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SPECIALTY  
PHARMACEUTICALS

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NASDAQ: NKTR  
PRICE: \$14.50  
RATING: BUY

**NKTR: VISIBLY INVISIBLE: SUPPLY, NOT DEMAND DELAYED EXUBERA; PFIZER'S FUMBLING FILLING, BUT PICKS UP THE BALL SETTING STAGE FOR POWERFUL, ALBEIT DELAYED, LAUNCH**

**Investment Conclusion:** *In Wall Street lingo, visibility is everything and without it, stocks usually underperform, as NKTR shares have of late. But what about a case where you can see why you're not seeing? From invisible invisibility (not knowing why we can't see) to visibly invisible? That's where we think we are now, which we conclude is a signal to buy. Why? In short: Demand greater than Supply is a lot better than Supply greater than Demand, which is what much of the thinking on Wall Street has likely been since Pfizer formally launched Exubera. We don't like it, but we now clearly understand this previously stealth execution risk, and given the unique supplier relationship between Nektar and Pfizer where Nektar makes devices and powder then ships to Pfizer for final filling and packaging, it makes sense to us. In short, what Nektar developed, perfected and scaled up over a decade, (the ability to take tiny 20 micron doses and the manufacturing process to crank out over a billion doses a year), Pfizer likely couldn't replicate at its own new site with its own people in a few quarters since the late January FDA approval. Did Nektar offer to help? Sure. But to borrow a Katrina metaphor, there may have been rumors of a "hurricane" in Indiana (where Pfizer's manufacturing site is), the innovators in San Carlos offered to send in "FEMA", but Pfizer declined and apparently struggled to get it right. Is it fixed now? Yes, as best as we can tell by Pfizer's guidance for a January 2007 GP launch (the company has been marketing to Endos and other specialists since July, but mainly to educate). But we suspect the yields aren't where they wanted to be and the bottom line; Pfizer couldn't deliver on stated internal production standard: "continuity of supply." If one thinks about it, if the pent-up demand was as high as we (and others) have postulated, Pfizer ran the risk of getting diabetics to switch to Exubera and not being able to refill prescriptions. Not exactly the way to start launching a potential blockbuster, in our view. So if one considers the context of the competitive landscape where we don't expect the second inhaled insulin to reach the market until at least 2010, it makes strategic sense to us for Pfizer to proceed with this phased launch, which as we learned from Pfizer last week, effectively delays Exubera visibility until Q1:07. So while in reality Exubera sales are not visible, we can at least say that Exubera is visibly invisible, which is better than invisibly invisible, which is where we were until the supply issue was apparent. We reiterate our Buy rating and \$30 target price.*

- **Red-Zone Fumble? Technology Transfer, Scale-up Issues: Pfizer Couldn't Replicate in a Few Quarters What Nektar Developed Over a Decade. Unforeseen? Yes; a Big Surprise Given New, Novel, Large Scale, Low Dose Process? Hardly.** We don't pretend

**Stock Data**

12-Month Price Target	\$30.00
52-Week Range	\$23.20 - 12.71
10-Day Avg. Daily Volume	1,916,223

**Revenues**

FY ends December	2005A	2006E	2007E
Revenue (MM)	\$126.3	\$200.5	\$320.4
Previous Estimate (MM)	-	NC	NC
Price/Revenue	10.3x	6.5x	4.1x
EV/Revenue	10.0x	6.3x	3.9x
Secular Growth Rate			NM

**Capitalization**

Shares Outstanding (MM)	89.7
Market Capitalization (MM)	\$1,300.6
Enterprise Value (MM)	\$1,262.9
Debt/Total Cap. (6/30/06)	62.3%
Cash (6/30/06) (MM)	\$475.9
Cash/Share (6/30/06)	\$5.31

**Earnings Per Share\***

	Q1	Q2	Q3	Q4	Fiscal Year EPS	Previous Estimate	P/E
	(\$0.31)	(\$0.32)	(\$0.28)	(\$0.40)	(\$1.30)	-	NM
	(\$0.33)A	(\$0.34)A	(\$0.33)	(\$0.32)	(\$1.32)	NC	NM
	NE	NE	NE	NE	\$0.04	NC	NM

\*Earnings Per Share before extraordinary items

NC indicates no change from current estimate. NE indicates no estimate. NM indicates not meaningful.

Sources: WR Hambrecht + Co estimates and company reports

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to know the details, but we can deduce the likely bottlenecks that may have resulted in Pfizer's inability to build enough inventory to support the visible launch we had expected back around ADA last spring, which became increasingly invisible since then and only now is getting clearer to us. As the innovator of Exubera, one might logically expect that Nektar would control all aspects of manufacturing, but the supply agreement with Pfizer limits what Nektar does. We know that Nektar has all its devices subcontracted, most by WST, and that Pfizer received all that it wanted. So no problem there. Nektar makes all the dry powder insulin, (the doses that are inhaled), at its headquarters in San Carlos, and Pfizer has been getting all it has ordered there as well. But both the Exubera device and doses of insulin powder must be shipped to Pfizer's finished dose manufacturing facility in the Terre Haute, Indiana facility where Pfizer makes the final dosage forms, which consist of 1mg and 3mg blister packs. These blister packs are shipped along with the Exubera device, initially bundled in starter kits priced at around \$182 (a month's supply which costs diabetics about \$20 to \$35 for Tier 2 co-pay or around \$50 for Tier 3). Since diabetics need to titrate each dose as a function of glucose monitoring tests, every dose is different, and given all the permutations, one can infer that Pfizer needed to make more 1mg doses than 3mg doses. Whatever the ratio might be, we suspect that perhaps Pfizer may not have had enough of one dose or another and since it makes sense that more 1mg doses were needed, the low dose volume may have been the bottleneck. While we are no manufacturing experts, we spent some time in drug delivery operations over a decade ago and distinctly recall a similar production launch delay when the lowest dose of a nicotine transdermal patch was "out of spec", resulting in lower yields during the initial commercial production batches. We suspect that Pfizer may have run into similar challenges and considering that this filling process was invented by Nektar with origins back into the early 90s, and scaled up to make billions of units at very low 20 micron insulin doses, the technology transfer challenges and what now are unforeseen manufacturing delays. So, putting our football metaphor back on the field, imagine there was this #1 draft pick, say Vince Young, the hero of last year's Rose Bowl, and he goes pro; was it any surprise when he dropped the ball? That's what happened here, but in this case, it was the veteran Pfizer, learning from a new playbook that appears to have pushed Exubera out by a few quarters longer than we might have expected. In the grand scheme of things, this is no big deal, in our view.

- **Mysterious Marketing: Pfizer Sales Force "Circling"**. Pfizer's Exubera marketing has felt like a plane that gets to its destination and then circles for an hour before ATC lets it land. That's been the feeling among Pfizer sales reps we have spoken with. They have been asked to limit their details and won't be compensated until January for Rx and sales. Hence, the anecdotal feedback that Wall Street has been getting since the July 18 launch meeting has suggested that Pfizer marketing isn't pushing Exubera. This made no sense if the product were available, but if it wasn't, then this bizarre holding pattern is understandable, in our view. So while Exubera is launched and anybody can get all the details on [www.exubera.com](http://www.exubera.com), the visibility that investors usually look for, even a few months after the formal launch has fallen short of initial expectations which until now, was difficult to explain. Pfizer cleared a lot of this up on its call last week, but NKTR stock continues to languish.
- **DTD (Direct to Diabetic – DTC Campaign by Pfizer Expected in Early 2007)**. While Pfizer didn't disclose details, the Q&A part of last week's call revealed that something big is in the works that will likely coincide with the broad GP launch in January. It is too soon for details, and Pfizer appears to be gearing up for a major direct to diabetic marketing campaign that will come in early 2007. The logic, which we infer from our meeting with Nektar, seems clear enough to us: we believe Pfizer is investing the balance of 2006 to maximize the educational component of Exubera among endocrinologists, diabetes educators, and major diabetes Rx prescribers. While our and other third party market research has identified pent-up demand across some 1M diabetics, we believe Pfizer is deliberately avoiding targeting patients until it trains clinicians on all aspects of Exubera. While this was signaled at ADA back in June, it was less clear that this process would take place over the next few quarters and would effectively limit the near-term uptake for Exubera. But if this marketing strategy is designed to

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maximize the trajectory of Exubera sales in 2007, who cares about what Rx data looks like at the end of Q3 where we are now?

- **Strategic implications for competitive landscape and Pfizer.** Investors should consider the implications of this technology transfer and scale up case study. At a minimum we are reminded that inhaled insulin is an enormously challenging endeavor; the Mt. Everest expedition of the industry, and beware to those who are traveling the same journey. While AIR insulin program is quietly proceeding with Eli Lilly fully funding the Phase 3 development program, and Alkermes (ALKS: Buy) scaling up production as it has for other new products in its 15 years history full of challenges and setbacks, ALKS stock has languished like NKTR, as there is little visibility for AIR insulin at this juncture, in our view. But MannKind (MNKD: Hold) is another story. First, the stock has held up like a champ. Management continues to profile its differentiated pk profile while signaling that the long-awaited partnership may not be too far away that keeps the shorts at bay. But we wonder what big pharma senior executive (and board) would sign the kind of big deal we suspect MannKind is seeking with large up fronts (well over \$100M) and a rich profit split to MannKind somewhere near 50:50, without the clear visibility of a successful first entrant Exubera. This note has been about manufacturing execution risk post FDA approval and with all the risk that Nektar has taken out of the story, its valuation now hovers just above MNKD which we believe is unlikely to reach the market before 2011. We applaud both Alkermes' and MannKind's bold commitments to develop second generation entrants in what we believe will be a \$5B category for novel insulin drug delivery products, which also might include an unexpected first entrant outside inhaled insulin. We expect to see Emisphere (EMIS: Buy) Phase 2 oral insulin data in the next week which, assuming more funding from a big pharma partner, could make this a potential threat to inhaled insulin should it reach market (which we view as unlikely before 2010). By then, Nektar should have an established base of over 1 million diabetics and a second generation on the market as well, but MannKind may not yet be on the market. That's interesting to us given the valuation gaps between NKTR, EMIS and MNKD. Finally, we suspect more than a few senior Pfizer execs who have fretted about the lack of internal know-how to scale up Exubera have considered the obvious strategic solution that would give Pfizer instant know-how, control, and effectively double its profit split. We don't think that an acquisition of Nektar is on the near-term radar screen, but as discussions go on about how to get Exubera out the door faster over this past few quarters, we can't imagine that buying NKTR was not a serious strategic alternative.
- **Conclusion:** While near-term visibility may limit NKTR's near-term appreciation as Rx trends may not get too exciting until some time after Thanksgiving, we conclude that NKTR stock has largely bottomed and this new information suggests that we may be at an important inflection point. Keeping it very simple, the bearish sentiment over the last several months reflected the belief that demand was less than supply when it seems to us that the reverse is the case. While this new revelation is a disappointment, our view is that NKTR stock has embedded the bear case and more. Visibly invisible is where we are now, which is just before visibly visible, which now is only a few months away, in our view. Finally, with Pfizer and maintaining its \$2B+ Exubera sales forecast for 2010 and the calendar set to turn to 2007, we believe valuation methodology will take another year of discounting with a stock that has already taken a 30% hit on what at the end of the day may be an effective one-time execution risk. For value and growth investors who have seen impressive gains across their portfolios these past few months, we believe NKTR should screen attractively with the fundamental investment thesis unchanged. We reiterate our Buy rating and \$30 target price.

# Nektar

## Earnings Model

(\$ in millions, except per share data)

				Year Ending December 31, 2006E								
	2003	2004	2005	Q1	Q2	Q3 E	Q4 E	2006E	2007E	2008E	2009E	2010E
Exubera Royalties	0.0	0.0	0.0	0.0	0.0	0.0	5.3	5.3	73.9	149.4	234.3	325.9
Exubera Manufacturing Revenue			0.0	3.4	30.0	30.0	30.0	93.4	142.6	218.3	274.7	340.1
Other Product Sales	27.3	25.1	29.4	9.0	14.2	9.0	9.0	41.2	50.8	69.4	79.7	223.4
Contract Revenues	79.0	89.2	81.6	14.8	14.3	14.0	14.0	57.1	53.0	45.0	50.0	50.0
Exubera Comm. Readiness Revenue			15.3	1.7	1.7	0.0	0.0	3.5	0.0	0.0	0.0	0.0
<b>Total Revenues</b>	<b>106.3</b>	<b>114.3</b>	<b>126.3</b>	<b>28.9</b>	<b>60.3</b>	<b>53.0</b>	<b>58.3</b>	<b>200.5</b>	<b>320.4</b>	<b>482.1</b>	<b>638.7</b>	<b>939.4</b>
Cost of Sales	14.7	19.8	23.7	7.5	35.7	29.3	33.2	105.7	106.0	190.1	269.0	418.9
Gross Profit	91.6	94.5	102.6	21.4	24.5	23.8	25.1	94.8	214.4	292.0	369.7	520.5
R&D	131.5	133.5	151.7	31.4	32.0	33.0	34.0	130.4	150.0	145.0	145.0	145.0
SG&A	22.0	31.0	43.9	16.5	20.9	20.0	19.0	76.4	52.0	50.0	55.0	56.0
Exubera Comm. Readiness Costs			12.3	1.5	1.0	0.0	0.0	2.5	0.0	0.0	0.0	0.0
Amortization of Intangible Assets	4.2	3.9	4.2	1.4	1.3	1.0	0.9	4.5	3.9	3.9	3.9	3.9
<b>Operating Income (loss)</b>	<b>(66.2)</b>	<b>(73.9)</b>	<b>(109.4)</b>	<b>(29.3)</b>	<b>(30.7)</b>	<b>(30.3)</b>	<b>(28.8)</b>	<b>(119.1)</b>	<b>8.5</b>	<b>93.1</b>	<b>165.8</b>	<b>315.6</b>
Interest Expense	16.3	13.0	11.8	5.1	4.9	5.0	5.0	20.1	14.0	11.0	14.0	14.0
Interest and Other Income, net	9.0	5.7	9.4	4.8	5.3	5.0	5.0	20.2	10.0	20.0	11.0	13.0
<b>Pretax Income</b>	<b>(73.4)</b>	<b>(81.3)</b>	<b>(111.9)</b>	<b>(29.6)</b>	<b>(30.3)</b>	<b>(30.3)</b>	<b>(28.8)</b>	<b>(119.0)</b>	<b>4.5</b>	<b>102.1</b>	<b>162.8</b>	<b>314.6</b>
Income Tax (benefit)	0.2	(0.2)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	94.4
<b>Net Income (Loss) before Extraordinary Charges</b>	<b>(73.6)</b>	<b>(81.2)</b>	<b>(111.9)</b>	<b>(29.6)</b>	<b>(30.3)</b>	<b>(30.3)</b>	<b>(28.8)</b>	<b>(119.0)</b>	<b>4.5</b>	<b>102.1</b>	<b>162.8</b>	<b>220.2</b>
Average Shares (Fully Diluted - in millions)	57.0	78.5	85.9	88.9	89.7	90.5	91.0	90.0	108.0	108.5	110.0	110.0
<b>EPS before Extraordinary Items</b>	<b>(1.29)</b>	<b>(1.03)</b>	<b>(1.30)</b>	<b>(0.33)</b>	<b>(0.34)</b>	<b>(0.33)</b>	<b>(0.32)</b>	<b>(1.32)</b>	<b>0.04</b>	<b>0.94</b>	<b>1.48</b>	<b>2.00</b>
<b>Growth Analysis</b>												
Total Revenues	12.0%	7.5%	10.5%	1.5%	111.1%	45.8%	77.2%	58.8%	59.8%	50.5%	32.5%	47.1%
Product Revenues	47.8%	-8.1%	17.1%	40.8%	159.6%	6.5%	-0.6%	40.3%	23.3%	36.6%	14.9%	180.3%
Gross Profit	4.3%	3.2%	8.6%	-7.8%	6.1%	-21.4%	-3.5%	-7.6%	126.2%	36.2%	26.6%	40.8%
R&D	-16.4%	1.5%	13.6%	-10.1%	-10.6%	-14.5%	-19.7%	-14.0%	15.0%	-3.3%	0.0%	0.0%
SG&A	-15.4%	40.7%	41.6%	81.1%	106.2%	82.7%	39.1%	74.2%	-31.9%	-3.8%	10.0%	1.8%
Operating Income	33.9%	-11.7%	-48.0%	-21.7%	-15.9%	-29.5%	18.8%	-8.8%	107.1%	997.3%	78.2%	90.4%
Pretax Income	31.7%	-10.8%	-37.6%	-13.3%	-12.5%	-27.1%	17.7%	-6.3%	103.8%	2177.9%	59.5%	93.3%
Net Income before Extraordinary Charges	31.5%	-10.3%	-37.8%	-13.3%	-12.5%	-27.1%	17.7%	-6.3%	103.8%	2177.9%	59.5%	35.3%
Earnings Per Share before Extraordinary Charges	33.6%	19.9%	-25.9%	-8.0%	-6.7%	-21.1%	20.8%	-1.5%	103.1%	2167.4%	57.3%	35.3%
<b>Margin Analysis</b>												
Product Gross Profit Margin	46.2%	21.1%	19.2%	39.5%	19.2%	25.0%	25.0%	24.4%	60.4%	56.5%	54.3%	52.9%
Gross Profit Margin	86.2%	82.7%	81.2%	74.1%	40.7%	44.8%	43.0%	47.3%	66.9%	86.5%	86.5%	86.5%
R&D	123.8%	116.8%	120.1%	108.5%	53.1%	62.3%	58.3%	65.0%	46.8%	30.1%	22.7%	15.4%
SG&A	20.7%	27.1%	34.7%	57.0%	34.7%	37.7%	32.6%	38.1%	16.2%	10.4%	8.6%	6.0%
Operating Margin	-62.3%	-64.7%	-86.7%	-101.4%	-50.9%	-57.1%	-49.5%	-59.4%	2.6%	19.3%	26.0%	33.6%
Pretax Margin	-69.1%	-71.2%	-88.6%	-102.4%	-50.3%	-57.1%	-49.5%	-59.4%	1.4%	21.2%	25.5%	33.5%
Net Income before Extraordinary Charges	-69.3%	-71.0%	-88.6%	-102.4%	-50.3%	-57.1%	-49.5%	-59.4%	1.4%	21.2%	25.5%	23.4%
Tax Rate	-0.2%	0.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	30.0%

Source: Company reports, WR Hambrecht + Co estimates

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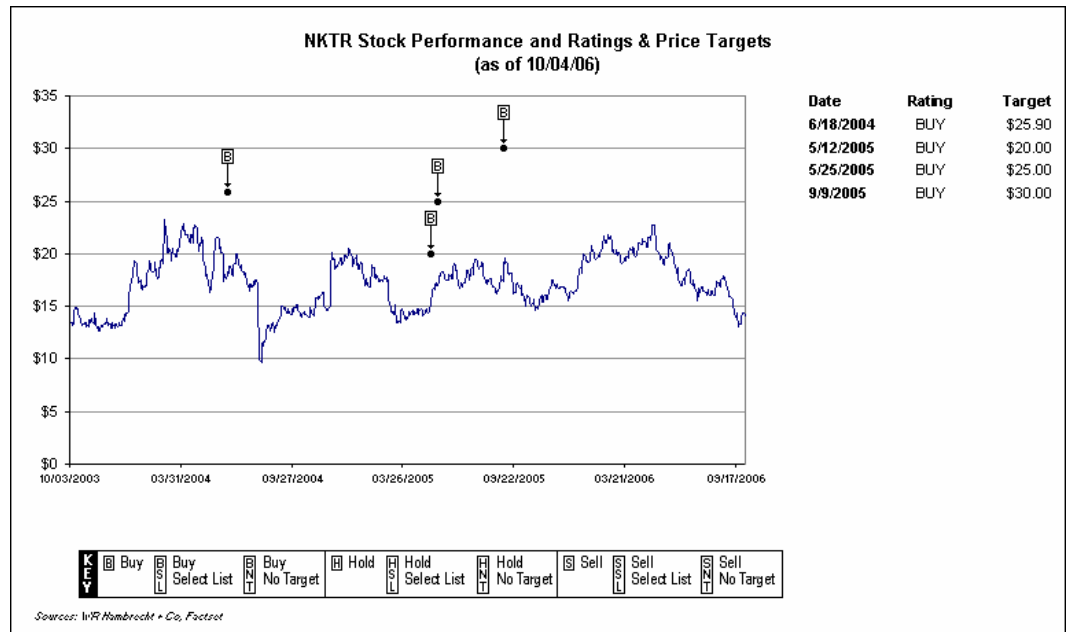
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### VALUATION METHODS TO DETERMINE PRICE TARGET

Our 12-18 month \$30 target price for Nektar Therapeutics (NKTR) is 35x our 2008 EPS estimate of \$0.94, discounted back one year at 25%.

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