

8-February-2010

Ironwood Pharmaceuticals (IRWD)

Developing a new treatment for irritable bowel syndrome and constipation.

Investment Rating: Marketperform

Pricing Update

Stock Data *(in mil, except per share)*

Current Price (8-Feb-2010)	\$11.71
Shares Outstanding	94.9
Market Capitalization	\$1,111.4
Enterprise Value	\$763.4

IPO Data

Offer Date	2/2/2010
Offer Price	\$11.25
Price Range	\$14.00 - \$16.00
Shares Offered (% insider)	16.7 (0%)
Deal Size	\$187.5
Use of Proceeds	Fund clinical trials

IPO Underwriters *(*bookrunner)*

J.P. Morgan*	Morgan Stanley*
Credit Suisse*	BofA Merrill Lynch
Wedbush PacGrow	

Key Financial Data *(\$ in mil)*

Income Model	FY Ended Dec		
	2008A	2009E	2010E
Sales	\$22.2	\$36.6	\$40.2
EBIT	-55.9	-62.5	-58.2
Net Income	-53.9	-61.1	-58.7
EPS	-0.72	-0.81	-0.62

Balance Sheet *As of 9/30/09*

Cash	\$288.9
Total Assets	339.6
Total Debt	3.4
Shareholders' Equity	198.2

Corporate Data

Employees	165
Year Founded	1998
Headquarters	Cambridge, MA
Phone Number	(617) 621-7722
Web Address	www.ironwoodpharma.com

Rating Analysis

Very Weak Neutral Very Strong

Long-Term

Company Fundamentals	<div><div></div><div></div><div></div><div></div><div></div></div>
Corporate Governance	<div><div></div><div></div><div></div><div></div><div></div></div>

Short-Term

Relative Valuation	<div><div></div><div></div><div></div><div></div><div></div></div>
Technical Strength	<div><div></div><div></div><div></div><div></div><div></div></div>

Ironwood prices 25% below its range and trades up 4% in its debut. Ironwood Pharmaceuticals raised \$188 million by pricing 16.7 million shares at \$11.25, below the proposed \$14-\$16 range. Despite pricing down and creating buzz as the biggest biotech IPO in almost eight years, Ironwood saw its stock rise only modestly in its debut as concerns regarding its ability to realize aggressive growth expectations with its Phase 3 drug (linaclotide) weighed on investor demand.

Valuation remains high despite the generous price cut. At the revised price, Ironwood is valued at over 4x 2012 MV/Sales (reflects 2015 sales discounted at 25%) with a market cap of roughly \$1 billion, while close peer Salix is trading at half this multiple with a market cap of \$1.4 billion. On an earnings basis, Ironwood is valued at 16x our 2014 earnings estimate (based on \$337mm in sales) vs. a 10x 2014 P/E for Salix. We therefore raise concerns over Ironwood's premium to this close peer, which is already generating product revenue and also has an IBS drug on the cusp of approval.

Initiate coverage with a marketperform rating. While linaclotide is likely to be approved and management has carefully guided Ironwood through its development stage and has secured a major collaboration agreement with Forest Labs, the main sticking point is valuation. When we compare Ironwood to other late stage biotech, it appears to be valued based on aggressive sales forecast assumptions. Additionally, management faces a challenge in convincing physicians to prescribe and payors to reimburse what non-IBS-C/CC sufferers regard as a nuisance, not a disease. Sales will be driven by consumer demand, which requires significant marketing, and the fact that Ironwood lacks credible pipeline candidates also adds risk.

Bull Insights

- Potential market is huge: estimated 40 mm US sufferers, only 10 mm treated
- Existing OTC and prescription treatments not fully effective
- Has shown efficacy with convenient once-a-day dosing and few side effects
- Is backed by well-known VCs and is partnered with Forest Labs
- IPO proceeds and milestone payments should fully fund commercialization

Bear Insights

- Will have high cash burn through 2013; plans to spend more than \$225 million
- Has only one late stage product; rest of pipeline is in Phase 1 or preclinical
- Must convince payors and physicians that a pricey prescription drug is justified
- Depends on partners to obtain regulatory approvals in Europe and Asia

Company Fundamentals
Rating: Neutral
Overview:

With 10 million Americans suffering from irritable bowel syndrome with constipation (IBS-C)/chronic constipation (CC) and lacking effective treatments, this VC-funded biotech believes it may have a blockbuster drug in linaclotide, which just completed successful Phase 3 trials for CC. Phase 3 trials for IBS-C should be done by 2H10, and if the safety and efficacy results are similar to those of CC, management predicts FDA approval by 2011 and a 2012 launch with broad labeling for both indications. Because a flawed and now withdrawn IBS-C drug achieved \$561 million in sales in 2006, management believes it may have a blockbuster drug and is supported by collaboration with Forest Laboratories.

Rating Rationale:

Ironwood meets all of the criteria for an investable biotech: a clear timetable to approval, fully funded launch, trials proving efficacy and safety supported by third party studies, good management pedigrees and credible venture backing/partnerships. Yet, many Phase 3 drugs have failed in the past and there are no other advanced pipeline candidates. Ironwood also has the challenge of convincing payors of the value proposition of linaclotide when a cheap OTC laxative is the standard of care. Thus, our enthusiasm for a mega-blockbuster is dampened by experience.

Business:

Developing a new small molecule compound to treat IBS-C and CC, painful disorders that affect tens of millions worldwide but are under-reported to physicians and not resolved by existing treatments. This once-a-day oral drug candidate, linaclotide, is a 14 amino acid peptide agonist that recently met all 32 primary and secondary endpoints with minor side effects in two Phase 3 CC trials involving 1,287 subjects. The company expects to have data from two Phase 3 IBS-C trials with 800 subjects each in late 2010 and, if successful, plans to ask the FDA for broad approval of linaclotide for IBS-C/CC in patients 18 and older. Also plans trials for opioid-induced constipation and pediatric. Has an agreement with Forest Labs to co-develop and co-market linaclotide in the US with a 50/50 share of profits. If linaclotide is successfully developed, licensing and milestone fees from Forest could total \$330 million, including \$125 million already paid. Has licensed Almirall to develop and market in Europe and Astellas to develop and market in Japan, South Korea and other Asian countries (remaining licensing and milestone fees could total \$40 million and \$45 million, respectively). Linaclotide was developed in house and Ironwood retains all other rights. Total milestone payments to date are \$250 million. Linaclotide is covered by a US composition of matter patent until 2025. Has no significant compounds in the pipeline.

Competition:

The major treatments for IBS-C/CC are OTC fiber and laxatives, prescribed in 83% and 91% of US cases, respectively. These tend to exacerbate bloating and pain. OTC Miralax (\$20 for 30 days of treatment) is the gold standard. In 2002, the FDA approved Zelnorm, a serotonin 5-HT₄ receptor agonist, which was successful and hit \$561 million in sales in 2006 but was withdrawn due to an unacceptable chance of heart attack. The only prescription product for IBS-C/CC is Amitiza (\$3.75/day), which is only modestly effective and causes chest pains and nausea. Resolor, a serotonin 5-HT₄ receptor agonist, was recently approved in Europe. Theravance has recently completed Phase 2 trials for a serotonin 5-HT₄ receptor agonist for treatment of CC.

Key Issues:

Despite successful Phase 3 trials for CC, there is always a chance that the Phase 3 trials for IBS-C may have problems or be delayed. Has spent more than \$290 million to date and plans to spend more than \$225 million prior to launch. Will remain dependent on a single product for years due to lack of pipeline products. Company believes reimbursement may be low (likely Tier III). Ironwood must convince payors to reimburse and doctors to prescribe a pricey drug over cheap gold standard Miralax. IBS-C/CC are under-reported to doctors due to embarrassment and are undertreated because they believe the conditions are a nuisance, not a disease. Relies on third parties for manufacturing and regulatory approval in Europe and Asia.

Income Statement Data

<i>FY Dec (\$ in mil)</i>	2006	2007	2008
Sales	\$3.1	\$10.5	\$22.2
EBITDA	-37.4	-54.7	-50.3
Operating Income	-39.6	-57.6	-55.9
Net Income	-37.2	-52.8	-53.9
EPS	-0.50	-0.71	-0.72

Cash Flow Data

Operating Income	-\$39.6	-\$57.6	-\$55.9
Plus: D&A/Non-Cash	2.2	2.9	5.6
EBITDA	-37.4	-54.7	-50.3
CFFO	-\$32.9	-\$5.0	-\$28.7
Less: Capex	2.8	2.7	22.9
Free Cash Flow	-35.8	-7.7	-51.7

Latest Results and Outlook

Recent Financial Trends:

For the nine months ended September 30, 2009, virtually all revenue was derived from collaboration payments. Research expenses rose 36% due to Phase 3 trials for CC. G&A rose due to increased employee headcount.

Outlook:

The thinking on the revenue model is this: pricing is +/- \$8/day, average patient usage is 130 days per year and 20% market share is achieved by 2016/2017. Assuming a mid 2012 US launch, we believe that linaclotide will ramp up to \$50 million in sales in that year (split with Forest, which is also reimbursing Ironwood in 2012 and 2013 for certain expenses) and that Ironwood's 50% share should hit over \$600 million in sales in 2016. (Zelnorm hit \$561 million in sales within four years.) We assume that Ironwood will be able to convince payors to support reimbursement, much the way the case was made for heartburn treatment Prilosec over OTC Tagamet.

On the strength of North American sales alone, breakeven should be achieved in late 2014 or early 2015. With European and Asian launches to occur in 2015/2016, the case can be made for linaclotide to top \$1 billion in worldwide sales in the 2016/2017 time frame. While this non-US boost to revenue will not be as great as US sales given licensing agreements, it will greatly boost profitability. Our model assumes operating margins can scale to 50%, although the decision to invest more heavily in its pipeline could have a material impact on this level of sustainable profitability.

Interim Results - 9 months ended

(\$ in mil)	Sep-08	Sep-09	% Chg
Sales	\$17.2	\$27.5	59%
EBITDA	-35.6	-41.5	16%
Operating Income	-39.1	-48.6	24%
Net Income	-42.6	-47.3	11%
EPS	-0.57	-0.63	9%

Cash Flow Data

Operating Income	-\$39.1	-\$48.6
Plus: D&A/Non-Cash	3.5	7.1
EBITDA	-35.6	-41.5
CFFO	-\$22.0	-\$13.1
Less: Capex	16.7	3.2
Free Cash Flow	-38.7	-16.3

Balance Sheet Data

(\$ in mil)	Actual 9/30/09	Adjusted 9/30/09	Post IPO 9/30/09
Cash	\$98.9	\$351.4	\$288.9
Total Assets	149.6	402.1	339.6
Total Debt	3.4	3.4	3.4
Shareholders' Equity	-275.8	260.7	198.2

Corporate Governance
Rating: Strong

The management has an impressive level of university medical center affiliation, experience with similar large scale product launches and has been successful in raising a significant amount of private capital as well as securing major partnerships. Three of the top four executives have been with the company for at least seven years. Ironwood is backed by well-known venture capitalists and there was no insider selling on the offering; however, only two out of eleven board members qualify as independent. The company raised \$75 million in its 2006 round of financing, \$50 million in 2007, \$50 million in 2008 and \$25 million in the nine months ended September 30, 2009.

Key Executive	Age	Position	Corporate Background
Peter M. Hecht	46	CEO	Since founding the company in 1998. Also serves on the board of Whitehead Institute, the Leadership Council for Integrative Cancer Research at MIT and the advisory board of NPO Infante Sano. Previously was a research fellow at Whitehead.
Michael J. Higgins	47	COO, CFO	Since 2003. Previously held various positions at biotech Genzyme.
Thomas A. McCourt	52	CCO	Chief Commercial Officer since September 2009. Previously worked at Amgen, where he led the brand team for denosumab (treats osteoporosis), Novartis, where he directed the launch of Zelnorm, and Astra Merck, where he served as brand manager for Prilosec.
Joseph C. Cook	67	Chairman	Since co-founding the company in 1998. Also co-founded Mountain Group Capital, a PE firm in Nashville. Currently serves on the board of biopharma Corcept Therapeutics and medical foods company Clinical Products. Previously served as chairman of Amylin Pharmaceuticals (1998-2009), where he was also CEO (1998-2003). Prior to that, spent 28 years at global pharma Eli Lilly.

Key Shareholder	Holdings	Additional Details
Ridgeback Capital	11.0%	New York-based VC firm. Invested in 2007 at \$6.25 per share and in September of 2008 and August of 2009 at \$12 per share.
Venrock	9.2%	Menlo-Park based VC firm. Has two board seats. Invested in 2007 at \$6.25 per share and in September of 2008 and August of 2009 at \$12 per share.
Polaris	6.6%	Boston-based VC firm. Has two board seats. Invested in 2007 at \$6.25 per share and in September of 2008 and August of 2009 at \$12 per share.
Morgan Stanley	5.6%	New York-based investment firm. Includes shares held through twenty-two funds, mostly mid cap growth focused.
Peter M. Hecht	5.4%	CEO.

Relative Valuation
Rating: Weak

At the revised price, Ironwood is valued at over 4x 2012 MV/Sales (reflects 2015 sales discounted at 25%) with a market cap of roughly \$1 billion, while close peer Salix is trading at half this multiple with a market cap of \$1.4 billion. On an earnings basis, Ironwood is valued at 16x our 2014 earnings estimate (based on \$337mm in sales) vs. a 10x 2014 P/E for Salix. We therefore raise concerns over Ironwood's premium to this close peer, which is already generating product revenue and also has an IBS drug on the cusp of approval.

Valuation Methods

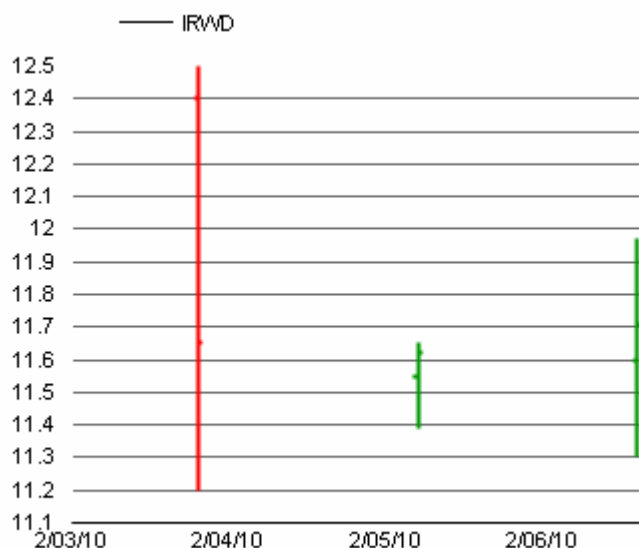
	<u>DCF</u>	<u>Relative</u>
Methodology	12.5x 2015 Net	14.1x 2014 P/E
Implied Value	\$10.40	\$8.93
Upside/Downside	-8%	-21%

View DCF Model at
www.ipointelligence.com/iporesearch/
Comparable Valuation Analysis

<i>IPO and Key Peers</i>	<i>Ticker</i>	<i>Price</i>	<i>Sales</i>	<i>Market Value</i>	<i>Enterprise Value</i>	<i>MV/Sales</i>		<i>P/E</i>		<i>LT Growth</i>	<i>P/B</i>
						2012	2013	2014	2015		
Ironwood	IRWD	\$11.71	\$32.5	\$1,111.4	\$763.4	4.3x	3.5x	17.2x	6.0x	30%	4.3x
Salix	SLXP	\$27.41	\$223.2	\$1,339.7	\$1,333.8	1.9x	1.5x	10.1x	n/a	20%	5.6x
Theravance	THRX	\$9.93	\$26.5	\$627.9	\$646.7	6.3x	2.4x	2.6x	n/a	10%	-3.6x
Sucampo	SCMP	\$3.41	\$67.4	\$142.7	\$57.9	1.2x	1.1x	3.6x	3.3x	12%	1.3x
Vertex	VRTX	\$37.61	\$100.8	\$6,976.4	\$6,263.7	3.8x	3.3x	11.0x	n/a	9%	11.5x
Intermune	ITMN	\$15.70	\$49.5	\$713.3	\$714.9	1.8x	1.4x	6.7x	n/a	n/a	-8.6x
Regeneron	REGN	\$25.73	\$338.3	\$2,055.0	\$1,737.7	2.8x	2.2x	10.8x	n/a	n/a	4.9x
Group Average						3.0x	2.0x	7.5x	n/a	13%	1.9x

Note: All dollars are in millions except for per share amounts.

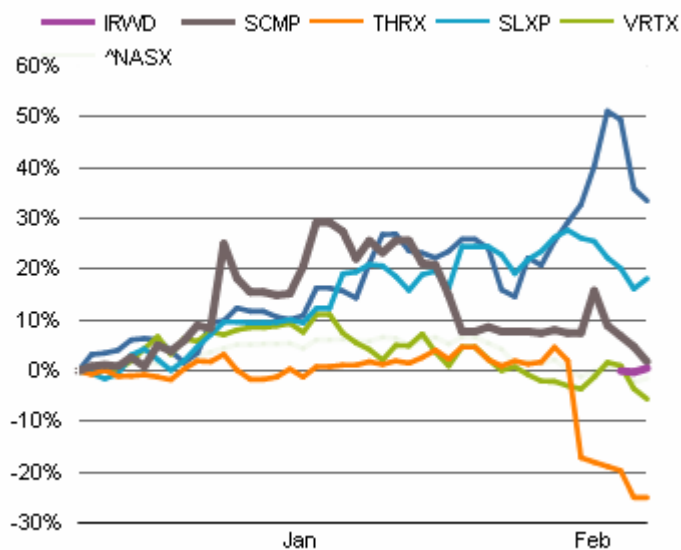
MV/Sales for Ironwood reflect 2015 revenue discounted at 25%.

Technical Strength
Rating: Neutral
**Stock Performance of IPO and its Peer Group
IRWD**


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IPO Performance Data

First Day	4%
Aftermarket	1%
Total Return	4%
Quiet Period Release	3/15/2010
Lock-up Release	8/1/2010
Days to Lock-Up Release	174
Shares Available for Sale	74,275,000
Percent of Total Shares Outstanding	78%

IRWD vs Key Publicly-Traded Peers vs Index


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Publicly - Traded Peer Group

Key Peers	Ticker	Stock Price	1-Mo. Return	3-Mo. Return	YTD Return
Ironwood*	IRWD	\$11.71	4%	4%	4%
Salix	SLXP	\$27.41	-2%	31%	8%
Theravance	THRX	\$9.93	-26%	-33%	-24%
Sucampo	SCMP	\$3.41	-17%	-18%	-16%
Vertex	VRTX	\$37.61	-8%	-4%	-12%
Intermune	ITMN	\$15.70	5%	16%	20%
Regeneron	REGN	\$25.73	6%	64%	6%
Indexes					
NASDAQ	CCMP	2,141.12	-5%	-1%	-6%
S&P 500	SPX	1,066.19	-5%	-2%	-4%
FTSE Renaissance IPO	IPOS	207.09	-3%	3%	-4%

Stock prices as of 02/07/10. *Returns reflect performance from offer date.

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Underperform	5.1%

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