Business Analysis For Sepracor
(SEPR)
As of November 1, 2006

Prepared for:
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FIN 3321

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## Sepracor Valuation

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Executive Summary

<table>
<thead>
<tr>
<th>SEPR: NASDAQ (12-23-06)</th>
<th>$57.82</th>
<th>EPS Forecast</th>
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<td>52 week range</td>
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<td>Revenue (2005)</td>
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<td>Book Value per Share</td>
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<td>Valuation Ratio Comparison</td>
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<td>$e est.</td>
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<td>Beta (β) est.</td>
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Valuations Estimates

| Actual Share Price 12-5-06 | $57.82 |

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<th>r²</th>
<th>Beta (β)</th>
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<td>2 yr beta</td>
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Ratio Based Valuations

| Forward P/E | 13.99 |
| Trailing P/E | 0.54 |
| P/S | 30.72 |

Intrinsic Valuations

| Discounted Cash Flows | $54.97 |
| Residual Income | $19.43 |
| Abnormal Earnings Growth | $33.24 |
| Long Run Residual Income in Perp | $76.40 |

Debt Risk

| Altman Z-Score | 2.0546 |

Charts:

- SEPRACOR Inc.
- Copyright 2006 Yahoo! Inc.
Sepracor is a pharmaceutical company that specializes in manufacturing prescription drugs for the treatment of respiratory and central nervous system disorders. In this section, we will discuss briefly the company’s history, its sales volume and growth, as well as the company’s stock performance over the last year. In addition, we will discuss Sepracor’s products, main competitors, market capitalization, and their total asset value over the last five years.

Sepracor was founded in 1984. According to the company’s website, they began working towards branding their own set of drugs to meet the needs of the pharmaceutical marketplace. Currently, Sepracor manufactures three different products: Lunesta, Xopenex, and the Xopenex inhaler. The first is a sleeping pill used to treat insomnia, while the second and third are used to treat asthma. In addition, the FDA approved a new drug from Sepracor called Brovana, an inhalation solution used in the treatment of bronchitis and emphysema. The company is headquartered in Marlborough, Massachusetts, and they have a manufacturing facility in Nova Scotia.

Over the past five years, the company has had 440% revenue growth, from $132,095,000 in 2001 to 820,928,000 in 2005, as detailed in the graph on the following page:
The firm has a market capitalization of 5.2 billion, according to yahoo.finance.com. Market capitalization is the total dollar value of all outstanding shares. Over the past year, the stock price of the company has varied between the ranges of $42.29 and $60.75 per share.
In the above graph, we see Sepracor’s total asset value over the past five years.

According to Sepracor’s most recent 10-K filing, the company’s two main competitors are Barr Pharmaceuticals, Inc., and Glaxosmithkline, both of which have products that treat respiratory disorders.

To conduct our analysis of Sepracor, we began with an analysis of the pharmaceutical industry using the five forces model. Using this model we assessed the type of industry and environment that Sepracor competes in. We determined that a strategy of product differentiation and innovation is the most essential factor for the company to be successful in the future.
From there, we determined the company’s significant accounting policies and how well management disclosed financial data in its quarterly and annual reports. We reached the conclusion that management does a good job in its financial reporting and that there are no attempts to mislead financial statement users.

Having assessed the adequacy of the financial statements, we then performed ratio analysis to determine how well the company did in the areas of liquidity, profitability and capital structure. We then compared these results to competitors’ performance in the same three areas. Stand-alone, and with respect to its competitors, Sepracor performs strongest in the area of liquidity.

Using our analysis of the financial statements, we then proceeded to forecast an income statement, balance sheet, and statement of cash flows for the next ten years. We project revenue and net income to grow strongly over the forecast period, assuming that Sepracor continues to pursue competitive strategies that are to its advantage.

Using our financial statement forecast, we then attempted to derive a value for the stock using available data, and also using three methods of intrinsic valuation. We then attempted to estimate the sensitivity of the company by changing discount rate. All of our valuations show the stock as extremely undervalued. However, we reached the conclusion that, given Sepracor’s history of losses and apparent turnaround over the past two years, that these valuations were not accurate. As of November 1st, 2006, we conclude that the company’s common stock is fairly valued at its observed price of $52.16. Copies of all relevant forecasts and calculations are included in the appendices.
Business/Industry Analysis

We turn our attention towards using the five forces model to analyze the industry. The five forces model is a useful tool in assessing the environment a firm operates in and determining what strategies it should pursue in order to be successful. We determined that Sepracor operates in an environment where success is determined by product differentiation and innovation.

Rivalry Among Existing Firms

We begin with rivalry among existing firms. There are several determinants of the degree of rivalry between firms in the pharma industry, among them the industry growth rate, concentration and balance of competitors, and product differentiation. According to medicalnews.com, the pharma industry is forecast to grow at an annual rate of 8.2% over the coming years. This means that firms are not fighting each other for market share and thus the degree of rivalry between existing firms is moderately low in this respect. However, companies’ ability to grow the market will be determined in part by their ability to continue manufacturing new and innovative products. Failure to do so will result in stagnation and increasing competition among existing firms and makers of generic products.

The second determinant of the degree of rivalry is the amount of differentiation and switching costs. The pharma industry is fairly fragmented, with certain companies focusing on medications that treat certain ailments. In addition, the size of the companies in the market ranges from the hundreds of millions to the hundreds of billions. This means that rivalry is low in this regard as well.

Concentration and balance of competitors is the final determinant of the degree of rivalry between firms. As mentioned above, there are a wide variety of
companies both in terms of size and type of product. This also reflects a low
degree of competition between firms.

**Threat of New Entrants**
The second force is the threat of new entrants into the market. This threat is
mostly determined by the barriers to entry for a particular market. For the
pharma industry, the four main components are economies of scale, first mover
advantage, access to distribution channels, and legal barriers to entry.

The costs associated with entering into the pharma industry are very high. The
extensive research and development costs in the pharmaceutical industry result
in large economies of scale. This makes it difficult for new firms to enter,
because they will suffer on a cost basis as compared to existing firms. In
addition, the fact that the pharmaceutical industry has a steep learning curve
also puts new entrants at a cost disadvantage.

Access to distribution channels is also severely limited. Most pharma companies
have a fairly limited supply and distribution channel. For example, most of
Sepracor’s sales come from transactions with three wholesalers. In addition, the
firm relies on only two outside vendors for raw materials. It would be fairly
difficult for potential entrants to either utilize these channels or build their own.

Perhaps the most significant barriers for new participants are the legal barriers.
The pharma industry is heavily regulated, both at home and abroad. This makes
it difficult for new entrants to acquire licenses, regulatory approval for new
drugs, or compete with drugs that have patents. Again, this makes entry into
the market difficult. These four factors combined indicate that the threat of new
entrants into the marketplace is very low.
Threat of Substitutes
The third force in the model is the threat of substitute products. As mentioned above, the fact that many drugs are patented is a significant obstacle to entry. However, when a drug’s patent expires, this means that existing firms will be able to market a generic substitute at a lower cost than the brand name. This is analogous to buying the house brand at the grocery store: the product is virtually identical to the name brand but is available at a lower cost.

Part of the threat of substitute products is consumers’ perception of whether those substitutes fulfill customer needs in an equal manner. As we will show, this is an opportunity to compete on the basis of product differentiation. We conclude that this threat is moderately low.

Bargaining Power of Suppliers
The fourth force is the bargaining power of suppliers. Bargaining power of suppliers is relatively limited because of the number of suppliers in the marketplace. Any number of companies are available to supply the chemical compounds needed to go into the finished product. As a result, the bargaining power of suppliers is relatively low.

Bargaining Power of Buyers
Finally, we turn to the bargaining power of buyers in the marketplace. Because of the small number of pharmaceutical wholesaler and distributors, and because of high switching costs related to the proprietary nature of the industry, these buyers’ power is limited. However, others, such as the government and HMOs, through public health programs and employee insurance, do wield significant power to exercise influence over prices. Overall, the bargaining power of buyers is moderate. The results of our Five Forces Analysis are presented in the table below:
Value Chain Analysis
Based on what we have seen from our five forces analysis, we can now make some assumptions about what Sepracor must do in order to build and maintain a competitive advantage in the pharmaceutical industry. The pharmaceutical industry is driven by investments in research and development and is very dependent on innovation. Sales are also driven by heavy marketing to healthcare providers. As such, we see that it is essential for Sepracor to focus heavily on these areas. Where possible, they must compete on the basis of product differentiation. This means that they must develop safe and effective products to set themselves apart from competitors. Because of their relatively small position in the marketplace and limited capital, it is sometimes necessary for them to share resources with other companies in the industry. We will focus on these strategies in the following section.

Competitive Advantage Analysis
Sepracor’s ability to succeed in the future will be due in large part to a strategy of innovation. The release of Lunesta in March of 2005 marked the introduction of the first non-narcotic, non-addictive treatment for insomnia. For the immediate future, Sepracor will not face direct competition from generics. Sepracor holds two patents for the therapeutic use of the drug and another that covers the active ingredient. Sepracor also relied heavily on a direct marketing campaign to physicians and others in the industry. This helped, in part, in achieving sales revenues for Lunesta of 329.2 million dollars in 2005.

Sepracor also produces two products for the treatment of asthma. They are Xopenex Inhalation Solution and Xopenex HFA, a metered dose inhaler (MDI).
Currently, the company holds several patents for this technology. Sales for the inhalation solution accounted for 428.5 million, or 52% of total revenues for 2005. It is also worth noting that Xopenex HFA is a very unique product in one respect. The Food and Drug Administration has mandated that MDIs containing chlorofluorocarbons (CFCs) must be taken off the shelves by 2008. The Xopenex MDI is unique because it contains no CFCs. Thus, this puts Sepracor at a substantial competitive advantage in this respect. Although sales of this MDI accounted for only about 1% of total revenues, it is expected that this number will grow in the coming years. In addition, the FDA recently approved another drug, called Brovana that will be used to treat emphysema and bronchitis. The company also has several other drugs under development that management asserts look promising.

Sepracor also creates value by entering into licensing and collaborative agreements with other companies. In Sepracor’s case, the company developed some chemical compounds in house and then licensed the patent rights and technology to other drug companies. These agreements are with Schering-Plough Corporation for Clarinex, Sanofi-Aventis for Allegra, and with UCB-Pharma for XYZAL/XUSAL, which are all allergy medications. These licensing agreements accounted for 51.2 million dollars in revenues for 2005. Sepracor has also entered into a collaboration agreement with ACADIA Pharmaceuticals to explore new medicinal platforms for certain types of receptors. This agreement also provides for the potential to develop new medications based on existing chemical compounds, and gives Sepracor exclusive right to these medications as long as they are not applied to the treatment of ocular disease.

In the pharmaceutical industry, promotion of one’s product is another source of value creation. Fully 70% of Sepracor’s employees are dedicated to sales and marketing. Lunesta commercials can be seen on most television stations (often
late at night). In addition, the company plans to add another 500 sales staff over the coming year.

Overall, the company looks poised to be a player in the treatment of respiratory and nervous system disorders for the time being. With its continuing innovation and marketing, as well as its collaborative and licensing agreements with other companies, Sepracor appears to be headed in the right direction. We now turn our attention to the company’s financial statements for a more quantitative analysis.

**Accounting Analysis**

We turn our attention now to Sepracor’s accounting policies. A thorough understanding of a company’s accounting policies is necessary before beginning more comprehensive financial ratio analysis. In this section, we will (1) identify key accounting policies, (2) assess the degree of potential accounting flexibility, (3) evaluate the company’s actual accounting strategy, (4) evaluate the quality of the company’s financial statement disclosures, (5) identify “red flags” that indicate financial statement manipulation, and (6) undo any accounting distortions.

**Key Accounting Policies**

In this section, we discuss Sepracor’s key accounting policies, with a brief description of each.

*Research and Development Costs*  As per GAAP, all research and development costs are expensed as incurred. Since it cannot be shown that these costs will provide certain future economic benefits, they are not capitalized and amortized. Again, this is in accordance with GAAP, FAS no. 2.
Concentration of Credit Risk   According to the financial statements, there is no significant concentration of off balance sheet debt. Sepracor’s major credit threat comes from their accounts receivable. This is because a majority of revenues come from three customers. Potential default by any one of these customers would be a significant problem for the company and would make it difficult for them to meet obligations as they come due.

Accounts Receivable and Bad Debt   Accounts receivable in 2005 and 2004 were primarily due to transactions with wholesalers, distributors, and retailers of Sepracor’s products. According to the financial statements, bad debt write-offs were not significant for the past three fiscal years. In addition, Sepracor conducts ongoing credit analysis of their customers and they monitor their receivables closely since a few customers comprise a significant portion of their overall revenues.

Amortization and Depreciation of Capital and Long Lived Assets   Sepracor has three types of capitalized assets for which they exercise the appropriate cost-allocation method. The first type is Property and Equipment. These assets are stated at cost. Costs of major improvements are capitalized; repair and maintenance costs that do not improve or prolong the life of the asset are expensed as incurred. Depreciation is recognized using the straight-line method over the estimated useful lives of the assets. Computers and software are assumed to have useful lives of three years. Laboratory, manufacturing, and office equipment have useful lives of ten years. Buildings are estimated to have useful lives of 30 years. Leasehold improvements are amortized over the estimated useful life of the improvement or the remaining term of the lease, whichever is shorter. In addition, Sepracor also amortizes debt issue costs over the term of the debt or the first date that they would be obligated to repurchase the debt, whichever is earliest. This seems counterintuitive, but it is required by GAAP. The company also amortizes its patents over their estimated useful lives.
Revenue Recognition  Revenue is recognized for product sales when the product is delivered and risks associated with ownership have passed to the buyer and the ability to collect is reasonably assured. In addition, the company receives royalties relating to its licensing agreements with third parties. For royalties that are estimable, revenue is estimated for the period and recognized. Any discrepancies are reconciled in the following quarter. Management asserts that these adjustments are not material. For those royalties which are not as easily estimated, revenue is recognized upon receipt of a royalty statement from the licensee. Other revenues are recognized as obligations associated with those revenues have been performed.

Rebate and Return Reserves  Some of Sepracor’s products are eligible for rebates because of government sponsored programs or other agreements. In addition, the company establishes a reserve for the return of products up to one year. The estimates are determined by historical analysis and by using independent reports from independent sources outside of the company.

Degree of Accounting Flexibility
The degree of accounting flexibility available to a firm is a good indicator of how well they are able to communicate the consequences of their economic activities. The more flexibility a firm has when applying GAAP, the more informative the accounting numbers can be, assuming that management exercises this flexibility responsibly. Conversely, the less flexibility a firm has, the less informative some of their data are. Sepracor Inc. has relatively low flexibility when disclosing financial data. The main areas of flexibility are found in their accounting procedures for R&D expenses, inventory valuation, estimates for bad debt, rebate and return reserves, and depreciation methods.
Research and development costs are expensed as incurred as required by GAAP, which significantly hinders the flexibility of accounting and earnings in periods of high product development. If these costs are capitalized and amortized based on the percentage of R&D that is expected to provide future benefits, it is possible that a more accurate picture of the firm's economic state will emerge. Sepracor has incurred substantial R&D costs in the past in its attempts to seek a competitive advantage on the basis of product differentiation. In a similar manner, the firm’s selling and administrative costs have also been very high, as the company pursues an aggressive marketing strategy to sell people on their products.

Inventory is valued by the lower of cost or market using the first-in, first-out method. All costs are expensed until FDA approval is granted to the product, at which time costs related to the product are capitalized. However, the inventory that is listed on the balance sheet could provide a degree of flexibility, should the company choose to switch to a different valuation method. For example, a switch to LIFO would increase cost of goods sold and reduce net income. However, it is highly unlikely that Sepracor would pursue this strategy due to their history of net losses and the deferred tax benefits associated with them.

Accounts Receivable is one of the most flexible areas of accounting for Sepracor. Because Sepracor sells mainly to wholesalers and distributors, its accounts receivable are made up of three firms that account for seventy-one percent of accounts receivable. Their estimated bad debt is based on prior experience with customers and ongoing credit analysis. Although bad debt has been insignificant in the past (2.4 percent, or $3,103,000 out of $1,274,497,000 in total assets for 2005), there still exists the possibility that the company might manipulate their allowance for bad debt as they see fit, although this would not have a material effect on earnings.
A related area of flexibility is in Sepracor’s allowance for rebate and return reserves. These reserves are set up for product returns and to compensate for the effects of government and private health care programs. These are shown on the balance sheet under “other current liabilities”. They make up only about 5 percent ($76,467,000) of total liabilities ($1,439,986,000) for 2005, and thus any drastic manipulation of this number would be both noticeable and, ironically, have little effect on the company’s bottom line.

Sepracor uses the straight line method of depreciation as their method of cost allocation. Estimated useful lives for assets are on par with other pharmaceutical companies. While there is some degree of flexibility to manage earnings, it is not large enough to have any real threat. An unjustified change in depreciation method would certainly be a red flag to potential investors.

**Evaluate Accounting Strategy**

When firms have a large degree of accounting flexibility, there is greater ability to communicate their economic position. Unfortunately, there is also greater ability to obscure the truth about the company’s financial status. Due to the general lack of flexibility in the pharmaceutical industry, Sepracor’s accounting policies closely mirror those of similar companies. We conclude that there is nothing nefarious about Sepracor’s accounting strategies.

The companies accounting policies are fairly conservative and there is no departure from GAAP found in the financial statements. Any potential areas of flexibility (bad debt expense, reserves for returns and rebates) are such a small portion of the balance sheet that any attempt to manage earnings from this perspective would be impractical. In addition, their policies regarding depreciation and inventory valuation follow industry norms as well. Perhaps the most telling fact about the lack of attempted earnings management is the fact that the company has operated at a loss from its incorporation to the fourth
quarter of 2005. This is reflective of an accounting strategy that is geared toward transparency, not obscurcation.

While transparency is essential for financial statements, managers and executives have a responsibility to keep certain information confidential for a number of reasons. Sepracor has a stake in the business of insomnia-treating prescription drugs, which are quickly becoming a booming business. Sanofi-Aventis is the maker of the leading anti-insomnia drug, ambien, which may lose its patent by the end of 2006. Huge amounts of money are being put into research and development for new drugs that will capitalize on this particular market. Therefore, information pertaining to the funding of researching drugs that have yet to be released to the FDA for phase one testing is especially secretive. Sepracor releases all information that it is required to relating to research and development of marketed drugs or drugs that have been approved for further testing, but the company does not offer any free details that may benefit competitors.

Finally, to help promote effective internal control over financial statement manipulation, the company’s web-site offers a public “Code of Conduct and Ethics,” which includes a section on Reporting of Concerns Regarding Accounting or Auditing Matters. It states that, “Employees may openly, confidentially, or anonymously submit concerns regarding questionable accounting or auditing matters or complaints regarding accounting, internal accounting controls or auditing matters to Sepracor’s hotline.”

Sepracor had not started to produce much profit until recently because of their extremely high research and development costs. We are reasonably certain that there has been no manipulation of accounting data for the purpose of hiding their losses. They have been making significant revenues lately, but research and
development costs related to Lunesta and Xopenex are just now starting to pay off in the form of profits.

Sepracor also fully discloses all information to the public about other corporate agreements they have with other corporations and how those agreements affect the company’s financial statements.

**Quality of Disclosure**

The quality of disclosure is an important aspect of the degree of difficulty an analyst might face when analyzing financial statements. Management has quite a degree of latitude when it comes to disclosure. With respect to the quality of disclosure, the company’s overall performance is above average. Sepracor provides excellent documentation of pertinent economic factors, financial performance, and forward-looking statements concerning their firm’s operations and financial conditions. Their annual report contains distinct sections highlighting all material economic data in addition to listing internal and external factors that could pose threats to future performance. The company does a good job disclosing market risk and business strategy, and their accounting disclosures are also fairly detailed.

Within these statements, they provide future economic objectives for their business strategies including schedules for completion of drugs under development, potential benefits of products, expectations of their research and development, as well as many other goals. They make sure to provide the readers of their records with disclosure that all future forecasts are strictly estimates. Sepracor also discloses all risks that could be encountered within the next financial period. They present in detail many risk factors they could face as a result of their financing operations, which includes a significant amount of debt and the related potential inability to meet those obligations. They also disclose their investments in other corporations, such as ARCADIA Pharmaceuticals and
Point Therapeutics, which are susceptible to changes in equity prices that could result in losses. Sepracor makes sure to cover all aspects of performance, good and bad, concerning their business activities and external factors which relate to the company.

With respect to accounting disclosure, Sepracor does an adequate job. There are detailed notes to the financial statements which cover significant accounting policies. In addition, line items in the audited financial statements are broken down into further detail to show the components of certain accounts. The company does an extensive job of disclosing this information so that the user can get a clearer picture of the firm’s financial position. For example, Sepracor breaks down the line item “Accrued Expenses” from the current liabilities section of the balance sheet into five separate components to give the user a clear indication of what obligations will be due and where they lie. Another good example of this is the inclusion of a pro forma statement regarding stock option expenses. Sepracor accounts for their stock options under APB 25, but show how net income (loss) and earnings (loss) per share would have been affected had they applied SFAS 123, which is an alternative treatment for stock based compensation. They also include the related discount rates, expected life, and weighted average volatility assumptions that they used in valuing their options.

Perhaps the only problem concerning accounting disclosure is a lack of a pro forma income statement showing the effects on earnings had certain research and development expenses been capitalized. This may be a reflection of the company’s conservative accounting policies and an unwillingness to make estimates relating to the future benefits that those costs may provide, given that those estimates are uncertain. It is up to the analyst to determine whether these costs should be capitalized, and by how much.
Identify “Red Flags”

In this section, we will attempt to identify any warning signs of earnings management on the part of Sepracor. These warning signs include large fourth quarter adjustments, asset write offs, related party transactions, and the existence of special purpose entities. In addition, we will run some diagnostic ratios which could indicate earnings management. We should note that we were unable to calculate several of the expense manipulation diagnostics because of the company’s history of negative cash flow and net losses.

With respect to the first four warning signs, there is nothing in Sepracor’s financial statements that would indicate any earnings management. The only significant write off was for a patent related to drug known as tecastemizole, for which the development program was discontinued. The amount of this write off was $18,814,000. In addition, there was a small write down in inventory due to product expiration and quality control issues in 2004, but this amount was not material enough to be of concern. There were no related party transactions or special entities reflected on Sepracor’s books for 2005.

Applicable sales diagnostic ratios are shown on the following page:
For the diagnostic ratios, there are some numbers that jump out. Sales divided by cash from sales was fairly consistent over the past five years. Sales over accounts receivable was also fairly consistent, although there was a significant spike due to increased sales and royalties of approximately 52%, as the chart shows. The sales divided by inventory has a good degree of variability as well, particularly for 2003. Sales increased significantly, while inventory costs remained relatively stable. This increase in sales can be explained by the jump in sales of Xopenex inhalation solution, which also explains the relative stability of inventory on hand, since Xopenex was the primary source of revenue for the company in 2003.
Below is a chart showing Sepracor’s sales to asset turnover ratio:

Sales over assets also increased significantly from 2004 to 2005, after having remained stable over previous years. This is primarily due to the increase in sales related to the commercial launch of Lunesta in 2005. We conclude that any variability is due to business conditions, and not to attempted earnings management.

**Undo Accounting Distortions**

After examining the financial statements of Sepracor, we believe that there are no distortions that need to be undone. While it can be argued that research and development costs could be capitalized and amortized, we feel that this would only serve to increase the difficulty of ratio comparison with other firms in the industry, and serve only to distort our analysis. Indeed, research and development costs related to marketed products are capitalized once the product is approved for sale. With respect to other research and development costs, the company says this:
Due to the length of time necessary to develop a product, the uncertainties related to the ability to obtain governmental approval for commercialization and the difficulty of estimating costs of projects, it is difficult to make accurate and meaningful estimates of the ultimate cost to bring our product candidates to FDA approved status.

Our review of the financial statements leads us to believe that there are no other significant distortions of accounting information. As such, we will leave the data intact as we proceed to our financial ratio analysis.

**Ratio Analysis/Forecasting**

Ratio analysis is a good starting point in the valuation and forecast of a company’s financials. There are two methods of this type of analysis. Time series, or trend, analysis, allows us to look at a company’s historical performance in terms of ratios and attempt to find a trend that we can project into the future when forecasting our financial statements. Cross-sectional analysis allows for the comparison of the target firm in terms of the performance of other firms in the industry and lets us evaluate the performance of the firm in relation to its competitors. The ratios we will use here can be grouped into three broad categories: Liquidity analysis determines how well a company can meet its obligations as they come due, profitability analysis helps show how profitable the company is, and capital structure analysis shows how a company finances its operating activities.
**Trend Analysis**

We begin with a look at Sepracor’s liquidity ratios for the past five years:

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<td>Current Ratio</td>
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<tr>
<td>Quick Asset Ratio</td>
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<td>3.83</td>
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<td>Inventory Turnover</td>
<td>1.58</td>
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<tr>
<td>Working Capital Turnover</td>
<td>0.12</td>
<td>0.58</td>
<td>1.34</td>
<td>0.60</td>
<td>1.07</td>
</tr>
</tbody>
</table>

Sepracor’s current ratio is determined by its current assets to current liabilities. This ratio is a good indicator of whether or not a company is able to pay debts as they come due. As shown in the chart, Sepracor stays above the commonly accepted benchmark of 2.0, with the exception of 2003. This is due mostly the maturity of a bond Sepracor had previously issued.

Some analysts and professionals feel that a firm’s quick ratio is a better way to accomplish the intent of the current ratio. The quick ratio is the sum of cash, marketable securities, and accounts receivable, divided by current liabilities. Note that this ratio does not include inventories, as they may not be as liquid as other current assets. For Sepracor, the quick ratio is good for every year except for 2003. Again, this is for the same reasons mentioned above.

Accounts receivable turnover measures how effective the company is at collecting its accounts receivable. Sepracor appears to turn over its receivables an average of 7.25 times a year. Dividing 365 by this denominator yields approximately 50, which means that the average time to collect receivables is about 50 days. Sepracor has stayed somewhat consistent the past few years, but they are down from a maximum of 11.04 in 2002. This may be due in part to the substantial revenue growth the past few years and the billing department’s attempts to keep up.
Inventory turnover is similar to receivables turnover in that it shows how many times a company turns its inventory over in a year. This number is attained by dividing cost of goods sold by inventory. This number allows us to determine how long a company takes to satisfy its obligations related to inventory. For Sepracor, it averages 2.61 for 2001-2005. Dividing 365 by this number gives about 140 days, which is how long it takes the company to pay off its inventory obligations. Summing this number with the average collection time in days for receivables above gives 190, which is the average cash to cash cycle for Sepracor over the last five years. This is potentially troubling because it is an extremely long time as compared to others in the industry, as we shall see later.

Working capital turnover allows us to see how much money is tied up in working capital. This ratio is computed as sales divided by the difference between current assets and current liabilities. Sepracor does a very good job with respect to this ratio. The only years when it gets above one are in 2003 and 2005, which saw increases in accounts receivable of approximately 30 million and 72 million, respectively.

We now look at measures of profitability for Sepracor:

**Profitability Analysis**

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Profit Margin</td>
<td>0.90</td>
<td>0.90</td>
<td>0.92</td>
<td>0.91</td>
<td>0.91</td>
</tr>
<tr>
<td>Operating Expense Ratio</td>
<td>2.44</td>
<td>1.78</td>
<td>1.22</td>
<td>1.44</td>
<td>0.93</td>
</tr>
<tr>
<td>Net Profit Margin</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>0.01</td>
</tr>
<tr>
<td>Asset Turnover</td>
<td>0.14</td>
<td>0.33</td>
<td>0.47</td>
<td>0.37</td>
<td>0.64</td>
</tr>
<tr>
<td>Return on Assets</td>
<td>0.19</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-0.04</td>
</tr>
<tr>
<td>Return On Equity</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-0.05</td>
</tr>
</tbody>
</table>

First, we look at gross profit margin. Gross profit is computed as revenues minus cost of revenues, divided by revenues. For Sepracor, this ratio is always
around .9, which means that every dollar of sales yields .90 cents in income. This is excellent performance.

Where Sepracor gets into trouble is in its operating expense ratio. This ratio is computed as total operating expenses divided by sales. For Sepracor, this includes substantial research and development costs and also extensive marketing costs as well. This relates to the nature of the industry and Sepracor’s key success factors of innovative product development and effective marketing of that product. These ratios are all well above one for the years 2001-2004, and are why Sepracor has continued to incur net losses until 2005. However, these costs are beginning to pay off for the company, which incurred its first profit in 2005 due to increased sales of Lunesta sleep medication.

Because of Sepracor’s history of net losses, evaluating the company’s returns on equity provides us with a nonsensical number up until 2005, when a positive net income divided by a negative owners’ equity yields a negative return on equity of .05. Therefore, we conclude that neither this measure, nor it’s associated internal and sustainable growth rate metrics, are appropriate for forecasting Sepracor’s pro-forma financials. Returns on assets have also been negative and are therefore not a good basis of comparison.

Now we look at the company’s capital structure:

**Capital Structure Analysis**

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt to Equity Ratio</td>
<td>-4.49</td>
<td>-2.85</td>
<td>-0.38</td>
<td>-4.14</td>
<td>-8.70</td>
</tr>
<tr>
<td>Times Interest Earned</td>
<td>-5.79</td>
<td>-3.28</td>
<td>-2.07</td>
<td>-8.62</td>
<td>-0.73</td>
</tr>
<tr>
<td>Debt Service Margin</td>
<td>-336.41</td>
<td>-244.48</td>
<td>-0.24</td>
<td>-95.19</td>
<td>-11.14</td>
</tr>
</tbody>
</table>
For all of these numbers, Sepracor performs dismally. The primary reason for this is the company’s history of net losses, coupled with its heavy debt financing of its operations. Given the profitability of the company in 2005, along with an expected positive net income in 2006, we do not feel that these ratios provide any meaningful basis of comparison, for either trends or cross sectional analysis.

Cross Sectional Analysis

Shown above is Sepracor’s current ratio, along with others in the industry. On the whole, Sepracor does a much better job than its competitors, other than 2003. Below are the quick ratios for Sepracor and its competitors, and Sepracor’s standing here is also good with the exception of 2003:
Now we look at accounts receivable turnover:

Sepracor also does well with respect to its competitors here as well in terms of averages, although they are outperformed by various individual competitors in every year.

Let us now examine the inventory turnover for the industry:

The trend in this chart varies considerably, as does Sepracor’s performance with respect to other companies. In 2003, the company performed extremely well against its competitors, but in 2005 was well below the industry average.
We now look at profitability ratios, beginning with the gross profit margin:

This ratio is perhaps one of the most consistent across the industry, and again, Sepracor outperforms its competitors. This industry average should be higher, but Barr Pharmaceutical’s ratio deviated significantly from the average in each year.

The last meaningful ratio in this section is the asset turnover ratio. Sepracor and its competitors’ ratios are shown below:
This is the only section where Sepracor underperforms with respect to its competitors. This is true in every year but 2005, where the company beat out the industry average, but did not exceed Barr’s ratio of 0.79.

As discussed above, we shall not compare return on assets or equity, except to note that we have no basis of comparison for these numbers. The same is true for the capital structure ratios, as these are so out of line with the industry that any attempt to provide meaningful insight would be an exercise in futility.

**Forecasted Financials**

We begin with a brief comment on methodology. We began with the income statement. While we were not able to compute either SGR or IGR, we decided that assuming an average growth rate of 37.5% for 2006-2010 would be appropriate, given the overall trend of the company’s sales growth for the last five years. Beyond 2010, we decreased this number incrementally for 2011-2016, finally ending up at a terminal growth rate of 20%. We felt that an operating margin of 90% would be acceptable for the company, and thus set our cost of sales at 10% of sales. For operating expenses, we assumed a mean of 20% in research and development and 60% of sales for selling and marketing expenses. We felt that there was too much variability in the other income (expense) section of the income statement, and so made no assumptions about line items included there. We assumed a marginal tax rate of 34%. From there, we went to the balance sheet.

The first assumption we made here was that current assets would continue to be an average of 80.43% of total assets for the duration of the forecast. This assumption was made based on the historical makeup of the balance sheet for 2001-2005. For certain line items, such as cash, we made assumptions about the recent percentage of total assets for the short term, assuming 10% for 2006, and then grew the number incrementally. The opposite was done for marketable
securities. We also assumed that total assets would increase at a rate 8.25% per year for the period covered by the forecast. After doing this, we “filled in the blanks” around our assumptions, using averages where appropriate, and making other assumptions where we felt the average was not appropriate. A similar approach was used for the liabilities and owners’ equity sections of the balance sheet. We assumed a constant growth rate for common stock and certain assumptions about treasury stock. We did know about debt obligations due in the future and included these as known amounts in the liabilities section.

From there, the cash flow statement was a relatively straightforward exercise. For operating cash flows, we took our assumptions from the balance sheet and derived these cash flows for the years 2006-2016. Although depreciation expense was not a line item in the income statement, we took the average for 2001-2005 and computed a five year moving average based on that. We did the same for all line items in the financing and investing sections of the cash flow statement, although we did not make any predictions about nonrecurring or highly variable line items.

### Limitations of the Model

First, it should be noted that all of the assumptions we made were based either on past performance, or a subjective judgment on our part. While these may be accurate in the short term, it is harder to see more than one or two years into the future. Therefore, we cannot assume that these assumptions will be accurate beyond the near term.

Nevertheless, we felt that our income statement does an accurate job of forecasting, at least for the next few years. The balance sheet is the major limitation of this forecast. In order to get it to balance, we made assumptions about accumulated other comprehensive income that we feel are neither reasonable nor accurate. Finally, we feel that our assumptions about cash
flows from operations will also be reasonable for the near term, if our balance sheet asset and liability predictions are correct. A copy of these statements is included in the appendix.

**Conclusion**

In this section we have discussed Sepracor’s performance in terms of ratios with respect to other companies and the industry, and we have also tried to derive trends (where possible) concerning the company’s performance. We have found that Sepracor does a decent job with liquidity, but that there are no meaningful trends in either the profitability or capital structure ratios. With respect to the projected financial statements, we feel that our short term forecasts are more accurate than our long term, and that Sepracor will continue to show profit for the foreseeable future.

**Valuation**

When conducting our valuation analysis, we ran into several problems that curtailed the accuracy of our estimates. Chief among these was an inability to compute a cost of debt (and consequently a cost of capital), based on available information published by Sepracor and by bond rating firms. Nevertheless, we attempted to use several accepted methods in order to value the firm. These methods include the method of comparables, the abnormal earnings growth model, the residual income model, and the discounted cash flows model. We shall discuss each of these in more detail in the following sections. All valuations are using data computed as of November 1, 2006.

**Method of Comparables**

The method of comparables involves using certain ratios to derive an appropriate stock price for a given firm. For Sepracor, we used three ratios. These ratios
were Price to Sales, Price to Earnings (trailing), and Price to Earnings (forward). The results for these ratios are shown below:

<table>
<thead>
<tr>
<th></th>
<th>P/E trailing</th>
<th>P/E forward</th>
<th>Price/Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sepracor</td>
<td>80.24</td>
<td>24.79</td>
<td>5.27</td>
</tr>
<tr>
<td>Barr</td>
<td>17.70</td>
<td>14.68</td>
<td>4.02</td>
</tr>
<tr>
<td>Merck</td>
<td>18.79</td>
<td>17.17</td>
<td>4.29</td>
</tr>
<tr>
<td>Eli Lilly</td>
<td>18.05</td>
<td>15.85</td>
<td>3.98</td>
</tr>
<tr>
<td>Industry</td>
<td>18.18</td>
<td>15.90</td>
<td>4.10</td>
</tr>
<tr>
<td>Assessed Value</td>
<td>0.54</td>
<td>13.99</td>
<td>30.72</td>
</tr>
</tbody>
</table>

As the chart shows, these ratios all yielded stock prices that were undervalued by very large amounts. A major reason for this is Sepracor’s history of net losses, and in the case of the P/E trailing ratio, the fact that Sepracor’s earnings for 2005 were only $0.03 per share. The P/E forward ratio also yields a very low stock price of $13.99 a share. The P/S Ratio comes closest to all of the multiples valuations, yielding a stock price $30.72. In sum, we conclude that these ratios are not a good basis for valuing Sepracor.

**Intrinsic Valuation Methods**

The intrinsic methods used to value Sepracor’s common stock were the residual income method, the abnormal earnings method, and the discounted free cash flows method. Since the company does not pay dividends, we did not use the dividend. We shall discuss the methodology behind each method and their results.

The first requirement for using the intrinsic valuation models listed above is computing the appropriate discount rate. For the first two methods, the appropriate discount rate to use is the cost of equity. To compute the cost of
equity, we used the capital asset pricing model (CAPM), shown in its general form below:

\[ Ke = Rf + \beta A(E(RM) - Rf) \]

Where \( Rf \) = risk free rate
\( \beta A \) = sensitivity of a change in stock price in response to fluctuations in the risk free rate
and \( E(RM-Rf) \) = the market risk premium.

For \( Rf \), we computed the average interest rate in the 7-year constant maturity treasury bill, and for beta we used a published beta from Google finance of 1.07. We decided to use a published beta because our regression analysis beta of 2.07 had only a 14% correlation between returns on the S&P 500 and Returns on Sepracor’s stock price. For the market risk premium, we used the long run historical average of about 8%. This average was computed using data compiled since 1923.

Substituting these values into the CAPM we obtain the following:

\[ Ke = 3.25\% + 1.07(8\%) \]
\[ Ke = 11.81\% \]

With this information, we are able to derive stock values for Sepracor.

**Residual Income Valuation**
Residual income valuation determines how much of a company’s earnings per share (EPS) are attributable to so-called “normal income”, that is, EPS multiplied by the cost of capital, and how much is attributable to “residual income” or the difference in EPS and normal income. We did this for each year of our forecast and for the ending perpetuity. The sum of these two numbers and of the beginning book value of equity equals the expected stock price. Using a cost of
We computed the expected stock price to be $19.93. This is significantly less than the observed share price on November 1 of $52.16. This may be the result of inaccuracies in our forecast of earnings per share, as well as errors in computing the discount rate. We do not feel that this valuation is accurate in its assessment of Sepracor’s correct stock price. However, the lower the cost of capital, the closer we come to the observed stock price. This is also true when we varied the growth rate. A growth rate of 4%, coupled with a cost of equity 8.5%, comes closest to the observed share price of $52.16.

<table>
<thead>
<tr>
<th>Sensitivity Analysis</th>
<th>g</th>
<th>Ke</th>
<th>0.01</th>
<th>0.02</th>
<th>0.03</th>
<th>0.04</th>
<th>0.05</th>
</tr>
</thead>
<tbody>
<tr>
<td>g</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>0.085</td>
<td>27.85</td>
<td>31.76</td>
<td>36.78</td>
<td>43.48</td>
<td>52.97</td>
<td>67.58</td>
<td></td>
</tr>
<tr>
<td>0.09</td>
<td>26.2</td>
<td>29.69</td>
<td>39.87</td>
<td>47.48</td>
<td>59.4</td>
<td>78.39</td>
<td></td>
</tr>
<tr>
<td>0.095</td>
<td>24.71</td>
<td>27.85</td>
<td>31.76</td>
<td>36.78</td>
<td>43.48</td>
<td>52.95</td>
<td></td>
</tr>
<tr>
<td>0.1</td>
<td>23.35</td>
<td>26.2</td>
<td>29.69</td>
<td>39.87</td>
<td>47.48</td>
<td>59.4</td>
<td></td>
</tr>
<tr>
<td>0.105</td>
<td>22.12</td>
<td>24.71</td>
<td>27.85</td>
<td>31.76</td>
<td>36.78</td>
<td>43.48</td>
<td></td>
</tr>
<tr>
<td>0.11</td>
<td>20.99</td>
<td>23.35</td>
<td>26.2</td>
<td>29.69</td>
<td>39.87</td>
<td>47.48</td>
<td></td>
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<tr>
<td>0.115</td>
<td>19.95</td>
<td>22.12</td>
<td>24.71</td>
<td>27.85</td>
<td>31.76</td>
<td>36.78</td>
<td></td>
</tr>
<tr>
<td>0.12</td>
<td>18.99</td>
<td>20.99</td>
<td>23.35</td>
<td>26.2</td>
<td>29.69</td>
<td>39.87</td>
<td></td>
</tr>
</tbody>
</table>

**Abnormal Earnings Growth Model**

The abnormal earnings growth model is similar to the residual income valuation model. The main difference is that it assumes that if the firm pays no dividends (as in the case of Sepracor), then the dividends are instead assumed to be reinvested at the cost of capital. The difference between “normal earnings” and dividend earnings reinvested is known as the abnormal earnings of the company. These are discounted back to the present and summed with beginning book value of equity and then divided by the cost of equity to arrive at the proper stock valuation. For Sepracor, this yielded a value of $32.66. While this is higher than the value obtained by using the residual income model, it is still nowhere close to the observed share price of $52.16. We can only conclude that our assumptions concerning future performance may be inaccurate, although we do not feel that this is the case. However, by varying the discount rate and the
growth rate, we are able to see what combinations come closest to the observed share price, as shown in the following chart:

<table>
<thead>
<tr>
<th>Ke</th>
<th>0.085</th>
<th>0.09</th>
<th>0.095</th>
<th>0.1</th>
<th>0.105</th>
<th>0.11</th>
<th>0.115</th>
<th>0.12</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>36.3</td>
<td>35.65</td>
<td>35.02</td>
<td>34.41</td>
<td>33.81</td>
<td>33.24</td>
<td>32.68</td>
<td>32.13</td>
</tr>
<tr>
<td>0.02</td>
<td>39.09</td>
<td>38.36</td>
<td>37.65</td>
<td>36.96</td>
<td>36.3</td>
<td>35.65</td>
<td>35.02</td>
<td>34.41</td>
</tr>
<tr>
<td>0.03</td>
<td>40.63</td>
<td>39.85</td>
<td>39.09</td>
<td>38.36</td>
<td>37.65</td>
<td>36.96</td>
<td>36.3</td>
<td>35.65</td>
</tr>
<tr>
<td>0.04</td>
<td>42.26</td>
<td>41.43</td>
<td>40.63</td>
<td>39.85</td>
<td>39.09</td>
<td>38.36</td>
<td>37.65</td>
<td>36.96</td>
</tr>
<tr>
<td>0.05</td>
<td>43.99</td>
<td>43.11</td>
<td>42.26</td>
<td>41.43</td>
<td>40.63</td>
<td>39.85</td>
<td>39.09</td>
<td>38.36</td>
</tr>
</tbody>
</table>

By varying the discount rate and the growth rate, we see that the observed stock price is closest to the estimated stock price using a cost of equity of 8.5% and a growth rate of 5%. Once again, we feel that these estimates are unreliable given our assumptions about future performance. While this model does not vary as wildly as the residual income model, we feel that even an optimal assessment of $43.99 still undervalues the stock by at least 8 to 9 dollars.

**Discounted Free Cash Flows to Equity**

This method involves taking forecasted information from the statement of cash flows and discounting it back to the present. The appropriate amounts to discount are cash flow from operations and cash flow from investing activities. This model differs from the above methods in that it relies on the weighted average cost of capital (WACC) to determine the discount rate. Unfortunately, we were unable to determine a WACC for Sepracor. The reason for this is twofold: First of all, the majority of Sepracor’s debt is issued at as zero coupon bonds. In the notes to the financial statements, the company lists each issuance of outstanding debt and its respective book values and market values. For Sepracor, the market values exceed the book values for the debt. This makes determining an imputed rate impossible, as all computations yield negative values. Furthermore, we were unable to obtain from any published source a
yield to maturity on Sepracor’s outstanding debt. Nevertheless, we determined that a WACC of 6.75% comes closest to mirroring Sepracor’s observed price of $52.16. But given Sepracor's extremely high debt to equity ratio, we do not feel that this accurate. In addition to this, Sepracor still has negative owner’s equity because of their history of net losses. The only inference we can make is that the WACC will eventually settle around 6.5% given their hugely improved earnings performance and management’s stated intent to finance more operations from equity rather than debt.

Altman Z-Score and Credit Analysis
Altman’s Z-Score is a credit analysis tool used to estimate the probability of business failure for a given firm. The score uses five ratios and assigns a weight to each ratio in order to determine the likelihood of business failure. A score of 3 or better is interpreted to mean the chances of business failure or very low. A score of 1.8 or less means that the firm is extremely likely to default on its obligations. For Sepracor, we calculated a Z-score of 2.0. This is on the lower end of the scale and is extremely close to the benchmark of 1.8. Once again, we must balance Sepracor’s history of net losses (and its subsequent negative retained earnings, one of the variables in the model) against its recent improved performance. Based on their recent performance, we feel that the likelihood of default is low. Sepracor’s forecasted revenues should be sufficient to meet its obligations.

Analysis and Recommendation
Based on our forecasted financial statements, and the corresponding valuation methods, we do not feel that our valuation estimates provide, with any reasonable certainty, the true assessment of Sepracor’s value. We feel that Sepracor’s unique situation of historical net losses means that these models are not appropriate indicators of Sepracor’s true potential. These models are best
applied with companies that are not heavily leveraged, or with histories of net losses.

With strong earnings growth and innovative products, we feel that the company will perform on par with the market, at least for the short term. While our quantitative analysis strongly suggests that we recommend a sell decision on this stock, we feel that the market has set reasonable expectations for Sepracor’s performance and that the company will meet, if not exceed these expectations. But, we will err on the side of caution and recommend a hold decision to investors. We consider the company’s share price of $52.16 as of November 1st to be a fair valuation.
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