NM	NM	NM	41.1%	26.4%
Cephalon/Salmedix *Oncology pipeline, with phase II product for non-Hodgkin's Lymphoma*	12-May-05	Cash	200.0	175.0	NM	NM	NM	NM	NM	NA	NA
Shire/Transkaryotic Therapies (TKT) *Human proteins for rare genetic diseases, including Dynepo*	21-Apr-05	Cash	1,600.0	1,538.8	19.9x	NM	NM	NM	NM	15.7%	57.6%
Jazz/Orphan Medical *Drugs for sleep disorders, pain and CNS disorders*	19-Apr-05	Cash	110.4	110.4	4.2x	NM	NM	NM	NM	22.9%	8.7%
Medicis/Inamed *Facial and breast aesthetics for plastic and other surgeries*	21-Mar-05	Cash/Stock	2,745.0	2,608.1	6.3x	31.6x	37.6x	19.0%	46.4x	3.0%	-2.4%
Valeant Pharmaceuticals/Xcel Pharmaceuticals *Privately held specialty pharmaceutical company focused on neurology products*	2-Feb-05	Cash	280.0	315.3	5.2x	49.2x	NM	NA	NA	NA	NA
Proten Design Labs/ESP Pharma *Privately-held, hospital-focused pharma company*	25-Jan-05	Cash/Stock	475.0	459.0	5.1x	17.0x	NA	NA	NA	NA	NA
QLT/Atrix *Drug delivery technologies and Atrigel*	14-Jun-04	Cash/Stock	771.8	661.5	10.3x	198.6x	NM	NM	139.8x	12.0%	12.7%
Bradley/Bioglan Pharmaceutical Assets *Dermatology and pain products*	9-Jun-04	Cash	188.3	280.6	5.1x	NA	NA	NA	NA	NA	NA
Allergan/Oculex Pharmaceuticals *Ophthalmic drug delivery technology platform*	14-Oct-03	Cash	230.0	230.0	950.4x	NM	NM	NM	NM	NA	NA
Barr Labs/Women's Capital Corp. *Plan B emergency oral contraceptive assets*	1-Oct-03	Undisclosed	21.0	21.0	NM	NM	NM	NM	NM	NA	NA
Cephalon/CIMA Labs *OraSolv technology for transmucosal delivery*	21-Aug-03	Cash	437.4	361.3	6.9x	23.8x	30.3x	22.9%	24.5x	13.9%	0.7%
Biovail/Pharma PASS *Developer of enhanced oral and CR technologies and formulations*	11-Dec-02	Cash	190.0	190.0	NM	NM	NM	NM	NM	NA	NA
Johnson & Johnson/OraPharma *Specialty pharmaceutical company focusing on treatment of oral diseases and disorders*	13-Nov-02	Cash	101.8	74.3	4.1x	NM	NM	NM	NM	63.2%	64.3%
King Pharmaceuticals/Meridian Medical Technologies *Medical technology company with Pharmaceutical and Cardiopulmonary systems*	21-Oct-02	Cash	243.9	230.9	2.8x	10.3x	12.0x	23.3%	24.5x	16.6%	29.7%
Johnson & Johnson/Alza Corporation *A research-based pharmaceutical company with drug delivery technologies*	27-Mar-01	Stock	10,370.7	10,439.6	10.6x	32.6x	38.9x	27.1%	46.4x	8.0%	5.4%
Summary Statistics for All Deals, Excluding Outliers:											
High					**19.9x**	**49.2x**	**52.9x**	**60.4%**	**53.4x**	**63.2%**	**185.9%**
Mean					**7.9x**	**28.3x**	**32.3x**	**25.7%**	**41.1x**	**26.1%**	**45.3%**
Median					**5.8x**	**30.5x**	**33.2x**	**21.9%**	**46.4x**	**22.6%**	**39.4%**
Low					**2.8x**	**10.3x**	**12.0x**	**9.4%**	**24.5x**	**3.0%**	**-2.4%**

Specialty Pharmaceutical Transactions - Generics

(Figures in USDm, except for multiples)

Acquiror/Target	Date Ann'd	Consideration	Transaction Value	Enterprise Value	Enterprise Value/LTM Revenue	EBITDA	EBIT	EBIT Margin	LTM P/E	Premium 1 Day	1 Month
Teva/Ivax *Global generic drug manufacturer with respiratory franchise*	25-Jul-05	Cash/Stock	7,400.0	8,182.3	4.3x	31.1x	34.1x	12.6%	39.6x	10.0%	19.0%
Novartis/Eon Labs *Domestic generic drug manufacturer*	21-Feb-05	Cash	2,695.0	2,499.0	5.8x	13.7x	14.5x	26.4%	23.8x	9.2%	22.1%
Novartis/Hexal AG *German privately-held generics manufacturer*	21-Feb-05	Cash	5,688.0	5,908.0	3.7x	NA	24.2x	NA	NA	NA	NA
Waren Acquisition/Warner Chilcott *Domestic specialty pharmaceuticals manufacturer*	27-Oct-04	Cash	2,930.0	2,959.2	6.4x	12.3x	16.1x	39.6%	23.8x	33.1%	41.2%
Teva/Dorom *Italian generic unit of Pfizer*	17-Aug-04	Cash	85.2	85.2	2.3x	NA	NA	NA	NA	NA	NA
Novartis (Sandoz)/Sabex *Canadian privately-held generics manufacturer*	7-Jun-04	Cash	565.0	565.0	6.3x	NA	NA	NA	NA	NA	NA
Teva Pharmaceutical Industries/SICOR *Manufacturer of injectable pharmaceuticals, APIs, and biogenerics*	31-Oct-03	Cash/Stock	3,400.0	3,248.0	6.2x	18.2x	18.7x	33.2%	24.3x	10.9%	41.0%
GTCR/Morton Grove Pharmaceuticals *Supplier of specialty and generic liquid pharmaceutical products*	31-Jan-03	Cash	190.0	190.0	2.6x	8.6x	9.5x	27.5%	NA	NM	NM
Novartis/Lek *Lending developer of generic drugs in Slovenia and Eastern Europe*	29-Aug-02	Cash	828.0	828.0	NA	NA	19.2x	12.2%	22.4x	10.4%	61.0%
PLIVA/Sidmak Laboratories *Domestic generic drug manufacturer*	11-Jun-02	Cash	152.9	211.9	2.1x	NA	49.3x	4.3%	NA	NM	NM
Baxter Healthcare/ESI Lederle *Generic injectables business of Wyeth*	10-Jun-02	Cash	305.0	305.0	1.4x	5.8x	7.0x	19.3%	NA	NM	NM
Stada Arzneimittel AG/Mova Laboratories *Domestic supplier of generic drugs*	7-Nov-01	Cash	NA	NA	NA	NA	NA	NA	NA	NA	NA
Barr Laboratories/Duramed Pharmaceuticals *Manufacturer of pharmaceuticals for women's health and hormone replacement*	29-Jun-01	Stock	567.8	615.0	5.8x	36.4x	46.9x	12.4%	71.8x	14.7%	73.9%
Alpharma/Purepac Pharmaceuticals *Manufacturer of generic and proprietary oral solid dose pharmaceuticals*	12-Jul-01	Cash	660.0	660.0	3.2x	16.5x	22.5x	14.1%	32.1x	NM	NM
Ivax Corp/Laboratorio Chile SA *Produces human and veterinary pharmaceuticals in Chile*	15-May-01	Cash	395.0	459.1	2.6x	9.2x	10.0x	25.9%	15.8x	40.0%	30.9%
Summary Statistics for All Deals, Excluding Outliers:											
High					**6.4x**	**36.4x**	**49.3x**	**39.6%**	**71.8x**	**40.0%**	**73.9%**
Mean					**3.5x**	**16.7x**	**23.4x**	**17.7%**	**32.3x**	**18.2%**	**35.3%**
Median					**2.6x**	**15.1x**	**22.3x**	**13.3%**	**27.1x**	**12.8%**	**32.3%**
Low					**0.9x**	**5.8x**	**7.0x**	**4.3%**	**15.8x**	**7.3%**	**10.0%**

NOTE: Transaction list abridged to save space. High, Mean, Median and Low calculations include deals (not shown) from January 1st, 1998.
SOURCE: S.A.M., Bloomberg and Lehman Brothers

Specialty Pharmaceutical Players

The urge to merge has not been limited to pure generics manufacturers. Recent mergers such as the QLT/Atrix deal or the acquisition of Transkaryotic Therapies (TKT) by Shire point to a different type of phenomenon. Such mergers are less about scale and breadth and more about access to unique and promising products and technologies. The acquisition of Atrix provided QLT with a biodegradable implant technology, while Shire gained Dynepo with the purchase of TKT—a product that could potentially become the first biogeneric to EPO.

While a trend towards an accelerated pace of consolidation in the specialty pharma subsector is less obvious, the potential is certainly there for additional deals to take place. Forest Laboratories, for example, is cash rich and lacking late-stage development projects with immediate market potential. It is not difficult to imagine the company adding a marketed product to its portfolio—either through an in-licensing deal, or through an acquisition in the not-too-distant future. Overall, we expect the specialty pharma sector to experience further consolidation, albeit at a less aggressive pace than the pure generic, commodity pharma subsector.

Recent Mergers

As mentioned, the generic industry has been marked by a number of significant mergers this year. Both the Sandoz/Hexal and Teva/Ivax deals were industry-transforming events for pure generic players. Though less transformational, deals in the specialty subsector were also interesting and abundant. What is noteworthy is the average premiums paid. Deals announced and/or completed since 2004 were done at an average premium of 35% for generics manufacturers, and at an average premium of 45% for specialty pharma companies, as compared to prices one month prior to announcement. Multiples of trailing (Last Twelve Months, LTM) sales, as shown in the figures on pages four and five, were well above the current industry average multiples of 2.6x and 4.5x for the generics and specialty pharma subsectors respectively. The same holds true for multiples of EBITDA, EBIT and net earnings.

Motivating Factors

The Teva/Ivax deal is about size, global reach and diversification into new product areas. Yet several deals happen for different reasons. The acquisition of Eon Labs by Sandoz added extended release technologies to the generic powerhouse, as well as significant U.S.-based manufacturing capacity. Similarly, the Sabex acquisition added injectable technology to help broaden the company's generic pipeline. Barr bought privately-held Women's Capital Corporation (WCC) to gain access to Plan B, an emergency contraceptive that the company hopes to sell over-the-counter one day.

Overall, these imply several rationales to merge, which we attempt to broadly classify here. As we have already seen, though, many deals are about a combination of many different factors.

- **Size and economies of scale.** Deals of size and scale have already been witnessed this year with both the Teva/Ivax and the Sandoz/Hexal deal. Such deals are likely to continue for some time as the industry sorts out the mid-sized players into targets and losers.

- **Expansion to new geographic regions with low generic penetration.** In a later section, we delve into the emerging generic markets, such as Central and Eastern Europe and the Asia/Pacific region. Clearly, this is a long-term opportunity for the generic sector, and in order to capitalize on it, large players will require a local presence in order to navigate the political and structural barriers to entry. Thus acquisitions by global players seeking entrance to these regions are likely.

- **Access to new technologies.** As alluded to previously, new technologies are important to the development of higher margin products with high barriers to entry. Of note, it appears that Alkermes' sustained release injectable technology is of particular interest to a number of partners, including large pharma. While the stock is underappreciated, it is not unreasonable to believe this company may also become an attractive target.

Given the many different motivating factors, combined with the competitive nature of several subsectors of the industry, it makes logical sense that consolidation will continue at a healthy pace.

Central and Eastern Europe: EU Integration Provides a Short Term Opportunity

In general, companies in emerging generic markets such as Central and Eastern Europe (CEE) are interesting targets. They offer a low cost structure, access to a relatively un-penetrated domestic market for generics, not to mention well-established local distribution networks. With the arrival of new EMEA regulations, drugs approved in developed countries will be sellable in all EU countries beginning January 1st, 2006. As a result, it will become strategic for a European company to have a presence in the ten new EU countries in order to channel previously approved generic products into these untapped markets. Novartis opened the way by acquiring the Slovenian company Lek. Others may follow suit, targeting firms such as Gedeon Richter in Hungary, Krka in Slovenia or Zentiva in the Czech Republic.

Russia: The Importance of a Domestic Presence

The Russian pharmaceutical market is one of the largest in the CEE region. Yet its per capita spending level is among the lowest, above only Romania, Ukraine and the other smaller ex-Soviet states. Hence, the potential is vast but much reform and modernization is required to exploit the opportunity.

To this end, however, the Russian pharmaceutical sector has seen considerable reform over the last year, with the government seemingly making an effort to modernize its domestic drug infrastructure and attract foreign investment. The most significant step forward has been the introduction of a drug reimbursement system early in 2005. The new system, the first of its kind in the country, is replacing an outmoded social benefits scheme and has begun to provide free healthcare to Russians, which must be considered a major step forward in the development of the country's healthcare system. Government officials are already reporting a 6- to 10-fold increase in prescription volume thus far in 2005. The new government-funded system seems set to accelerate spending on pharmaceuticals, making the market all that more attractive for generic manufacturers. In fact, new draft legislation, reportedly set for implementation, will enforce the prescribing of generic drug names, rather than trade names, opening the market even further to generic players.

In an effort to protect its domestic producers, the Russian government has declared it will only reimburse drugs produced and packaged domestically. Hungarian generics manufacturer, Gedeon Richter, is well positioned, having purchased a Russian-based facility just two years ago. For other global players, the political and structural barriers are significant, making acquisition the easiest route to market entry. We are likely to see considerable activity related to this region in the future.

China & India: Access to Cheap Manufacturing Sites & Large Potential Markets

M&A activity in the Asia-Pacific region has been marked by consolidation of indigenous drug manufacturers, particularly in China and India. Yet, it seems very likely that western companies will soon look to Indian and Chinese companies as more than just partners (and vice versa)—if several plans are not already underway to merge. Indian generics firms have found it difficult to enter developed markets, due to a lack of legal expertise, regulatory clout and importantly, distribution relationships. Partnerships such as the Cipla/Ivax relationship

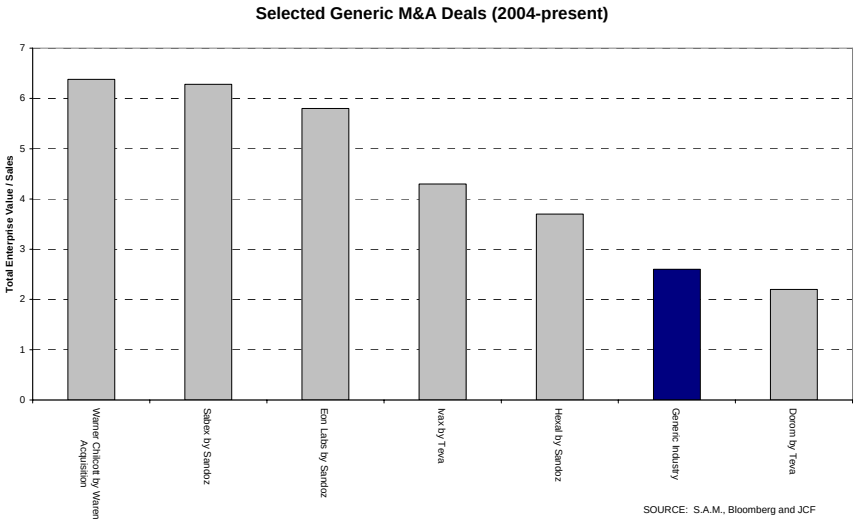
are very telling of what's to come. Similarly, the Indian and Chinese markets are massive untapped markets for western generics firms seeking to expand their global presence. Obstacles for western companies in these regions include cultural and language barriers.

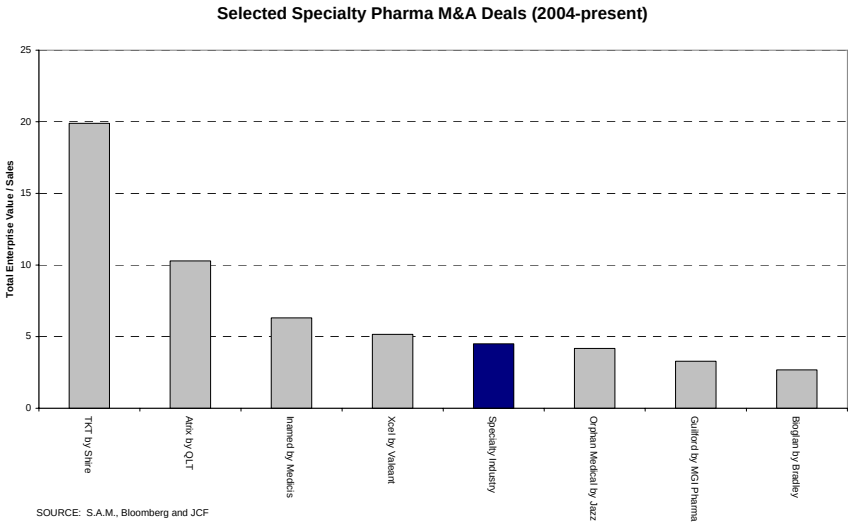
The Indian pharmaceutical industry is on par with the best in the world. Processes in India are cost-effective and India has a large number of FDA-approved plants. The growth is steady, and more mergers are expected with European and US companies, as manufacturing is considerably cheaper in India. Cipla, an API supplier with a long-standing relationship with Ivax, may be a target of choice.

The Asia-Pacific prediction builds on figures from 2004, which revealed that, for the first time, the number of deals in Asia-Pacific (278) exceeded those in North America (252). Deal activity rates grew in all markets except Eastern Europe. Western Europe saw a growth rate of 11%, North America 20% and Asia-Pacific 37%.

Will Pharma Gobble up the Generics Industry?

We are often asked if the pharmaceutical industry will take out its mortal enemy by acquiring generics firms. Big pharma clearly had no interest in being first to introduce lower-margin generics to the market to compete with their own brands. In fact, since the mid-1990's large pharma has spun out most of its generic businesses in an attempt to focus on R&D and innovation. While small, Pfizer's Italian generic unit, Dorom was sold to Teva in 2004. Similarly, Ranbaxy acquired RPG (Aventis's French generics business) along with its subsidiary OPIH SARL in 2003. Yet some pharma players are now interested in the generic business, and are focusing on higher margin products (e.g. Novartis/Sandoz is interested in biogenerics). Indeed, deals between pharma and generic companies of late have centered on this theme. Novartis/Sandoz acquired Hexal and Eon Labs for several reasons, but a key motivating factor included the focus on high-margin, difficult-to-manufacture products. Similarly, Novartis/Sandoz has a profit sharing arrangement with Momenta for generic Lovenox, a very complex and difficult-to-characterize molecule—and one that is likely to enjoy high margins for a generic product. Overall, though, we believe that wholesale acquisition of the entire generic industry by pharma is unlikely. It is reasonable to assume that some deals will happen, but less plausible that the entire generic industry will be swallowed





up by pharma, and even less reasonable to suggest that all pharma players would be interested in diversifying into this business.

Conclusion

Further such activity in the generics industry is inevitable, as several motivating factors converge, including: the need for size and scale; geographic expansion to under-penetrated markets; and access to new products and technologies, not to mention the (potential) strategic interest of large pharma. For the investor, this should provide a solid underpinning to current prices. Indeed, as the figures on the previous page demonstrate, many of the recent deals have been executed at significant premiums to the industry's current valuation. Attempting to identify the targets is a risky game, however, as many mid-sized firms will simply go out of business as a result of the increasing competition. The safer and more rewarding strategy for the long term investor is to focus on the large players among the pure generic companies likely to lead the consolidation movement, and to select a few smaller niche players with clear competitive advantages in their respective areas of expertise. The obvious candidates include Teva, Barr Pharmaceuticals and Stada. Companies in emerging generic markets in the CEE region and Asia also represent attractive investments, though leadership in local markets will again be an important differentiating factor between winners and losers. Potential winners in these regions include Gedeon Richter, Zentiva and Krka. In summary, there is considerable motivation to support continued merger activity at an accelerating pace. This is indeed an exciting time to invest in the generics industry.

Sanjay Patel, B.Sc.
Financial Analyst

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Sectoral Asset Management

Sectoral Asset Management (S.A.M.) is an SEC-registered investment advisor based in Montreal whose focus is on managing global equity portfolios by industry. S.A.M. has one of the world's longest track records in managing biotech equities and is a sub-advisor of numerous healthcare and biotech funds offered by partners in Europe, USA, Japan, and Taiwan. S.A.M. has also launched an alternative investment fund that offers an attractive exposure to the growing healthcare/biotech sector through both long and short positions. The firm's assets are USD2.2 billion as of September 30, 2005.

Investment Professionals

Jérôme Pfund, CFA	Chief Executive Officer
Michael Sjöström, CFA	Chief Investment Officer
Vincent Ossipow, Ph.D.	Chief Scientific Officer
Laurent Payer, CFA	Senior Portfolio Manager
Stephan Patten, CFA	Portfolio Manager
Sanjay S. Patel, B.Sc.	Financial Analyst
Carmen Tang, M.Sc., MBA	Financial Analyst
Pierre Gauthier, CFA	Trader
Bandhna Mamak, CFA	Risk and Operations Manager

Scientific Advisory Network

Under the supervision of Dr. Vincent Ossipow, S.A.M. has established a proprietary network of motivated and talented researchers and clinicians in complementary disciplines worldwide. The Scientific Advisory Network (SAN) is designed to support S.A.M. with scientific due-diligence in its investment process. SAN's members include:

Amanda Adler, MD, Ph.D.	Epidemiology/Diabetes	Addenbrooke's Hospital, Cambridge, UK
Aurelio Balsalobre, Ph.D.	Molecular biology	IRCM, Montreal, Canada
Pao-Hsien Chu, MD	Cardiology	Chang Gung Memorial Hospital, Taipei, Taiwan R.O.C.
Sui Huang, MD, Ph.D.	Oncology	Harvard Medical School, Children's Hospital, Boston, USA
Henry I. Miller, MS, MD	Health Policy / Regulation	Hoover Institution, Stanford CA, USA
Olivier Schaad, Ph.D.	DNA chips	University of Geneva, Geneva, Switzerland
Adam Smith, D.Phil.	Drug Discovery	Informa, London, UK

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