This 3DAdvisors Report Covers:	
✓	**Insider Trading**: Insider Trading Behavior
	Accounting: Quality of Earnings Issues
	Governance: Corporate Governance Issues
✓	**Fundamentals:** Fundamental analysis

On Eve of 2008 Guidance, CEO Stock Grant Rescinded

Pharmaceutical Product Development Inc. (NASDAQ:PPDI) Update

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Contact: Bob Gabele (954) 779-3974 or bgabele@3DAdvisors.com

Business Description

Pharmaceutical Product Development Inc., a contract research organization, provides drug discovery and development services, post-approval expertise, and compound partnering programs. The Company operates in two segments: Discovery Sciences and Development. The Company also offers support services, such as product launch services, medical information, patient compliance programs, patient and disease registry programs, product safety and pharmacovigilance, phase IV monitored studies, and prescription-to-over-the-counter or Rx-to-OTC programs. It offers its services to pharmaceutical, biotechnology, and medical device companies, as well as academic and government organizations. The Company has operations in the Americas, Europe, Africa, the Middle East, Asia, and Australia. Pharmaceutical Product Development, Inc. was founded in 1985 and is headquartered in Wilmington, North Carolina.

Summary of 3DAdvisors Findings for PPDI

- **Insider Trading:** Rescinding stock award of long-time CEO exceedingly rare
- **Fundamentals:** Competitive pressures increasingly evident in financial results
- **Fundamentals:** Key Development segment revenues continue to slow
- **Fundamentals:** R&D costs may also continue to pressure outlook

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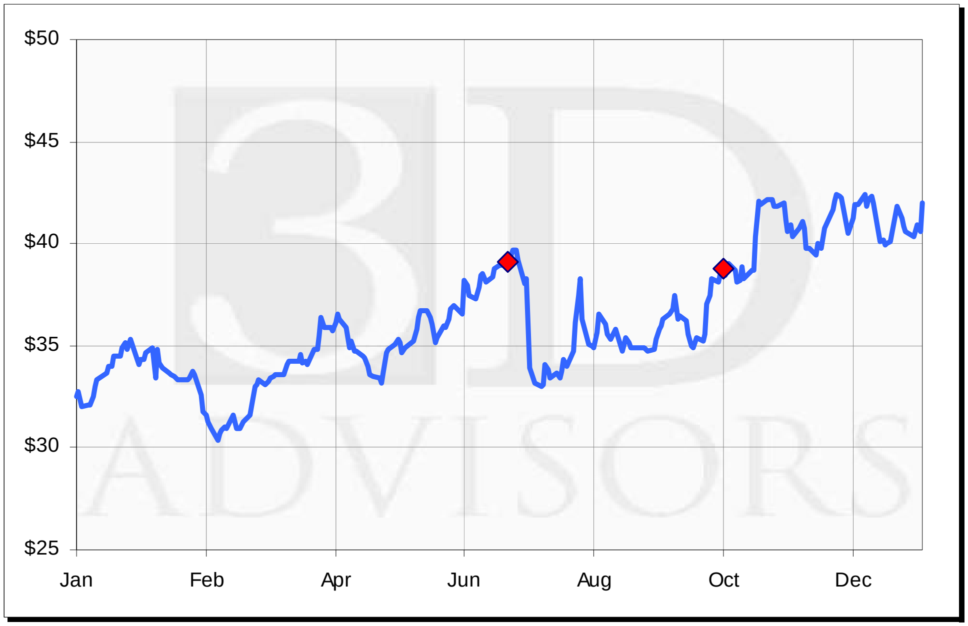
Discussion of 3DAdvisors Findings for PPDI

A very recent sequence of unusual and most likely related events has kept our interest high in PPDI as the timing and context of the actions suggest to us the possibility of a negative surprise coming, perhaps as early as the Company's delayed 2008 guidance now scheduled for release on January 8th. The series of events started innocently enough on December 5th with what appeared to be a routine Restricted Stock grant of 100,000 shares to CEO **Fredric Eshelman**. Then on December 19th, an SEC Form 8-K was filed disclosing that on the 13th Director **Marye Anne Fox**, who served on the PPDI Compensation Committee, had abruptly announced her departure, effective January 3rd. These first two events appeared unconnected to us until December 27th, when Eshelman filed another Form 4 disclosing that the 100,000 share Restricted Stock grant awarded earlier that month had been *rescinded*, suggesting the Company had taken the almost unheard of step of taking back a stock grant made to its chief executive. This very unusual sequence, combined with the trading, accounting and fundamental items we had previously covered in our prior reports on the Company (07/09/07 and 10/10/07), has led us to focus once again on the Company and conclude that more volatility may lie just ahead.

Figure 1. PPDI Daily Closing Price, 01/03/06 through 01/04/08. Red diamonds are the dates of the prior 3DA reports on the Company. Source: Reuters and 3DAdvisors, LLC.



Interestingly, events from just last week seem to imply the opposite; that all is well with the Company. The shares rallied on Friday (01/04/08) on news that drug development partner Takeda Pharmaceutical had asked the FDA to approve its Type II diabetes drug SYR-322, also known as alogliptin, in the U.S. The development will trigger a milestone payment of $15 to $25 million in the current quarter and spurred a flurry of analyst "Buy" reiterations and/or target hikes, pushing PPDI shares up 3.4% on a day the Dow and NASDAQ would fall by 1.96% and 3.77%, respectively.

While the Takeda announcement was clearly welcome news for the Company's struggling Discovery Sciences segment, where revenues have been contracting since 2005, it does little to reverse certain trends facing the Company's core Development segment which has been running into competitive headwinds of late, headwinds which we covered most recently in our update on 10/10/07. And even though the Company seemed to report strong results in Q3 to the relief of management and analysts, causing the shares to rally up to the $42 level, signs that competitive pressures have increased further were evident in the numbers as well: DSO's continue their climb; Unbilled Receivables continue to increase as a percentage of total A/Rs; Cancellation Rates remain high, and; contract terms are getting longer while upfront cash from customers (Deferred Revenue) is dropping relative to total Revenue. And now, with competitive pressures continuing to mount and just before the Company is to release its 2008 guidance, we have a restricted stock grant to the CEO, an abrupt resignation of a director on the Compensation Committee, followed by the stock grant being rescinded.

Insider Trading: Rescinding stock award of long-time CEO exceedingly rare

Eshelman's December Restricted Stock award was indeed odd. He was the only insider to receive such an award at year-end as the Company typically makes such awards during Q1. He had received a similar one-time grant back in May of 2005, where the Company had issued the following disclosure in a Form SEC 8-K:

> The Committee approved this award to Dr. Eshelman to reward him for his contributions to the Company's achievements and to motivate him to continue providing his leadership and vision to accomplish the Company's business objectives.

This time, however, there was no 8-K disclosure of the award. We must point out how rare it is to find such instances of "*rescinded*" Restricted Stock awards. We have seen "forfeits" of such awards but to see one "rescinded" is a truly unique occurance that we are not willing to discount especially given the fact that, coincident with this, there was an abrupt departure of Marye Anne Fox, a seasoned director who served on the Compensation Committee. We believe her departure is almost certainly linked to the unusual gyrations involving Eshelman's rescinded stock grant. Fox was no rookie director either, having served on the PPDI board since 2002, and who also sits on several other boards at notable public companies, including:

- Red Hat Inc. (RHT): Joined board in 2002, Audit Committee member
- Boston Scientific Corp. (BSX): Joined board in 2001, Audit Committee member
- W.R. Grace & Co. (GRA): Joined board in 1996, Audit Committee member

The reason given for her departure from PPDI's board was that it was "due to the demands of her job as Chancellor of the University of California at San Diego and scheduling matters made it difficult for her to attend Company Board and Committee meetings". Not lost on us is the fact that Ms. Fox has not severed her ties from any of the other boards she serves on in spite of her apparently tight schedule at the University where she has been Chancellor since 2004.

Our calls to the Company regarding the "rescinding" of Eshelman's award have thus far gone unanswered. Perhaps it is serendipitous, but the event raises our curiosity with regards to the Company's postponed and soon-to-be-released guidance scheduled for January 8th. Since 2001, PPDI has consistently released its yearly guidance between the dates of December 4th and December 13th. This year's guidance - delayed by one month and after management and the board have had a chance to see audited results for 2007 - suggests to us that there may very well be a connection between Eshelman's rescinded award and the board's perception of last year's results and what lies ahead.

Fundamentals: Competitive pressures increasingly evident in financial results

Clearly, Eshelman was on the defensive back in Q2 when, hat in hand, he found himself explaining how $250 million in business wins "vaporized right in our face" (Eshelman, Q2 conference call). The collective sigh of relief, however, which surfaced in

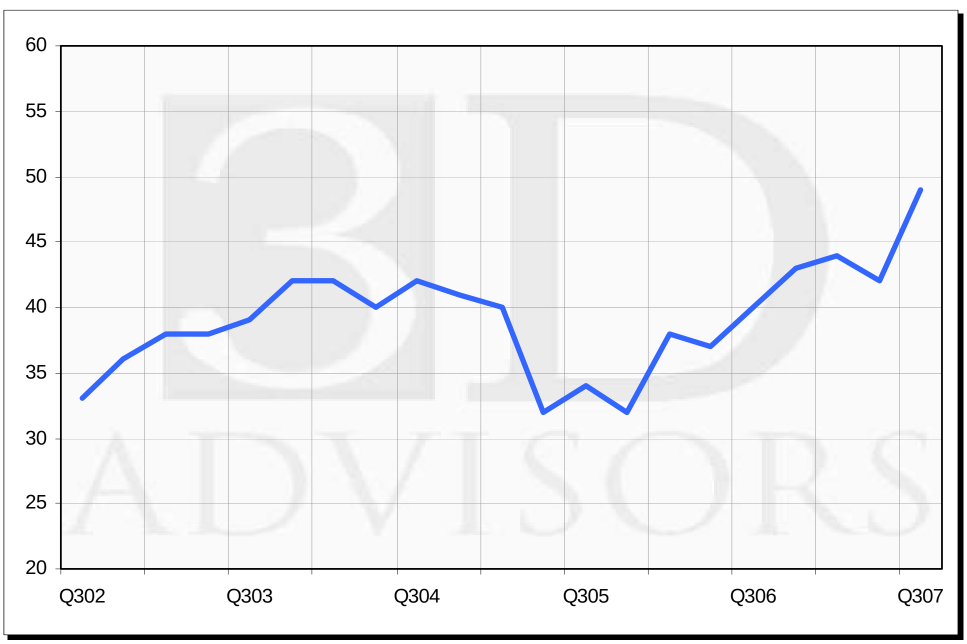
Q3 when the quarter appeared to be back on track, may be short-lived as most of the related clues continued to point towards PPDI's customers finding themselves in stronger bargaining position than in past periods.

By PPDI's own admission, customers are demanding, and getting, better terms. There is no better evidence of this than the continuing trends in DSO's, Unearned Income (read: Deferred Revenue) and the Company's increasing use of Unbilled Receivables in its A/R mix:

- **DSO Growth:** According to the prepared text from new CFO **Dan Darazsdi** (Q3 conference call): *"Current clients have negotiated longer payment terms and/or delayed billing milestones, which have negatively impacted our DSO's".* DSO growth concerns have manifested themselves in recent conference calls with the most recent event (Q3) prompting Eshelman to comment:

> I think, as Dan indicated, more and more we get contractual pressure from clients to adjust payment terms outward. Sometimes we get a different mix of payment terms versus GAAP accrual, which can obviously make the cash go one way or the other. Depends on the mix of the business units at any given quarter because some by their nature have a longer DSO. I think when we were down in the 30s, we said at that time we did not think it was sustainable and gave a sort of target for us back in those days of around 40. Clearly we are above 40. Whether or not we can get back to 40 is another issue. But as Dan said, there's a lot of attention being focused on this right now and we'll do our very best to get it down, but no guarantees in this particular market.

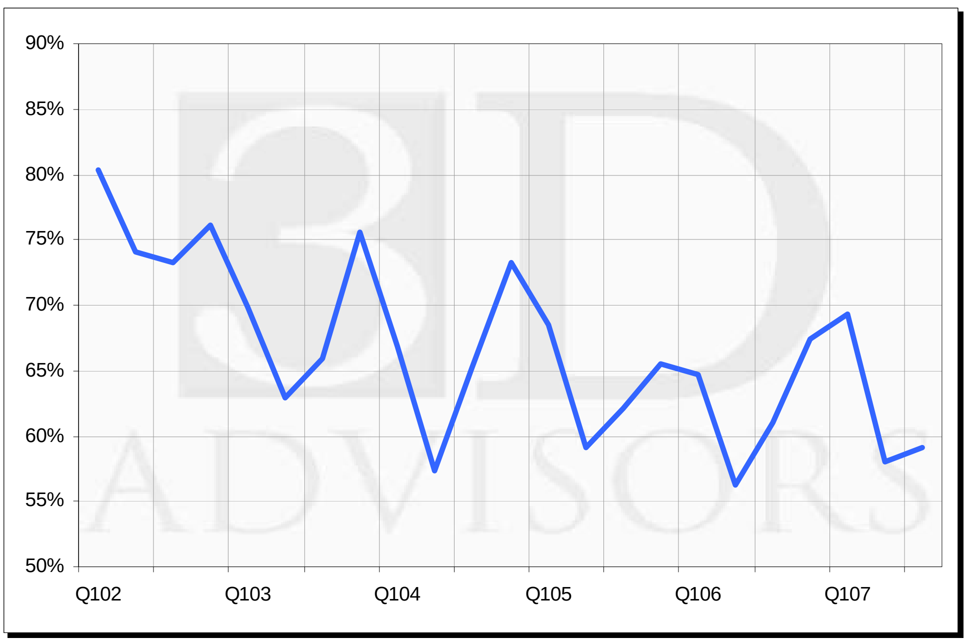
Figure 2. PPDI Days Sales Outstanding (DSO), Q302 through Q307. Source: PPDI SEC Filings.



The Company's DSO calculation is different from the norm, to say the least. The calculation involves adding unbilled receivables to regular receivables (read: billed to customers) and deducting unearned income to arrive at a receivables number into which some unexplained daily sales amount is divided. One wonders if the calculation involved using only actual receivables owed by customers and sales represented by those receivables might present a less favorable DSO number with its attendant effect on future cash collections.

- **Deferred Revenue Slippage:** Clearly telegraphed in the Q3 earnings conference call is the reduced willingness of customers to pay up-front cash in order to secure contractual commitments. Though this may not be a large problem for PPDI given the relative strength of its balance sheet, this additional sign of an increasingly competitive market should not go ignored. Figure 3 below graphs the ratio of PPDI's Deferred Revenue at the end of each quarter to booked Revenue for that quarter going back to Q1 of 2002. The downward trend is a result of fewer prepayments, which potentially represent future revenues to be booked, versus current revenues recognized in each period.

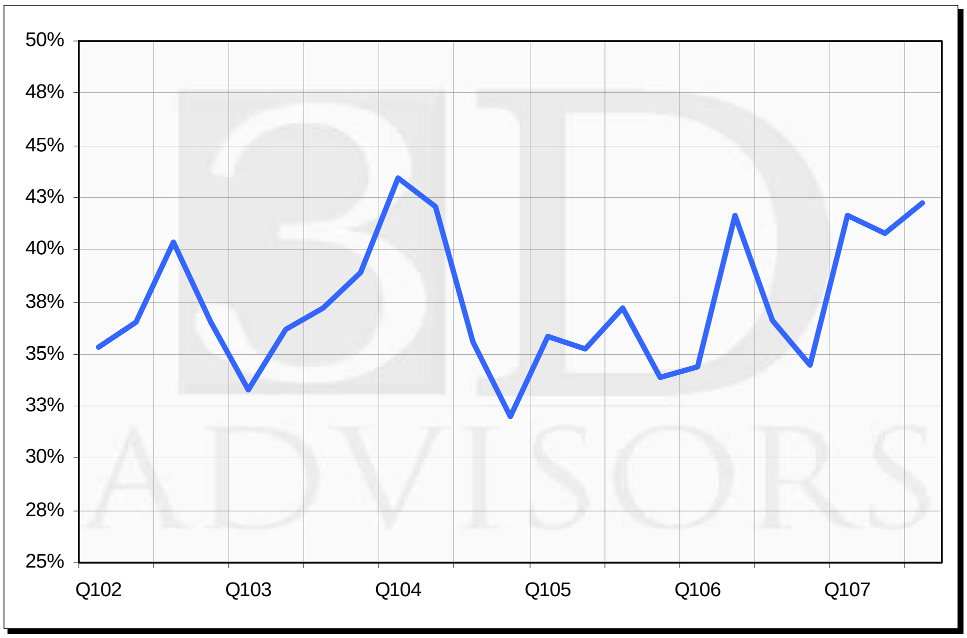
Figure 3. Ratio of Deferred Revenue to Total Revenue, Q102 through Q307. Source: PPDI SEC Filings.



- **Increasing Use of Unbilled Receivables in A/R Mix:** There has been a trend towards increasing use of Unbilled Receivables in PPDI's A/R mix in recent periods. In fact, for the last three sequential periods and four of the last six, Unbilled Receivables have represented more than 40% of A/R's., well above the 33% to 38% in recent periods since 2001 (see Figure 4 below).

Clearly, with most of PPDI's revenues recognized using Percentage of Completion (POC), one need not belabor the point concerning the opportunities that exist for managing out of period revenue and costs. Perhaps the most illuminating example is the fact that whether one compares Q306 and Q307 or the respective nine month periods for each year, the margin on Development revenue is always 50%. And then, with overall A/Rs increasing by 15% for the Q3 period, PPDI reduced their related allowance by 28%. To meet its stated goal of 50% margins, management could easily throttle development revenue and costs recognized under POC to maintain the bottom line. If you consider the fact that during Q3 Unbilled Receivables rose by 40% year-over-year while Billed Receivables hardly increased at all, you have a pretty good idea as to how the Company maintains margins at 50%.

Figure 4. PPDI Unbilled Receivables as a Percentage of Total A/Rs, Q102 through Q307. Source: PPDI SEC Filings.



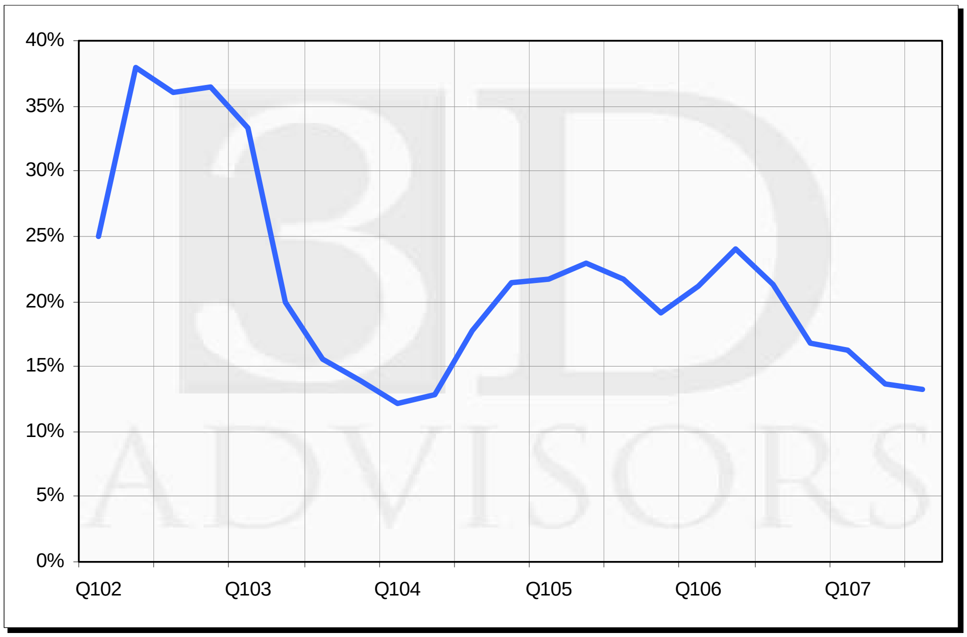
As we mentioned in our 10/10/07 update report, in April/May of 2007 the SEC began looking into PPDI's use of POC accounting and had requested the Company to furnish it with further clarification on its revenue recognition under the method. New information was provided by the Company to the SEC that revealed not only further detail concerning its POC use but also, for the first time, that some of its large customers negotiate rebates based on the volume of services purchased. This was the first time such rebates had ever been mentioned by the Company and it would seem that the practice is yet-another example of increasing competition in the picture for PPDI, not to mention the potential for managing its revenue figures.

The SEC review of PPDI's POC practices as they were described in the Company's 2006 SEC Form 10-K was never disclosed in an SEC Form 8-K or any other formal periodic filing. The only evidence of this communication between the Commission and PPDI exists in the publication of the correspondence between the two in an EDGAR filing (the actual communication is included in the appendix of our above-referenced 3DA report). Whether the Commission's review of PPDI's POC practices is complete is not known.

Fundamentals: Key Development segment revenues continue to slow

During the Q3 conference call, questions persisted about the decline in the year-over-year growth rate for PPDI's Development segment revenues. The rate not only has been dropping but is also below the Company's targeted 15% to 20% range.

Figure 5. PPDI Development Segment Revenue Growth, Year-Over-Year, Q102 through Q307. Source: PPDI SEC Filings.



Questions about the slowing of growth in the Development segment prompting the following exchange during the Q3 call:

> **Analyst:** I believe you mentioned earlier in the call spending to reaccelerate growth. Could you step back? I think if you go back to the third quarter of last year your development revenue growth was 21%, it was just over 13% this quarter. Can you just give us your impressions on what were the key drivers of that slow down? And beyond the obvious of signing up more new business, what are going to be the keys to move this number up again?
>
> **Fred Eshelman:** Well, several factors came into play, one of which, of course, is the law of big numbers that percentage growth probably would decrease over time. Besides that, I think some slower BD growth than we had expected, the signing of a number of longer-term contracts, which do not flow into revenue as fast as some of the ones that we had in the past. And, of course, on a quarter-by-quarter basis the mix might differ a little bit. Certainly in the future, as you point out, the most obvious thing is we've to rev up our BD engines so that we're actually coming in ahead of projections rather than on or behind. We have to watch closely the mix of the things that we're signing, because obviously if the average length of contract starts to stretch out on us again, then it's going to take longer to flow it through revenue. As you've noted over the past few quarters, though, we think that the average length of contract has stabilized because it did pull back from the high we

> experienced in one quarter -- I can't remember which -- where I think it jumped out to almost 36 months, it's now back to about 32. Shrinking length of contract, more sales, better utilization rates, and so forth, we're going to work on all of those to get our revenue growth back into the target arena that we've talked about all these years, which is a 15% to 20% top-line growth.

"Law of Big Numbers" or not, the fact is that the Company finds itself between the rock of increasing competition and the hard spot of maintaining a previously stated growth rate that it may not be able to hold. And now, in attempting to re-ignite growth, it may find itself boxed into a "Buyers Market" for its services. Unless, that is, it chooses to lower its forecasted growth rate.

Fundamentals: R&D costs may also continue to pressure outlook

With the 2008 guidance looming, one wonders about the Company's R&D commitment with regards to the statin compound it licensed from Ranbaxy Laboratories in early 2007 and intends to develop as a treatment for dyslipidemia, a metabolic disorder often characterized by high cholesterol levels. Currently, PPDI must bear all the costs and expenses for the development, manufacturing and marketing of the compound.

However, an article published on the DrugResearch.com web site on May 3rd opens its second paragraph by stating the following, "The in-licensing move is highly unusual for a contract research organization (CRO) like PPD, whose primary business model is providing drug development assistance on a fee-for-service basis." [1] The article goes on to quote Fred Eshelman who says, "The opportunity to develop and commercialize Ranbaxy's statin is a logical extension of our compound partnering program. It meets the rigorous requirements for our partnering strategy and further strengthens our metabolic franchise." However, the article continues, "Eshelman did stress, however, that the company is 'now aggressively seeking a commercial partner' for the compound in order to help shoulder the burden that the added research and development expenditure will have on the business. 'If we do not find a partner by the end of 2007 we will have to look at restructuring our Compound Partnering division in order to avoid having to alter our financial guidance', said Eshelman."

The logic of taking on such a competitive market as statins by shouldering the whole project before actually finding a partner has been questioned by some, as recently as in the Q3 conference call. The fact that PPDI has yet to find a development partner for this project will be yet-another interesting component with regards to the Company's soon-to-be-released 2008 guidance.

Giving attention to various aspects of the business such as greater use of POC accounting to boost revenues, increasing competition and pricing pressure, lower unearned income to provide future revenues (declining amounts of up-front cash), delayed release of 2008 guidance and the upcoming year end with the required truing up of accounts in preparation for the release of audited financial statements, one wonders if the impending release of fourth quarter results and guidance for the year 2008, may have negative overtones not previously recognized.

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[1] Barnes, Kirsty. "PPD bags a bargain from Ranbaxy." DrugResearcher.com. May 3, 2007.