Eli Lilly, based in Indianapolis, discovers, develops, manufactures and markets medicines for human and animal health. Lilly products treat depression and pain, diabetes, osteoporosis, cancer and many other conditions. The shares are a component of the S&P 500.

**Analyst's Notes**

*Analysis by John Eade, July 23, 2015*

**ARGUS RATING: BUY**

- Recent weakness offers buying opportunity
- LLY shares have lagged the market over the past quarter, with a gain of 0.5% versus the S&P 500’s 2.7% advance.
- The revenue and earnings deltas have started to improve for LLY, which is beginning to move beyond its patent cliff years of 2012-2014.
- Assuming that sales of new products gain traction, we forecast a return to double-digit growth in 2016.
- We also like LLY’s growing dividend, which appears secure and currently yields about 2.3%.

**INVESTMENT THESIS**

Our rating on Eli Lilly & Co. (NYSE: LLY) is BUY and our target price is $92. The earnings and revenue deltas have started to improve for LLY, which is beginning to move beyond its patent cliff period of 2012-2014. We expect Lilly to resume an earnings growth path this year and attract investors who have been scared off by the loss of patent protection for blockbuster anti-depressant and schizophrenia drugs, among others. In preparation for these losses, Lilly has been developing new drugs, and currently boasts a clinical pipeline that includes three recent product launches and several product candidates in Phase III trials. The company’s focus is on treatments for diabetes and cancer. Management is also working to align Lilly’s legacy cost structure to reflect the new revenue reality. We remain positive about the company’s long-term outlook, and view nonfundamental sell-offs as buying opportunities. Lilly's investment attractions also include a solid and sustainable dividend yield of about 2.3%.

**RECENT DEVELOPMENTS**

The revenue and earnings deltas continue to improve for LLY. Second-quarter earnings came to $0.90 per share, up 24% from the prior-year quarter and ahead of the 18% gain in 1Q. Second-quarter non-GAAP revenue rose 1% year-over-year to $5.0 billion, compared to a 6% decline in 1Q15 and a 14% drop in 4Q14. Non-GAAP net income rose 20% to $955 million. EPS came in $0.16 above consensus expectations. For the first half, 2016.

**Market Data**

*Pricing reflects previous trading week’s closing price.*

<table>
<thead>
<tr>
<th>Price ($)</th>
<th>75</th>
<th>50</th>
<th>25</th>
<th>10</th>
<th>5</th>
<th>0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rating</td>
<td>BUY</td>
<td>HOLD</td>
<td>SELL</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>EPS ($)</th>
<th>1.14</th>
<th>1.16</th>
<th>1.11</th>
<th>0.74</th>
<th>0.70</th>
<th>0.68</th>
<th>0.66</th>
<th>0.75</th>
<th>0.87</th>
<th>0.90</th>
<th>0.71</th>
<th>0.80</th>
<th>0.96</th>
<th>1.90</th>
<th>0.79</th>
<th>0.90</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quarterly</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Annual</td>
<td>4.15</td>
<td>2.79</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Revenue ($ in Blt)</th>
<th>5.6</th>
<th>5.9</th>
<th>6.0</th>
<th>5.8</th>
<th>4.7</th>
<th>4.9</th>
<th>4.9</th>
<th>5.1</th>
<th>4.6</th>
<th>5.0</th>
<th>5.0</th>
<th>5.3</th>
<th>4.9</th>
<th>5.2</th>
<th>5.3</th>
<th>5.6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quarterly</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Annual</td>
<td>23.3</td>
<td>19.6</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>FY ends</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec 31</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Please see important information about this report on page 5

©2015 Argus Research Company
the company earned $1.77.

Along with the 2Q results, the company raised its 2015 non-GAAP EPS guidance to $3.20-$3.30 from $3.10-$3.20 and its revenue guidance to $19.7-$20.0 billion from $19.5-$20.0 billion.

Management also provided an update on its new product pipeline during the 2Q conference call:

-- Cyramza (ramucirumab) was launched in the U.S. for the treatment of second-line metastatic colorectal cancer and in Japan for gastric cancer. EU regulators are reviewing Cyramza for the treatment of second-line metastatic non-small cell lung cancer. In 2Q, Cyramza sales totaled $87 million, up from $68 million in 1Q.

-- Trulicity, for Type II diabetes, was launched in Japan.

-- Jardiance (empagliflozin) has been submitted for FDA and EU approval for treatment of Type II diabetes.

-- Ixekizumab, for psoriasis, has been submitted for FDA and EU approval. In Phase III trials, the drug was determined to be statistically superior to Enbrel (manufactured and distributed by Amgen) and placebo. Enbrel is a multibillion-dollar blockbuster drug. Psoriasis affects about 125 million people worldwide, and approximately eight million people in the U.S. Nearly 17% of those affected have moderate to severe plaque psoriasis. The Phase III trials showed that ixekizumab performed significantly better than Enbrel and placebo after 12 weeks of treatment under two different dosing regimens. Approximately 90% of patients treated with ixekizumab achieved at least a 75% reduction in plaque psoriasis and about 40% achieved complete skin clearance.

-- Baricitinib, for rheumatoid arthritis, met another primary end point in a second Phase III trial. Lilly is partnering with Incyte Corp. (INCY: BUY) on this product. Management has termed this molecule as potentially 'best in class' and expects additional trial data to be released later this year, with a regulatory filing to follow.

-- Abemaciclib, a CDK 4/6 inhibitor for advanced breast cancer and advanced lung cancer, has entered Phase III trials. Management has also termed this molecule as potentially 'best in class.'

-- Necitumumab, for stage IV metastatic squamous non-small-cell lung cancer, has been granted fast-track status by the FDA, and Lilly has filed for approval. Management expects FDA action by the end of the year.

-- Tanezumab, for osteoarthritis pain, is being developed by Lilly in collaboration with Pfizer Inc. (PFE: BUY). Phase III trials have resumed, but we do not expect to see Phase III readouts until 2017.

-- Solanezumab is still being studied for its potential to slow the progression of Alzheimer’s Disease. And Lilly, along with AstraZeneca, has initiated a Phase II/III study of AZD3293, an oral BACE inhibitor that is being studied for Alzheimer’s.

-- Lilly is also pairing two of its pipeline products in combination with immuno-oncology drugs marketed by Bristol-Myers Squibb and Merck. These studies are in Phase I/II.

In terms of performance, LLY shares have soared over the past year as the company released a number of promising new products.
Analyst’s Notes...Continued

quarter, with a gain of 21% versus the S&P 500’s flat performance. Over the past year, the shares have also outperformed, with a gain of 36% versus a 7% increase in the S&P 500. The beta on LLY shares is 0.29.

Earnings & Growth Analysis

When building our earnings models for drug companies, we place a special emphasis on the growth of key products. For Lilly, that’s currently Alimta, for cancer; Humalog, for diabetes; and Forteo, for osteoporosis. In the second quarter, Alimta sales were down 7% year-over-year at $664 million; Humalog sales dropped 7% to $654 million; and Forteo sales rose 6% to $328 million. These products accounted for 33% of Lilly’s 2Q sales. Soon we will be adding Cyramza, Trulicity and Jardiance to this list.

Sales trends for the company’s other billion-dollar products and business lines are as follows:

-- Cymbalta, the antidepressant that has lost patent protection in the U.S., declined 32% to $274 million.
-- Humulin, also for diabetes, was down 10% at $316 million.
-- Cialis, for ED, was flat at $568 million.

Sales of Lilly’s Animal Health products rose 40% to $841 million, driven by the acquisition of Novartis’ animal health business.

Our 2015 revenue forecast is $20 billion, which assumes about 2% growth. We think that sales of Cialis, which is now approved for the treatment of benign prostatic hyperplasia, along with continued growth in diabetes products, and for Cyramza, will drive revenue above the midpoint of management’s target range.

In terms of margins, management continues to focus on cost cutting. COGS accounted for 21.8% of 2Q sales, above average for the industry. But the net margin was a healthy 19%, as management has focused on reducing spending on SG&A (down 8% in the quarter) and R&D (down 5%).

The company’s share buyback program also contributed to 2Q EPS. Shares outstanding declined 1% year-over-year.

We are raising our 2015 EPS estimate to $3.28 from $3.15, based on expectations for further growth in sales of Cyramza and further cuts in operating expenses. Our estimate is just above the midpoint of management’s guidance range and implies growth of 18% this year. We are maintaining our 2016 EPS estimate of $3.65; this assumes another year of double-digit growth, driven by sales of new products and ongoing share buybacks.

Now that the company has moved beyond its patent cliff period, we expect earnings to grow at a 7% rate over the next five years.

Financial Strength & Dividend

Our financial strength rating for Lilly is Medium, the midpoint on our five-point scale. The company achieves average scores on our three main measures of financial strength: leverage based on debt/cap; profitability and interest coverage.

Lilly pays a dividend. On December 15, management...
announced a 2% increase in the quarterly payout to $0.50, or $2.00 annually, for a projected yield of about 2.3%. We think the dividend is secure and poised to grow along with earnings. Over time, we think that Lilly management will attempt to set aside 40%-45% of earnings for dividend payments. Our dividend estimates are $2.00 for 2015 and $2.08 for 2016.

The company also has a stock buyback program.

MANAGEMENT & RISKS

The chairman, CEO and president of Lilly is Dr. John Lechleiter, 61, who joined the company in 1979. He has served as president and CEO since 2008. The CFO is Derica W. Rice, who was promoted to his position in 2010 and joined the company in 1990. The Eli Lilly Endowment owns about 13% of the outstanding LLY shares.

Investors in the LLY shares face numerous risks. Drug development is inherently risky: products in the pipeline may not progress for technical or commercial reasons, and pipeline disappointments are likely to impact the share price.

In addition to organic growth, Lilly also grows via acquisition, including two recent animal health deals. Lilly management has stated its interest in acquiring other assets, though its potential targets are likely to be more of a bolt-on nature than transformative. There are risks that any significant acquisition may be dilutive and that anticipated synergies may not be realized.

Patent expirations for Lilly's top products represent a significant challenge for management - and a risk for investors. The company may not be able to develop new products to replace the sales of older drugs that will be lost to generic competition.

COMPANY DESCRIPTION

Eli Lilly, based in Indianapolis, discovers, develops, manufactures and markets medicines for human and animal health. Lilly products treat depression and pain, diabetes, osteoporosis, cancer and many other conditions. The shares are a component of the S&P 500.

VALUATION

We think that LLY shares are attractive at current prices in the mid-$80s. Over the past 52 weeks, LLY has traded between $60 and $90. The shares are in a bullish technical trend of higher highs and higher lows that dates to October 2013.

From a fundamental standpoint, the shares trade at 22.8-times our 2016 EPS forecast, toward the high end of the peer group range. That said, Lilly’s solid dividend yield of 2.3% is attractive in a low interest rate environment. Our revised target price of $92 implies a dividend yield of 2.2%. This is more in line with the industry average - and more representative of a growth stock, which we expect Lilly to once again be by the end of this year.

On July 23, BUY-rated LLY closed at $86.76, up $0.38.
About Argus

Argus Research, founded by Economist Harold Dorsey in 1934, has built a top-down, fundamental system that is used by Argus analysts. This six-point system includes Industry Analysis, Growth Analysis, Financial Strength Analysis, Management Assessment, Risk Analysis and Valuation Analysis.

Utilizing forecasts from Argus’ Economist, the Industry Analysis identifies industries expected to perform well over the next one-to-two years.

The Growth Analysis generates proprietary estimates for companies under coverage.

In the Financial Strength Analysis, analysts study ratios to understand profitability, liquidity and capital structure.

During the Management Assessment, analysts meet with and familiarize themselves with the processes of corporate management teams.

Quantitative trends and qualitative threats are assessed under the Risk Analysis.

And finally, Argus’ Valuation Analysis model integrates a historical ratio matrix, discounted cash flow modeling, and peer comparison.

THE ARGUS RESEARCH RATING SYSTEM

Argus uses three ratings for stocks: BUY, HOLD, and SELL. Stocks are rated relative to a benchmark, the S&P 500.

- A BUY-rated stock is expected to outperform the S&P 500 on a risk-adjusted basis over a 12-month period. To make this determination, Argus Analysts set target prices, use beta as the measure of risk, and compare expected risk-adjusted stock returns to the S&P 500 forecasts set by the Argus Market Strategist.
- A HOLD-rated stock is expected to perform in line with the S&P 500.
- A SELL-rated stock is expected to underperform the S&P 500.

Argus Research Disclaimer

Argus Research is an independent investment research provider and is not a member of the FINRA or the SIPC. Argus Research is not a registered broker dealer and does not have investment banking operations. The Argus trademark, service mark and logo are the intellectual property of Argus Group Inc. The information contained in this research report is produced and copyrighted by Argus, and any unauthorized use, duplication, redistribution or disclosure is prohibited by law and can result in prosecution. The content of this report may be derived from Argus research reports, notes, or analyses. The opinions and information contained herein have been obtained or derived from sources believed to be reliable, but Argus makes no representation as to their timeliness, accuracy or completeness or for their fitness for any particular purpose. This report is not an offer to sell or a solicitation of an offer to buy any security. The information and material presented in this report are for general information only and do not specifically address individual investment objectives, financial situations or the particular needs of any specific person who may receive this report. Investing in any security or investment strategies discussed may not be suitable for you and it is recommended that you consult an independent investment advisor. Nothing in this report constitutes individual investment, legal or tax advice. Argus may issue or may have issued other reports that are inconsistent with or may reach different conclusions than those represented in this report, and all opinions are reflective of judgments made on the original date of publication. Argus is under no obligation to ensure that other reports are brought to the attention of any recipient of this report. Argus shall accept no liability for any loss arising from the use of this report, nor shall Argus treat all recipients of this report as customers simply by virtue of their receipt of this material. Investments involve risk and an investor may incur either profits or losses. Past performance should not be taken as an indication or guarantee of future performance. Argus has provided independent research since 1934. Argus officers, employees, agents and/or affiliates may have positions in stocks discussed in this report. No Argus officers, employees, agents and/or affiliates may serve as officers or directors of covered companies, or may own more than one percent of a covered company’s stock.

Morningstar Disclaimer

© 2015 Morningstar, Inc. All Rights Reserved. Certain financial information included in this report: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. Past performance is no guarantee of future results.