

Lannett: Citron Exposes the Lawsuits **that will Wipe Out the Equity**

Citron Explains Clearly Why:

- **Lannett will be the First Pharma Company to go Bankrupt amid Continuing Drug Pricing Scrutiny**
- **If Even Modest Price Cuts Hit Either of Lannett's Cash Cow Drugs, It Will Violate Its Debt Covenants**

\$13-\$15 Near Term Target
Equity Worthless Over Long-Term

Over the past year, almost every media outlet in the US has dissected the pharmaceutical industry to expose the culprits of rampant opportunistically driven price gouging. We are now well past that point. The next question investors will have to ask is:

“Which companies will collapse under their debt load from levered acquisitions, based on the assumption of endless unrestrained drug price increases?”

The one company standing out most starkly is Lannett (NYSE:LCI). While Valeant, Mylan, and Horizon have multiple product lines across numerous specialties, Lannett is heavily leveraged, and extremely dependent on the profit windfall from just a few of its drugs to generate enough revenue to service its debt load.

In the past month we have seen a series of lawsuits against Lannett that Wall Street has completely overlooked. These lawsuits, along with the Trump

administration's dedication to confront indiscriminate drug price raises, illuminates a clear path to 0 for the equity of Lannett.

In this story Citron will explain these 4 essential points

1. Explain the dependence of Lannett's business on only **three** products (most heavily reliant on just **one**).
2. Reference NEW COURT DOCUMENTS showing conclusively that Lannett has indeed conspired to fix drug pricing.
3. Illustrate the effect of price competition on generic drugs – through Lannett's own product mix
4. **Provide a sensitivity analysis projecting how Lannett WILL become insolvent if and when it is forced to take modest price reductions**

Lannett's product mix chart is the foundation of this story.

(In thousands) Medical Indication	Three Months Ended September 30,	
	2016	2015
Antibiotic	3,780	2,727
Anti Psychosis	17,320	2,742
Cardiovascular	12,694	8,303
Central Nervous System	10,350	—
Gallstone	12,883	19,972
Gastrointestinal	18,052	76
Glaucoma	5,783	6,822
Migraine	7,160	5,542
Muscle Relaxant	3,532	1,661
Obesity	835	979
Pain Management	6,608	8,133
Respiratory	2,213	—
Thyroid Deficiency	39,838	41,102
Urinary	5,101	215
Other	10,347	8,159
Contract manufacturing revenue	5,063	—
Total	\$ 161,559	106,433

*** Citron did not include Gastrointestinal because it is mainly Omeprazole (generic Prilosec) and Pantoprazole (generic Protonix) . These are both proton pump inhibitors that are low margin, high volume, and highly competitive.

Notice the drugs that this business is based on

- Thyroid Deficiency – Levothyroxine (Levo) (#1 revenues by far)
- Anti Psychosis – Fluphenazine (Fluph) (#2 revenues)
- Cardiovascular (Digoxin) (#3 revenues)

These 3 drugs are responsible for over **43%** of Lannett's gross revenue...and a disproportionate share of its net revenues!

Lannett lives and dies on the price of Levothyroxine (Levo).

Levo is generic Synthroid, which is the second most prescribed generic drug in the United States. Whereas most generic drug prices are destined to drift lower, Levo prices are approximately 200-300% higher than they were in 2013. Although there are some smaller competitors, the two real players for Levo are Lannett and Mylan.

In **November of 2016**, Bloomberg reported that Lannett, amongst other companies, received a subpoena from the **U.S. Department of Justice** regarding generic drug pricing collusion:

U.S. Charges in Generic-Drug Probe to Be Filed by Year-End

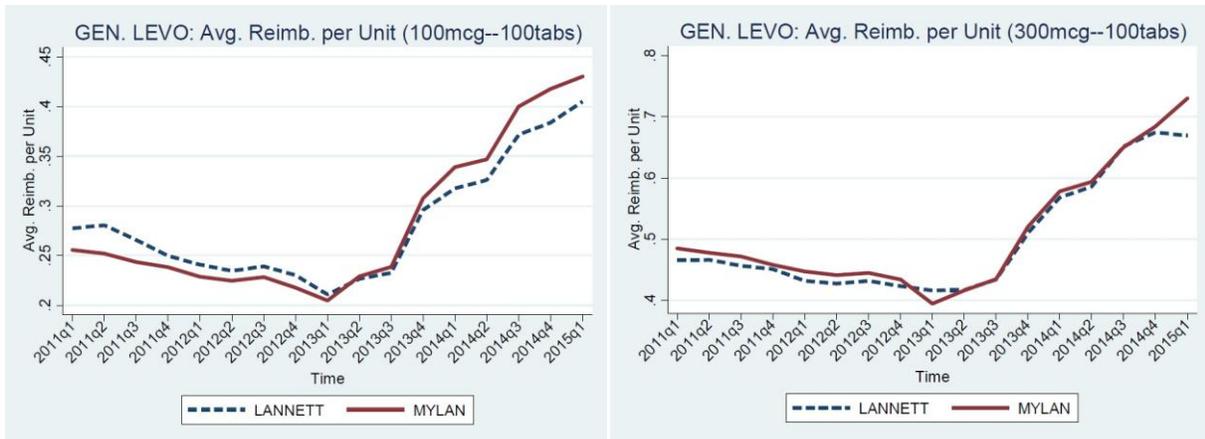
<https://www.bloomberg.com/news/articles/2016-11-03/u-s-charges-in-generic-drug-probe-said-to-be-filed-by-year-end>

Wall Street took notice of this Bloomberg news coverage, and sent Lannett stock down to \$17.

But what happened in the following two months has gone unnoticed by Wall Street ... Until Now...

It's easy to dismiss Citron coverage as "biased", but it's denying reality to dismiss the data from the lawsuits filed against Lannett in the last month. The case for price fixing Levo was presented by not just one but **TWO** lawsuits ... filed in just the past month.

Let's start here, with a glimpse into the basic pricing charts for Levo over the past 3 years, as presented in one of the lawsuits currently pending against Lannett. Are we to believe that these prices were not fixed?



Just two of many charts in the National Benefit Fund vs Lannett and Mylan class action complaint filed 12/14/2016. NBF is one of the strongest labor management funds in the nation.

</wp-content/uploads/2017/01/National-Benefit-Fund-Class-Action-Complaint-Collusion-Against-Lci.pdf>

Just two weeks later, on December 28, the Rochester Drug Co-operative, one of the nation’s fastest growing healthcare distributors, filed a similar lawsuit against Lannett accusing them of price fixing the price of Levo.

</wp-content/uploads/2017/01/Rochester-vs-Lannett-Complaint.pdf>

Both of these lawsuits (especially the Rochester Drug Co-op suit) do an **amazing** job detailing the roadmap of what the Department of Justice is undoubtedly finding while investigating Lannett.

Collusion on price hikes is beyond question. These lawsuits are better than a smoking gun: they are DNA evidence and nothing short of a confession.

Lannett's CEO has actually **bragged** about raising prices and **is now worried** about competitors:

“Mylan is one of those rational competitors, so we’re not really expecting anything crazy from them.”

-- Arthur Bedrosian, Lannett CEO

“You mean after I sent them the thank you note?”

He continued: “So whenever people start acting responsibly and raise prices as opposed to the typical spiral down of generic drug prices, I’m grateful. Because Lannett tends to be active in raising prices.”

-- Arthur Bedrosian, Lannett CEO

The price of Levo and the future of Lannett will be sealed on of these 4 inevitable events.

1. Competitors lowering pricing amongst current scrutiny
2. Lannett is forced to eliminate the price increases over the past 2 years
3. Another generic enters the Levo market, which is inevitable at these prices
4. Lannett cannot possibly sustain their Levo supply agreement at current terms. This distribution deal, which expires in 2019, will either fall due to price fixing, or be dramatically repriced. The gravy train ends, either way.

Lannett’s second largest drug last quarter was Fluphenazine (Fluph).

In what some would call the ultimate demonstration of “chutzpah” Lannett raised the price on this newly acquired drug schizophrenia drug by 1900% in the middle of 2016 ... amidst the middle of the drug pricing scrutiny storm.

Arthur Bedrosian:

No you didn't....yes you did....no you didn't....yes you did.



These two Forbes articles written this year do a good job of describing this egregious behavior...they also expose the CEO's fake (mail order) degree and former tax problems.

1. <http://www.forbes.com/sites/nathanvardi/2016/10/06/another-drug-company-that-raises-prices-like-crazy/#4a0f99033488>
2. <http://www.forbes.com/sites/nathanvardi/2016/11/03/lannett-leads-generic-drug-maker-stock-plunge-on-news-of-escalating-federal-pricing-probe/#3ae43d321dcc>

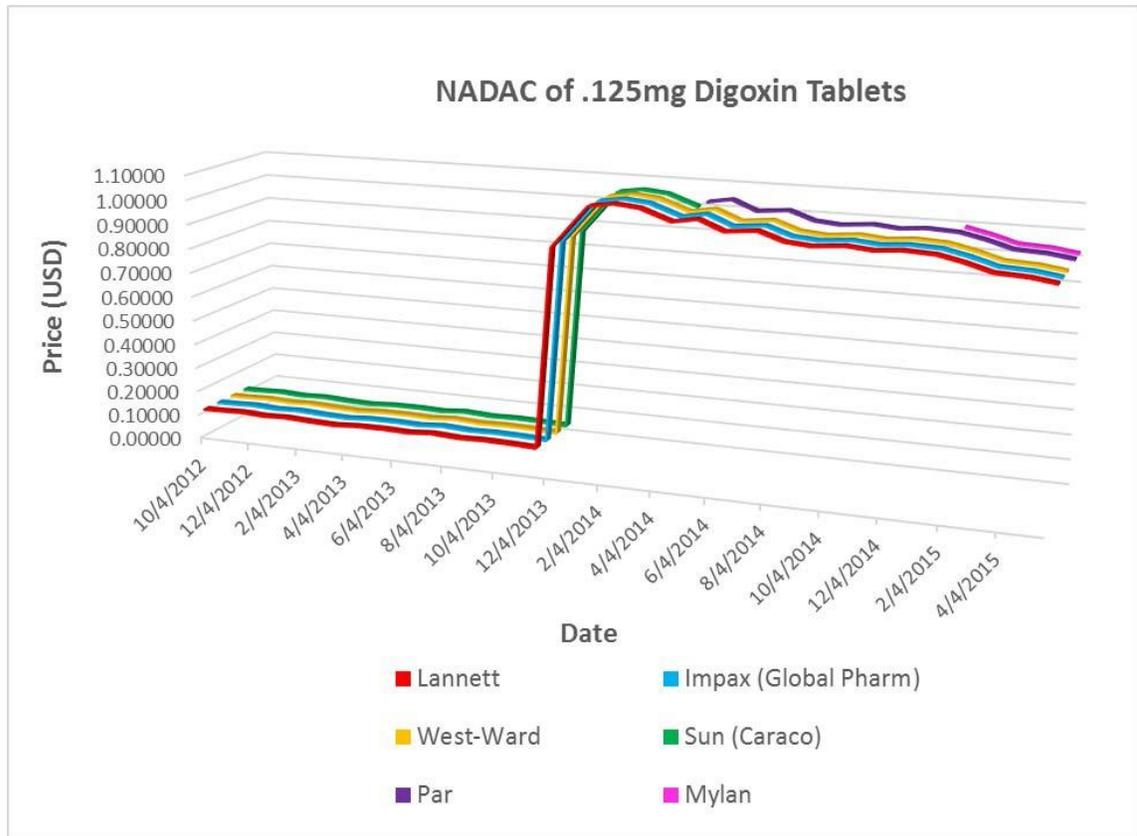
Why did they raise the price of the Fluph 1900% in a year? Not because they wanted to, but that had to! Lannett acquired the rights to Fluph in their untimely, hideously mispriced 2015 acquisition of Kremers, which closed just weeks after the now infamous "Hillary tweet".

In a move that can only be understood as reflecting complete desperation, Lannett submitted its bid for Kremers **without a Material Adverse Events Clause** in their contract. They bought Kremers for **\$1.3 billion**, despite [Kremers just having lost their largest customer, primarily due to the FDA's ruling about declassification of their generic Concerta](#)...the customer had accounted for close to **40%** of Kremers' EBITDA before that ruling.

After leveraging up Lannett as far as it could be stretched to fund the acquisition, the only thing left to do was what they know best: – gouge pricing on the remaining drug. Note this Kremers acquisition was the turning moment where they company acquired debt and rose to its highest level of incompetence.

"Cardiovascular Drugs" = Digoxin

The third highest revenue drug in Lannett's portfolio is Digoxin. Below is a chart of pricing of generic Digoxin.



Velardi vs Lannett & Others -- Class action suit.

</wp-content/uploads/2017/01/Velardi-vs-Lannett-Class-Action-complaint.pdf>

<https://www.bloomberg.com/news/articles/2016-11-03/u-s-charges-in-generic-drug-probe-said-to-be-filed-by-year-end>

<https://www.bloomberg.com/news/articles/2016-12-22/widespread-drug-price-increases-point-to-collusion-study-finds>

“According to Lannett, "Irrational Competitors" were those who competed on price in order to obtain market share,” NECA-IBEW said. “The statement is a signal that Lannett understood that Impax, Par and Mylan, among others, were no longer interested in competing on price, an understanding that could only exist if the three firms had reached a consensus on how to price.”

<https://www.law360.com/articles/776335/generic-cos-face-another-antitrust-suit-over-drug-prices>

It does not take an antitrust attorney to understand that chart is a detailed map of what price fixing looks like. That is why in November of 2016, Bloomberg reported that the DOJ is investigating Lannett and other for price fixing Digoxin. What CEO Bedrosian might consider in his words a “rational competitor” quickly turns into a "co-conspirator" when this pattern is exposed.

Gallstone Segment

Look at what happens when someone doesn't collude. The revenue breakdown shows a steep decrease in the price of the generic, as natural market forces keep prices in trim.

Lannett's gall bladder medicine Ursodiol is a likely "tell" for the stock after the effects on larger drugs follow the pattern. Lannett said that the price of its gallstone medicines, including Ursodiol, rose by 907% in the year ended June 30, 2015, adding \$58.7 million to sales. More important than sales: **all price increases go right to the bottom line.**

But now that competition has showed up, revenues for Lannett's gall bladder segment fell by 35%. (**Green highlight in the revenue segment table, page 2, above.**) This vulnerability for the rest of Lannett's portfolio is obvious.

“Two years ago, ursodiol’s wholesale price was as low as 45 cents a capsule. Then in May 2014, generic drug manufacturer Lannett Co. hiked its price to \$5.10 per capsule, and one by one its competitors followed suit – with most charging nearly the same price. Experts say this is not how a competitive marketplace is supposed to work.”

-- LA Times Sept 1, 2016

<http://www.latimes.com/business/la-fi-mylan-price-hikes-20160830-snap-story.html>

OK, Wall Street- This is Where the Rubber Hits the Road: Citron Does The Work to Show Lannett's Path to Bankruptcy!

Lannett has the clearest path to bankruptcy in the pharmaceutical industry.

We worked out the financial scenario to show that if Lannett had to roll back pricing to where it was just 2.5 years ago, the company would violate their debt covenants ... and go bankrupt!

Citron did some digging into LCI’s debt covenants, which require LCI to not exceed a 4.25x Net Debt / EBITDA covenant through 12/31/17 (which then moves lower from there):

10-Q Sept 2016

The Amended Senior Secured Credit Facility contains a financial performance covenant that is triggered when the aggregate principal amount of outstanding Revolving Credit Facility and outstanding letters of credit as of the last day of the most recent fiscal quarter is greater than 30% of the aggregate commitments under the Revolving Credit Facility. The covenant provides that Lannett shall not permit its first lien net senior secured leverage ratio as of the last day of any four consecutive fiscal quarters (i) from and after December 31, 2015, to be greater than 4.25:1.00 (ii) from and after December 31, 2017 to be greater than 3.75:1.00 and (iii) from and after December 31, 2019 to be greater than 3.25:1.00.

The Amended Senior Secured Credit Facility also contains a financial performance covenant for the benefit of the Term Loan A Facility lenders which provides that Lannett shall not permit its net senior secured leverage ratio as of the last day of any four consecutive fiscal quarters (i) prior to December 31, 2017, to be greater than 4.25:1.00, (ii) as of December 31, 2017 and prior to December 31, 2019 to be greater than 3.75:1.00 and (iii) as of December 31, 2019 and thereafter to be greater than 3.25:1.00.

By shedding only ~\$81M of EBITDA, Lannett would trip its current debt covenant today

Citron estimates that Levothyroxine and Fluph have produced ~\$157M of excess contribution margin since FY 13 (Levo) and FY 16 (Fluph). If LCI loses just 51% of that excess contribution margin, they trip the debt covenant.

Another way to look at it:

Based on 10-K disclosures, Levothyroxine price increases alone added ~\$78M to revs/EBITDA from FY 13 through FY 16. Therefore, if Levo prices alone go back to FY 13 levels, Lannett's financials go right to the edge of violating the debt covenant (\$78M of EBITDA lost vs. \$81M needed to violate covenant). This is without Digoxin or Fluph.

At these price levels, Lannett would no longer generate cash. This would likely accelerate their tumble toward restructuring.

Here are several alarming scenarios we modeled out as to what would happen to LCI's leverage ratios if their key drugs are even reduced slightly in price:

LCI**Debt Analysis**

Term Loan A Gross	264.7
Term Loan B Gross	757.4
Revolver	125.0
Debt	1,147.1
Debt	1,147.1
Cash	(241.7)
Gross Debt	1,147.1
Net Debt	905.4
Debt / EBITDA	3.90x
Net Debt / EBITDA	3.08x

	Covenant Break-Even	Sensitivity -- % of EBITDA Given Back		
		50%	75%	100%
FY 17 EBITDA "Guidance"	293.8	293.8	293.8	293.8
<u>Fluphenazine Impact</u>				
Fluphenazine Upside vs. FY 16	73.5	73.5	73.5	73.5
% Given Back	51%	50%	75%	100%
EBITDA Lost	(37.8)	(36.8)	(55.1)	(73.5)
<u>Levothyroxine Sodium Impact</u>				
Levo Upside vs. FY 13	83.6	83.6	83.6	83.6
% Given Back	51%	50%	75%	100%
EBITDA Lost	(43.0)	(41.8)	(62.7)	(83.6)
Total EBITDA Lost	(80.8)	(78.6)	(117.8)	(157.1)
% Reduction	-27%	-27%	-40%	-53%
Total PF EBITDA	213.0	215.2	176.0	136.7
Net Debt / PF EBITDA	4.25x	4.21x	5.15x	6.62x
12/31/17 Covenant	4.25x	4.25x	4.25x	4.25x

Note: LCI guides to EBIT, not EBITDA so D&A is estimated based on last Q run-rate.

With the amount of debt currently loaded, at 3.9x EBITDA, there is no doubt in our mind that drastic steps are going to have to be taken over the next four years in order for this company to be able to survive without a restructuring – in fact, we think it is near impossible.

It gets worse for Lannett. In the past week, its headwinds got stronger.

Citron was not going to release this article until we understood the current state of generic pharmaceutical pricing. For this we looked to the recent JP Morgan healthcare conference, to which Lannett was not even invited, to gauge the commentary surrounding larger generics. The message of “challenging generic pricing environment” was a constant underlying theme amongst all of the larger players.

Worse, this past week President Elect Trump expressed his continued dedication to lowering prescription drug pricing, stating that the industry is getting away with “murder” and opening the door for foreign drug companies.

One example how this trend can break Lannett is to look at a recent ANDA filed by Apotex, a sizable Canadian pharma company who is a huge supplier of generics to the US, with low-cost manufacturing capability in India. Apotex lists Levothyroxine as "filed" with the FDA.



Under Development		Developed			
API	Stage	API	Stage	API	Stage
***		***		***	
Ritonavir	To Be Filed	Irbesartan	Approved	Trosipium Chloride	Approved
Rivaroxaban	R&D	Labetalol Hydrochloride	Approved	Valacyclovir Hydrochloride	Approved
Saxagliptin	R&D	Lacosamide	Filed	Valganciclovir	Filed
Tetrabenazine	R&D	Lansoprazole	Approved	Valproic Acid	Approved
Tiagabine Hydrochloride	To Be Filed	Letrozole	Approved	Valsartan	Approved
Ziprasidone HCl (Crystalline)	R&D	Levofloxacin	Approved	Varenicline Tartrate	Approved
		Levothyroxine Sodium	Filed	Voriconazole	Filed
		Linezolid	Filed	Warfarin Potassium	Filed
		Lorazepam	Approved	Warfarin Sodium Clathrate	Approved
		Memantine Hydrochloride	Approved	Zolmitriptan	Approved
		Misoprostol Dispersion 4%	Approved	Zonisamide	Approved
		Moclobemide	Approved		

<http://www.apotexpharmachem.com/images/downloads/product-list/us/Apotex%20Pharmachem%20Product%20List.pdf>

If the government can't stop them, the free market will.

Conclusion

In this report, **Citron has proven a clear path to bankruptcy.** Lannett will clearly fall under their own debt load as they encounter macro trends which they cannot escape. It should be noted that Lannett is not a real pharmaceutical company -- for years it lingered as a single digit stock and even traded under cash at one point, until management learned how to raise prices and rip off the government. They then levered up the company and made an egregiously overpriced acquisition that will prove to be fatal.

CEO Bedrosian once boasted to a conference “In the generics business you are only as strong as your most stupid competitor”

Well, **now** the truth is you are only as strong as your most scrutinized competitor.

Citron points out that Concordia has already followed this path from \$24 to \$2. For Lannett, it is only a matter of time.

Goodnight Lannett – Cautious Investing To All.