

November 13, 2012

HEALTHCARE/BIOTECHNOLOGY

**Stock Rating:**
**OUTPERFORM**

12-18 mo. Price Target	\$16.00
VSTM - NASDAQ	\$6.65

3-5 Yr. EPS Gr. Rate	NM
52-Wk Range	\$12.24-\$6.58
Shares Outstanding	20.1M
Float	8.3M
Market Capitalization	\$141.3M
Avg. Daily Trading Volume	9,899
Dividend/Div Yield	NM/NM
Book Value	NM
Fiscal Year Ends	Dec
2012E ROE	NM
LT Debt	\$0.0M
Preferred	NA
Common Equity	\$96M
Convertible Available	No

EPS Diluted	Q1	Q2	Q3	Q4	Year	Mult.
2011A	(1.85)	(2.89)	(2.68)	(2.87)	(10.59)	NM
2012E	(0.47)A	(0.34)A	(0.51)A	(0.36)	(1.67)	NM
Prior (E)	--	--	(0.35)	--	(1.50)	NM
2013E	--	--	--	--	(1.46)	NM
Prior (E)	--	--	--	--	(1.39)	NM

# Verastem, Inc.

## 3Q12 Results; FAK Inhibitor Program On Track

**SUMMARY**

VSTM reported 3Q12 results. The company is on track to advance lead candidate, VS-6063, a FAK inhibitor, into a ph.II mesothelioma trial in mid-2013. The study results in 2H15 will provide significant proof-of-concept and could support accelerated approval. Additionally, we continue to believe the FAK program has broader potential across many different cancers and note second FAK inhibitor, VS-4718, will enter the clinic next year. Outside the FAK program, VSTM has additional shots on goal with a PI3K/mTOR inhibitor entering the clinic in 2013, and the preclinical Wnt research collaboration with Eisai. Based on the company's novel cancer stem cell (CSC) platform and growing pipeline, we believe VSTM has compelling long-term value. We reiterate our Outperform rating.

**KEY POINTS**

- **3Q loss per share of \$0.51 was greater than our \$0.35 est.** This was largely due to \$3.4M in license fees related to the acquisition of VS-6063 from Pfizer. VSTM ended 3Q with \$97.4M in cash, which we estimate will fund operations until ph.II results for VS-6063 in 2H15.
- **VS-6063 mesothelioma study to provide proof-of-concept.** We believe the study makes strategic sense. Mesothelioma exhibits high CSC incidence and the study will enroll Merlin loss patients, which appear more sensitive to FAK inhibition. Additionally, given the poor mortality with current mesothelioma treatments, positive PFS/OS results could potentially lead to accelerated approval.
- **FAK program has broader potential.** FAK overexpression occurs in many solid tumors and has been correlated with poorer survival in certain cancers. Further, with VS-4718, VSTM has greater flexibility to explore different indications. Additionally, we believe CSC-targeted therapies likely will have greater efficacy in the combo setting and look to ph.I VS-6063+chemo data in 2014.
- **Earlier pipeline developing.** We expect VS-5584 ph.I results at YE14. Although results are difficult to handicap, PI3K and mTOR are fairly validated targets in oncology. We look for an update on the preclinical Wnt program in the next 12 months.
- We are adjusting our model following 3Q12 results.

**Stock Price Performance**

**Company Description**

Verastem is a biopharmaceutical company focused on discovering and developing novel drugs that selectively target cancer stem cells.

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**Stock prices for other companies mentioned in this report (a/o 11/13/12):**

Eisai (ESALY-OTC, \$42.35, Not Covered)

Pfizer (PFE-NYSE, \$24.11, Not Covered)

## Verastem Income Statement

Amounts in thousands, except per-share figures

	2012									
	2010A	2011A	1QA	2QA	3QA	4QE	2012E	2013E	2014E	2015E
<b>Revenues:</b>										
Product royalty	-	-	-	-	-	-	-	-	-	-
Other revenue	-	-	-	-	-	-	-	-	-	-
<b>Total operating revenue</b>	-	-	-	-	-	-	-	-	-	-
<b>Operating expenses:</b>										
Cost of goods	-	-	-	-	-	-	-	-	-	-
Research & development	400	9,883	4,803	4,683	8,132	5,000	22,618	22,000	23,700	24,100
Selling, general & administrative	384	3,815	2,125	2,213	2,298	2,318	8,954	9,133	9,407	9,689
<b>Total operating expenses</b>	<b>784</b>	<b>13,698</b>	<b>6,928</b>	<b>6,896</b>	<b>10,430</b>	<b>7,318</b>	<b>31,572</b>	<b>31,133</b>	<b>33,107</b>	<b>33,789</b>
<b>Income (Loss) from operations</b>	<b>(784)</b>	<b>(13,698)</b>	<b>(6,928)</b>	<b>(6,896)</b>	<b>(10,430)</b>	<b>(7,318)</b>	<b>(31,572)</b>	<b>(31,133)</b>	<b>(33,107)</b>	<b>(33,789)</b>
Other income (expense)	(2)	(17)	51	71	63	76	261	307	352	186
<b>Pretax income (loss)</b>	<b>(786)</b>	<b>(13,715)</b>	<b>(6,877)</b>	<b>(6,825)</b>	<b>(10,367)</b>	<b>(7,242)</b>	<b>(31,311)</b>	<b>(30,826)</b>	<b>(32,755)</b>	<b>(33,604)</b>
<b>Income tax provision (benefit)</b>	-	-	-	-	-	-	-	-	-	-
<b>Net income (loss)</b>	<b>(786)</b>	<b>(13,715)</b>	<b>(6,877)</b>	<b>(6,825)</b>	<b>(10,367)</b>	<b>(7,242)</b>	<b>(31,311)</b>	<b>(30,826)</b>	<b>(32,755)</b>	<b>(33,604)</b>
<b>Basic &amp; diluted net loss per share</b>	<b>(\$0.92)</b>	<b>(\$10.59)</b>	<b>(\$0.47)</b>	<b>(\$0.34)</b>	<b>(\$0.51)</b>	<b>(\$0.36)</b>	<b>(\$1.67)</b>	<b>(\$1.46)</b>	<b>(\$1.49)</b>	<b>(\$1.48)</b>
Basic & diluted common shares outstanding (1)	850	1,295	14,693	19,863	20,160	20,360	18,769	21,160	21,960	22,760
(1) IPO in 1Q12 results in conversion of preferred stock to common stock										

Source: Company documents and Oppenheimer & Co. Inc.

## Investment Thesis

Based on a unique discovery platform, VSTM is developing cancer stem cell (CSC)-targeted therapies. We believe there is growing evidence CSCs have a key role in tumor initiation/metastasis. VSTM expects to advance lead candidate VS-6063, a FAK inhibitor into ph.II testing in mid-2013. Based on early-stage data and compelling biological rationale, we believe FAK inhibition has broad anticancer potential across cancer types. We believe VSTM is an attractive long-term investment and expect the stock to appreciate as clinical progress and high profile scientific publications further underscore the importance of CSCs.

## Price Target Calculation

Our price target of \$16 is based on a forward DCF valuation. We model a ~52% EBIT margin and ~30% tax rate in the out years, resulting in a 2027 free cash flow of ~\$83M. We utilize a 15% discount rate to reflect the early stage of VSTM's drug candidates, but utilize a 3% terminal growth rate to reflect the productivity of the company's discovery platform. Our valuation also includes \$200M in technology value, which we believe is conservative based on platform acquisition comps.

## Key Risks to Price Target

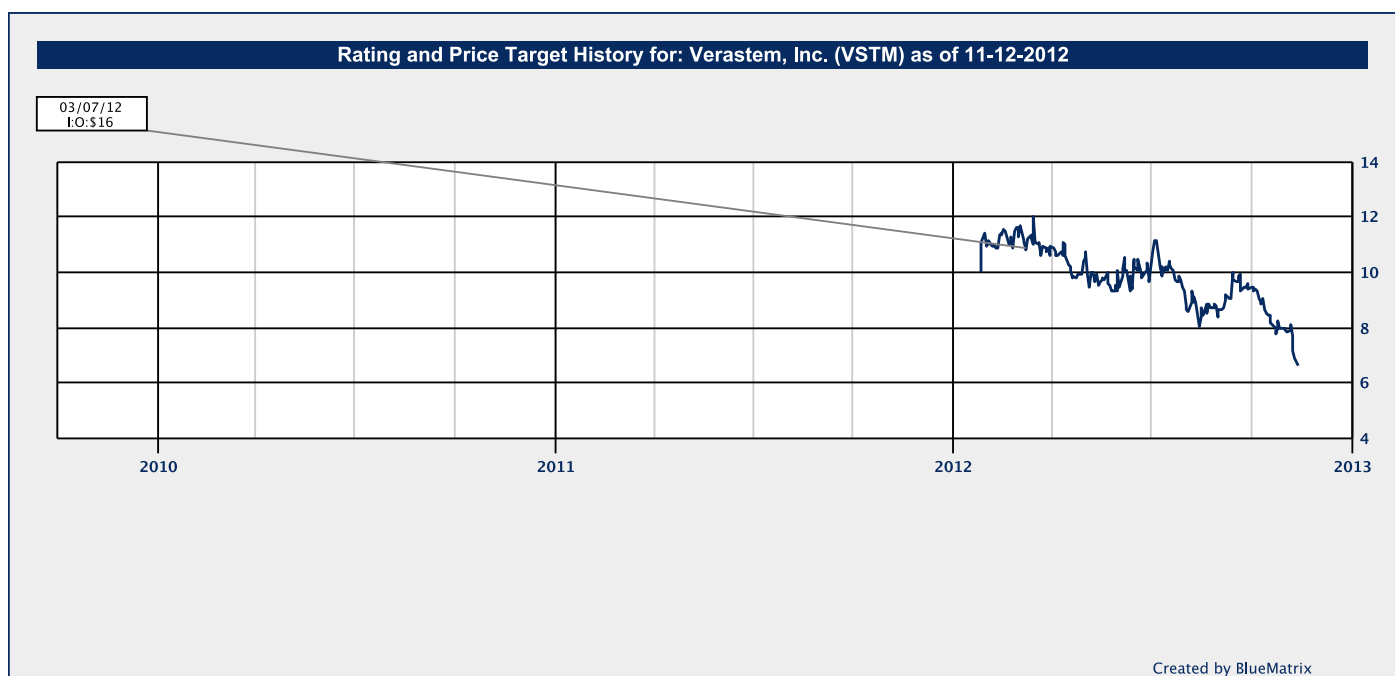
Key risks to our price target include, but are not limited to, clinical failure of VSTM's drug candidates, success of competing drugs in the clinic, and failure to secure funding for operations. There is liquidity risk with the shares, based on the company's float.

## Important Disclosures and Certifications

**Analyst Certification** - The author certifies that this research report accurately states his/her personal views about the subject securities, which are reflected in the ratings as well as in the substance of this report. The author certifies that no part of his/her compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in this research report.

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## Distribution of Ratings/IB Services Firmwide

Rating	IB Serv/Past 12 Mos.			
	Count	Percent	Count	Percent
OUTPERFORM [O]	310	54.01	139	44.84
PERFORM [P]	259	45.12	86	33.20
UNDERPERFORM [U]	5	0.87	2	40.00

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