

RESEARCH NOTE
September 25, 2006

Brian D. Rye, CFA (215) 665-6679
brye@jmsonline.com

ViroPharma (VPHM-\$12.42)

Could a Biopharmaceutical Company Go Private? For VPHM, It Might Actually Make Sense

	EARNINGS PER SHARE (Dec.)				2004A	2005A	2006E
	OLD	NEW	P/E RATIOS				
2004A	(\$0.73)	--	NM	F1Q	(\$0.63)	\$0.33	\$0.12A
2005A	\$2.02	--	NM	F2Q	(\$0.20)	\$0.09	\$0.25A
2006E*	\$0.85	--	14.6x	F3Q	(\$0.13)	\$0.31	\$0.25
2007E*	\$1.11	--	11.2x	F4Q	\$0.22	\$1.17	\$0.24

**note: per JMS policy, our EPS estimates now include an estimated impact of FAS No. 123r*

Yield: 0.0%

Market Cap: \$852 million

3-Yr Growth Rate: NM

Dividend: 0.00

Rating: BUY

Avg. Daily Volume: 2,127,670

Research analyst certification and important disclosures are located on pages 4-6.

This stock is appropriate only for speculative accounts with a high tolerance for risk and price volatility.

GENERAL INVESTMENT CONCLUSION: We are maintaining our BUY rating and \$14 fair value estimate. ViroPharma stands as one of the few profitable, cash-flow positive companies within the small-cap biopharmaceutical industry. We remain comfortable with the low end of management's *Vancocin* sales guidance for 2006, and we believe that generic competitors will be unlikely to enter the market before 2008, whether or not the FDA reverses the recent OGD generic recommendations. We believe the wholly owned maribavir – set to enter Phase III testing within the next few weeks – remains an under-appreciated asset, and we note that Wyeth is shouldering the vast majority of the current financial burden for the intriguing HCV-796 program that recently generated highly encouraging Phase Ib data.

A BIOPHARMACEUTICAL LBO??? A LAUGHABLE CONCEPT FOR MOST, BUT NOT FOR VPHM

The marked increase in companies' (and private equity investors') appetites for "going-private" transactions during the past 18 months, across all industries, has been staggering. In the wake of hospital giant HCA's announcement last month that it is going private in a \$33 billion transaction, we sense that the LBO spotlight may now be widening its scope to include other sectors within the healthcare industry; thus, we felt it would be prudent to briefly consider the going-private possibilities for the biopharmaceutical companies within our universe.

As one might expect, we estimate that the development-stage and/or "money-losing" companies that dominate our coverage universe have virtually NO near-term likelihood of being taken private by the traditional private-equity firms. That leaves Genentech, ImClone and ViroPharma for us to consider. First, given Roche's majority stake in Genentech, the premium valuation commanded by shares of DNA and the sheer size of the company (along with the attractiveness of stock-related compensation to recruit and retain top talent), we do not believe Genentech will be taken private anytime soon. Regarding ImClone, we again remind investors that although the company has consistently generated "profits" on the net income line over the past several quarters, these positive EPS figures are bluntly a mirage (due primarily to the deferred revenue recognition policy regarding previously received license fees and milestone payments totaling over \$900 million), masking far weaker cash-flow characteristics that we believe will prohibit any serious thought of taking ImClone private. Thus, we are left to examine ViroPharma, and while its sub-\$1 billion market capitalization may pale in comparison to the size of some of the recent behemoths

electing to go private, we nonetheless feel that the company possesses several characteristics that we believe actually make it a fairly attractive candidate.

- **ViroPharma Possesses a Relatively Strong Balance Sheet and Is Currently a Cash-Flow Machine.** We estimate that ViroPharma sports a cash balance of roughly \$190 million, with NO debt, and we note that during the first six months of the year alone, the company generated \$23 million in cash flow from operations (fueled by \$73 million in *Vancocin* sales). To be sure, we do not believe that there is a great deal of “fat” to trim from the company’s commercial organization (the *Vancocin* marketing effort, for example, does not employ an active salesforce), as evidenced by the fact that the company’s operating margin during the second quarter was an impressive 59%. Looking ahead, while ViroPharma is on track to initiate two company-sponsored studies for maribavir before the end of the year, we remind investors that Wyeth is footing the bill for approximately 85% of the development costs associated with the promising hepatitis-C drug candidate, HCV-796.
- **Due Largely to Investor Concerns/Hysteria Regarding the OGD Issue, Valuation Remains Depressed.** Despite (i) a strong performance in August and (ii) the fact that the company is on track to generate year-over-year growth of 30% for the highly profitable *Vancocin* during all of 2006, shares of ViroPharma are currently trading at just 11.2x our 2007 EPS estimate, with a Technology Value / Sales (last quarter annualized) ratio of roughly 4.8x and a Technology Value / EBITDA (last quarter annualized) ratio of approximately 6.0x. In large part, we attribute this situation to investor fear regarding the possibility that the recent change in recommendations by the FDA’s Office of Generic Drugs (OGD) will not be reversed, opening up the floodgates for generic competitors. Management has done an admirable job of presenting the FDA with a series of cogent legal and scientific arguments in support of its hope to have this decision reversed so that generic companies would be simply required to conduct non-inferiority clinical trials, and our belief is that the company has produced sufficient evidence to at least force an advisory panel meeting to discuss the OGD’s change in recommendations in an open forum. However, we remind investors that the FDA is under no specific timetable to act on this issue, and this uncertainty is likely to continue to exert pressure on shares of VPHM (and on the psyche of shareholders) until it is resolved.
- **ViroPharma Is Entering a Stage Where Being a Public Company Frankly Offers Few Benefits.** Virtually every investor meeting and media interview involving ViroPharma management begins and ends with the OGD issue, which sits in the FDA’s hands and whose potential resolution has no specific timetable. We suspect that the range of responses the company will consider upon learning the FDA’s final decision might be best deliberated/enacted away from the undoubtedly frenzied public’s eye. If nothing else, we have to believe that management is growing weary of the repetitive questions from investors and analysts alike (including the author of this report) regarding an issue which is now largely out of its control. Moreover, the key 2006 data for ViroPharma’s top pipeline programs (highly encouraging Phase II data for maribavir and Phase Ib data for HCV-796) have now been released, and VPHM shares now reflect the data’s resulting positive impact; thus, other than the fully expected initiation of maribavir’s Phase III program and HCV-796’s Phase II study before the end of the year, there are few *near-term* clinical catalysts on which stockholders can focus their attention as value-driving events. Lastly, management has repeatedly indicated that it is in the process of evaluating several in-licensing/acquisition opportunities for new drugs, coupled with a search for a new head of commercial operations, and we believe the existing, needless “artificial” deadline of a new-product announcement by year-end (now expected by investors) can only hinder what must be a thoroughly comprehensive evaluation process that has its own timetable. In summary, since the company appears to have no near-term need to access the capital markets, we bluntly conclude that the company finds itself in a position where being a privately held entity for a certain period might very well make for a better use of management’s time and be preferable for the entire company’s day-to-day operations.

We stress that we are by no means predicting that ViroPharma is setting itself up to go private, and we are unaware as to whether or not the possibility has even been brought up for discussion at the management or board level. Our purpose here, in the wake of the recent wave of LBO activity, was to scan an analytical eye over our coverage universe and provide investors with our best guess as to which company would, in our sole opinion, be the most plausible candidate for such a transaction. To us, that company is ViroPharma.

VALUATION SUMMARY

Our \$14 fair value estimate, under the assumed scenario that generic competition for Vancocin arrives with a bang during 2008, is based on a “sum of the parts” revenue analysis of Vancocin, ViroPharma’s other product candidates, and the company’s cash currently under development. (Should the FDA reverse the OGD’s change in recommendation, our fair value estimate would move appreciably higher.) Rather than attempting to employ traditional valuation metrics for this unique stock, we believe investors should focus on the following issues when evaluating VPHM shares: (i) revenue potential for each technology, (ii) timeline for the clinical trials and regulatory filings, (iii) the competitive landscape, and (iv) the level of financial resources available to fund these technology development projects.

INVESTMENT RISKS

Recent OGD Decision, If Upheld, Could Open the Generic Floodgates. Our understanding is that Akorn (AKN), Strides and others are in the process of developing generic versions of ViroPharma’s flagship product, *Vancocin*. While the manufacturing process is actually somewhat complicated, we believe it is only a matter of time before competitors are able to address all the pertinent issues. Furthermore, if the OGD’s recent change in recommendation, which suggests that approval for such compounds could be granted solely on the basis of dissolution tests, is allowed to stand, we believe generic competition could enter the market during 2008 and negatively affect ViroPharma’s subsequent top- and bottom-line results.

ViroPharma’s Efforts To In-License or Acquire Additional Products May Not Prove To Be Successful. The company currently sports roughly \$190 million in cash and no debt; additionally, we expect *Vancocin* to be a generator of positive cash flow for at least the next two years. Management reiterated that it expects to add at least one new “value driver” during the remainder of 2006, but there are no assurances that the company will be able to close on such a transaction or that the acquired compound will produce the desired commercial results.

Although Maribavir and HCV-796 Appear Promising, Meaningful Clinical and Regulatory Risks Remain. To be sure, we were quite impressed with maribavir’s Phase II data in CMV, though we note that Phase III studies have yet to be initiated. HCV-796 is the only non-nucleoside polymerase inhibitor currently under development for hepatitis C, but the HCV space is quite crowded, and we suspect that even in a best-case scenario, it will be several years before this product candidate is commercially available.

COMPANY DESCRIPTION: *ViroPharma, headquartered in Exton, Pennsylvania, is a biopharmaceutical company that develops and commercializes products to treat serious infectious diseases in hospital settings. The company is currently marketing Vancocin (an oral version of the antibiotic Vancomycin) to treat serious clostridium difficile-associated diarrhea (CDAD) in the United States. It is also developing Maribavir for the treatment and prevention of cytomegalovirus (CMV), is co-developing HCV-796 to treat Hepatitis C Virus (HCV) infections with Wyeth Pharmaceuticals and has licensed the investigational common cold treatment pleconaril to Schering-Plough.*

EARNINGS MODEL AVAILABLE ON REQUEST

RESEARCH ANALYST CERTIFICATIONS AND IMPORTANT DISCLOSURES

I, Brian D. Rye, the primarily responsible analyst for this research report, certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject securities or issuers. No part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views I expressed in this research report.

Janney Montgomery Scott LLC ("JMS") is a market maker in the securities of ViroPharma (VPHM) and Imclone (IMCL) and may at any time hold a long or short position in this security.

Janney Montgomery Scott LLC ("JMS") may seek compensation for investment banking services from VPHM, IMCL, and Genentech (DNA) in the next 3 months.

The research analyst is compensated based on, in part, Janney Montgomery Scott LLC's profitability which includes its investment banking revenues.

Investment opinions are based on each stock's 6-12 month return potential. Our ratings are not based on formal price targets, however our analysts will discuss fair value and/or target price ranges in research reports. Decisions to buy or sell a stock should be based on the investor's investment objectives and risk tolerance and should not rely solely on the rating. Investors should read carefully the entire research report which provides a more complete discussion of the analyst's views.

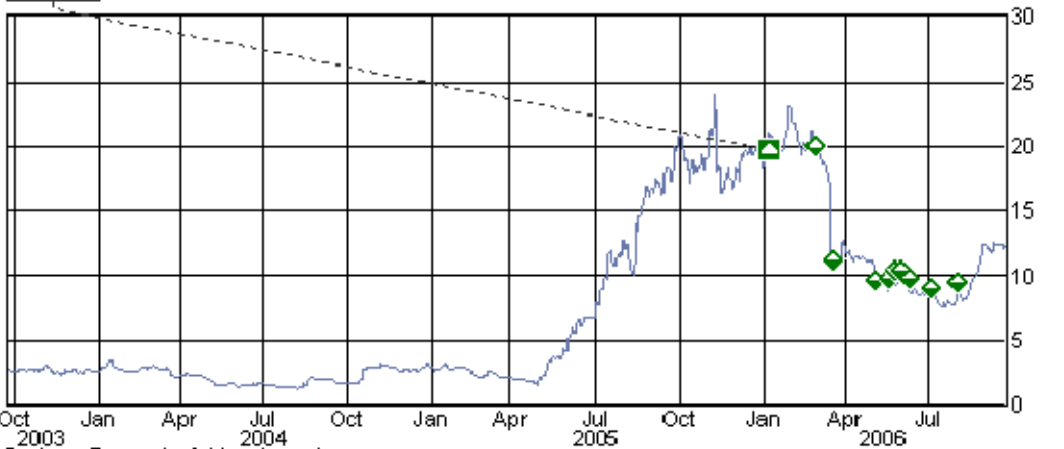
BUY Janney expects that the subject company will appreciate in value. Additionally, we expect that the subject company will outperform comparable companies within its sector.

NEUTRAL Janney believes that the subject company is fairly valued and will perform in line with comparable companies within its sector. Investors may add to current positions on short-term weakness and sell on strength as the valuations or fundamentals become more or less attractive.

SELL Janney expects that the subject company will likely decline in value and will underperform comparable companies within its sector.

Janney Montgomery Scott LLC ratings for VPHM (ViroPharma)
Closing Price Sep 22, 2006: \$12.42

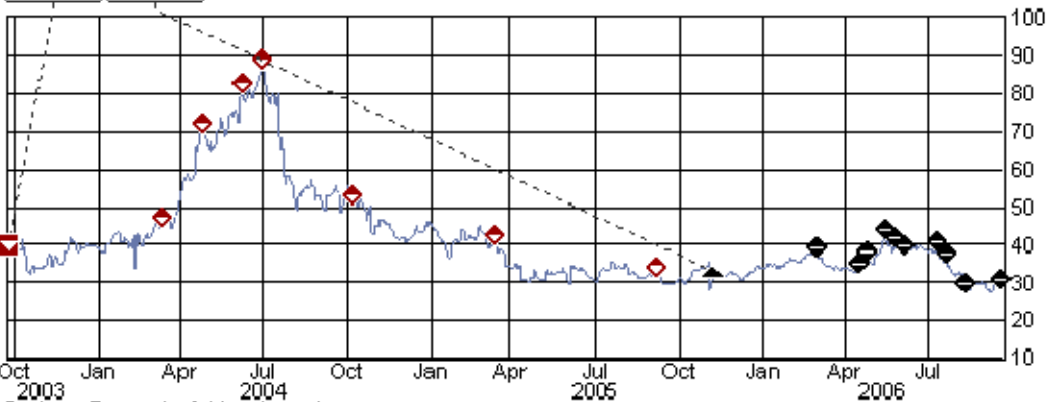
01/06/06
B: \$19.18
T: N/A

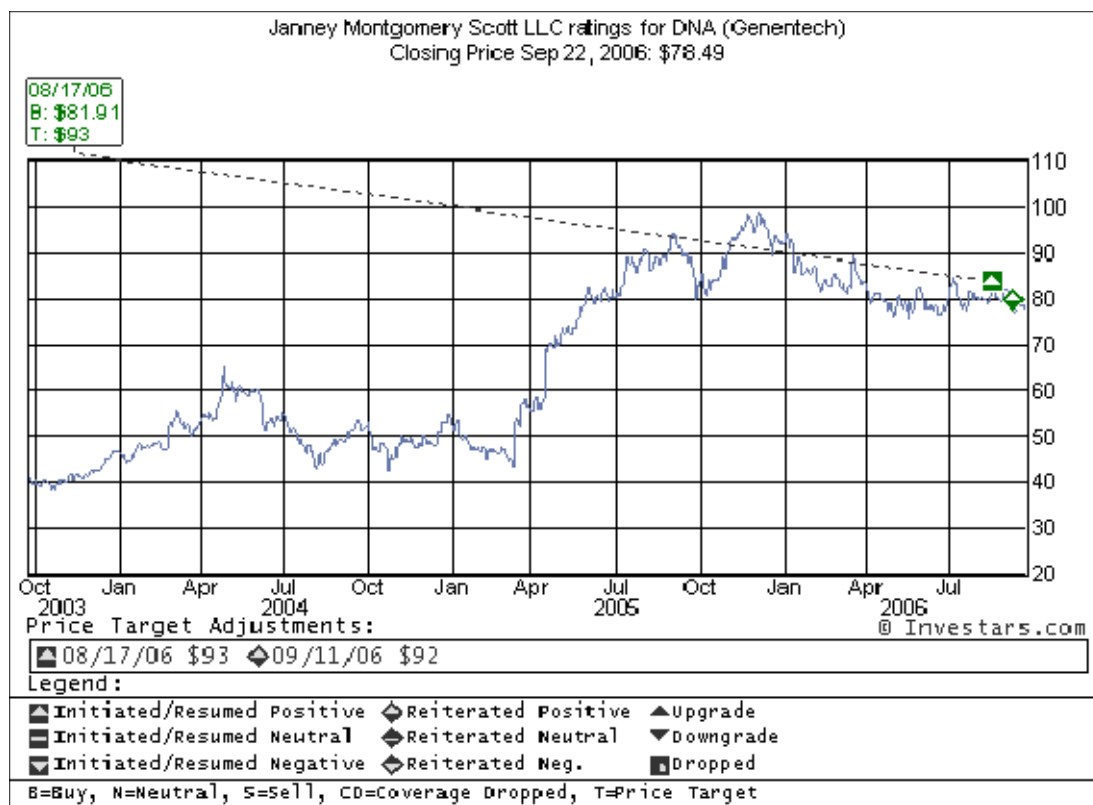


Janney Montgomery Scott LLC ratings for IMCL (ImClone Systems)
Closing Price Sep 22, 2006: \$29.62

09/22/03
S: \$48.15
T: \$23

11/04/05
N: \$28.65
T: \$29





Janney Montgomery Scott Ratings Distribution*

<u>BUY</u>	<u>NEUTRAL</u>	<u>SELL</u>
49%	50%	1%

*As a percent of total coverage. See ratings definition above. Total does not equal 100% due to rounding.

Janney Montgomery Scott Ratings of Investment Banking Relationships*

<u>BUY</u>	<u>NEUTRAL</u>	<u>SELL</u>
4%	5%	0%

*Percentages of each rating category where JMS has performed Investment Banking services over the past 12 months.

OTHER DISCLOSURE:

This research report is provided for informational purposes only and shall in no event be construed as an offer to sell or a solicitation of an offer to buy any securities. The information described herein is taken from sources which we believe to be reliable, but the accuracy and completeness of such information is not guaranteed by us. The opinions expressed herein may be given only such weight as opinions warrant. This Firm, its officers, directors, employees, or members of their families may have positions in the securities mentioned and may make purchases or sales of such securities from time to time in the open market or otherwise and may sell to or buy from customers such securities on a principal basis. Supporting information related to the recommendation, if any, made in the research report is available upon request.