Ophthotech

Ophthotech Monetizes Fovista OUS Rights with Profit-Share-Like Economics

Overweight

OPHT, OPHT US

Price: $31.46

▲ **Price Target: $51.00**
Previous: $40.00

Ophthotech announced, after the close today, that it out-licensed the OUS rights for Fovista to Novartis in a deal potentially exceeding $1B, including a massive $200M upfront, which fortifies Ophthotech's already strong cash position (now ~ $500M), and a mid-30% royalty - approaching profit-share-like economics. Indeed, the strong terms validate, in our view, the drug's clinical profile, its robust development program, and its strong commercial potential. Further, by monetizing the OUS rights and partnering with Novartis, the company (1) executes on its promise of securing an OUS partner without giving up US rights, and (2) reduces the drug's OUS development costs, and (3) leverages Novartis' entrenched position in ophthalmology. Based on the deal terms, we are updating our model and raising our December 2014 PT to $51 from $40; reiterate Overweight rating.

- **Strategy and timelines remain unchanged.** On the call, Ophthotech reiterated that the timelines to data from the 3 pivotal studies remain on track (2016; JPMe: mid-2016) and that its positioning remains unchanged. Specifically, the company continues to be agnostic on how Fovista is used / combined with anti-VEGF therapies. That said, it is clear that Novartis will be motivated for Fovista to be used in combination with its agents (either Lucentis or, likely Novartis' proprietary anti-VEGF inhibitor: ESBA1008, further details below); we ultimately view the partnership as helping Ophthotech against other emerging anti-PDGF therapies.

- **Clarity on deal economics.** Ophthotech will receive a $200M upfront payment, plus is entitled to near-term patient enrollment milestones of $130M (which we assume the company will reach in 2015), OUS approval milestones of up to $300M, and sales milestones up to $400M. Ophthotech is also entitled to a mid-30% royalty on standalone Fovista sales, as well as equivalent economics on sales of a co-formulated product (details below). Ophthotech and Novartis will share OUS development costs going forward, though Ophthotech remains in control of the pivotal phase 3 studies.

- **Other development opportunities.** Novartis also announced that it will develop (1) a co-formulation of Fovista and a proprietary anti-VEGF treatment, and (2) a Fovista pre-filled syringe, which is more important in OUS markets in our view. Ophthotech is entitled to opt-in, under certain conditions (undisclosed), to the US rights to the co-formulated product and the pre-filled syringe.

Biotechnology

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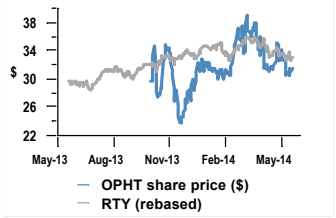
Price Performance



	YTD	1m	3m	12m
Abs	0.5%	-1.0%	-12.7%	5.9%
Rel	4.7%	1.4%	-9.7%	-5.8%

Ophthotech Corp. (OPHT;OPHT US)

FYE Dec	2012A	2013A	2014E (Prev)	2014E (Curr)	2015E (Prev)	2015E (Curr)
EPS ($)						
Q1 (Mar)	-	(6.07)	(0.64)A	(0.64)A	-	-
Q2 (Jun)	-	(6.07)	(0.68)	(0.64)	-	-
Q3 (Sep)	-	(10.26)	(0.81)	(0.70)	-	-
Q4 (Dec)	-	(0.65)	(0.88)	(0.77)	-	-
FY	(2.52)	(6.34)	(3.02)	(2.75)	(3.65)	(3.22)

Source: Company data, Bloomberg, J.P. Morgan estimates. Note: Q1, Q2 2013 numbers reflect JPMe as co. still to disclose actual numbers; increaed share count plus IPO account for numbers not summing.

Company Data	
Price ($)	31.46
Date Of Price	19 May 14
52-week Range ($)	42.54-22.61
Market Cap ($ mn)	1,015.59
Fiscal Year End	Dec
Shares O/S (mn)	32
Price Target ($)	51.00
Price Target End Date	31-Dec-14

See page 6 for analyst certification and important disclosures.

- **Rationale for Novartis.** Novartis has an entrenched ophthalmology franchise, spanning Alcon's front-of-the-eye and vision care assets, as well as, more importantly, the OUS rights to Lucentis (which generated $2.4B in OUS sales in 2013), Thrombogenic's Jetrea for vitreomacular adhesions, as well as two recently highlighted pipeline assets in phase 2 trials (LFG316 for geographic atrophy, and ESBA1008, a proprietary anti-VEGF being evaluated in wet AMD). We see the deal as leveraging the company's existing footprint, as well as a potential avenue for differentiating ESBA1008 from Regeneron's Eylea.

- **Impact on royalty sales / dilution.** Based on today's deal, we believe the company's strong cash position will render a potential third and final Fovista royalty sale tranche to Novo A/S as unnecessary. Further, we no longer see any need for the company to carry out further dilutive financings prior to the US commercialization of Fovista.

- **Adjusting estimates.** Based on the deal terms, namely amortization of milestone revenue, modestly decreased R&D costs (due to Novartis cost share), reduced need for further dilutive financing, and increased cash position, we are raising our 2014 and 2015 EPS estimates to ($2.75) and ($3.22) from ($3.02) and ($3.65), respectively.

- **Reiterate Overweight rating**. We are raising our price target to $51 from $40. We value the Fovista US rights at $24/sh, the OUS royalties at $15/sh, and the company's projected YE14 cash position at $12/sh). Any Fovista milestones (beyond the upfront fee) and value from Zimura provide upside to our estimates.

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Changes to Our Model

Based on the deal terms, namely amortization of milestone revenue, reduced need for further dilutive financing, we are raising our 2014 and 2015 EPS estimates to ($2.75) and ($3.22) from ($3.02) and ($3.65), respectively.

Table 1: Changes to Our Model

	2014E OLD	2014E NEW	2015E OLD	2015E NEW
Expenses				
R&D	76.0	76.0	100.0	100.0
SG&A	24.3	24.3	26.5	26.5
Total Op Ex	100.3	100.3	126.5	126.5
Net income	-100.2	-91.4	-125.5	-110.8
GAAP EPS ($)	**-3.02**	**-2.75**	**-3.65**	**-3.22**
shares	33.2	33.2	34.4	34.4

Source: J.P. Morgan estimates.

Investment Thesis, Valuation and Risks

Ophthotech *(Overweight; Price Target: $51.00)*

Investment Thesis

Fovista is the key value driver for OPHT shares. Based on the efficacy data from the phase 2b, the combination of an anti-PDGF and anti-VEGF offers potentially best-in-class efficacy with meaningful improvements against the traditional regulatory endpoints of visual acuity, as well as an underappreciated endpoint, regression of neovascularization lesions, against which traditional therapy had minimal effect. As such, we view the phase 3 results as being significantly de-risked and believe Fovista will find use in both treatment-naïve AMD patients, and those requiring monthly anti-VEGF injections. We further view the company's recent licensing deal with Novartis as validation. We believe Fovista has a two- to three-year head start over other anti-PDGF therapies in development.

Valuation

Our December 2014 $51 price target is based on our sum-of-the-parts NPV analysis. Our analysis is based on projected Fovista sales from a projected launch in 2017 through 2025. We conservatively modeled a 12.5% WACC and zero terminal values for the drug in the US and EU. Based on the above projections and assumptions, as well as probability of success adjustments, we derive a valuation of $51/share, comprising US sales of Fovista of $24/sh, OUS sales of Fovista of $15/sh, and $12/sh for net cash. Fovista downstream milestones and any value from the company's second asset, Zimura, should be viewed as upside to our model.

Risks to Rating and Price Target

Key downside risks to our rating and price target include (1) clinical risk associated with outcome of the phase 3 studies of Fovista, (2) commercial risk that the drug will

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offer meaningful benefit over the current treatment paradigm as well as the impact of competing agents risk, and (3) reimbursement risk for Fovista.

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J.P.Morgan

Ophthotech: Summary of Financials

Income Statement - Annual	FY13A	FY14E	FY15E	FY16E
Revenues	0	9	15	-
Cost of products sold	0	0	0	-
Gross profit	-	-	-	-
SG&A	(14)	(24)	(27)	-
R&D	(33)	(76)	(100)	-
Operating income	(47)	(91)	(112)	-
EBITDA	(47)	(91)	(112)	-
Net interest (income) / expense	-	-	-	-
Other income / (expense)	(4)	0	1	-
Income taxes	0	0	0	-
Net income - GAAP	(57)	(91)	(111)	-
Net income - recurring	(57)	(91)	(111)	-
Diluted shares outstanding	9	33	34	-
EPS - excluding non-recurring	(6.34)	(2.75)	(3.22)	-
EPS - recurring	(6.34)	(2.75)	(3.22)	-

Balance Sheet and Cash Flow Data	FY13A	FY14E	FY15E	FY16E
Cash and cash equivalents	211	161	50	-
Accounts receivable	7	7	7	-
Inventories	-	-	-	-
Other current assets	0	0	0	-
Current assets	217	168	57	-
PP&E	0	0	0	-
Total assets	218	168	57	-
Total debt	0	0	0	-
Total liabilities	48	48	48	-
Shareholders' equity	170	120	9	-
Net income (including charges)	(51)	(91)	(111)	-
D&A	0	0	0	-
Change in working capital	(3)	0	0	-
Other	4	0	0	-
Cash flow from operations	(50)	(91)	(111)	-
Capex	(0)	(0)	(0)	-
Free cash flow	(50)	(91)	(111)	-
Cash flow from investing activities	(0)	(0)	(0)	-
Cash flow from financing activities	255	42	0	-
Dividends	-	-	-	-
Dividend yield	-	-	-	-

Income Statement - Quarterly	1Q14A	2Q14E	3Q14E	4Q14E
Revenues	0A	1	4	4
Cost of products sold	0A	0	0	0
Gross profit	-	-	-	-
SG&A	(6)A	(6)	(6)	(6)
R&D	(14)A	(17)	(21)	(24)
Operating income	(21)A	(21)	(23)	(26)
EBITDA	(21)A	(21)	(23)	(26)
Net interest (income) / expense	-	-	-	-
Other income / (expense)	0A	0	0	0
Income taxes	0A	0	0	0
Net income - GAAP	(21)A	(21)	(23)	(26)
Net income - recurring	(21)A	(21)	(23)	(26)
Diluted shares outstanding	32A	33	34	34
EPS - excluding non-recurring	(0.64)A	(0.64)	(0.70)	(0.77)
EPS - recurring	(0.64)A	(0.64)	(0.70)	(0.77)

Ratio Analysis	FY13A	FY14E	FY15E	FY16E
Sales growth	-	-	66.7%	-
EBIT growth	246.6%	92.8%	22.3%	-
EPS growth - recurring	151.1%	(56.5%)	17.0%	-
Gross margin	-	-	-	-
EBIT margin	-	(1036.6%)	(760.5%)	-
EBITDA margin	-	(1036.6%)	(760.5%)	-
Tax rate	0.0%	0.0%	0.0%	-
Net margin	-	(1036.1%)	(753.7%)	-
Net Debt / EBITDA	444.1%	175.8%	44.6%	-
Net Debt / Capital (book)	515.2%	393.2%	122.1%	-
Return on assets (ROA)	(51.3%)	(47.4%)	(98.6%)	-
Return on equity (ROE)	(246.6%)	(63.1%)	(172.0%)	-
Enterprise value / sales	-	-	-	-
Enterprise value / EBITDA	-	-	-	-
Free cash flow yield	(17.6%)	(8.8%)	(10.2%)	-

Source: Company reports and J.P. Morgan estimates.
Note: $ in millions (except per-share data).Fiscal year ends Dec

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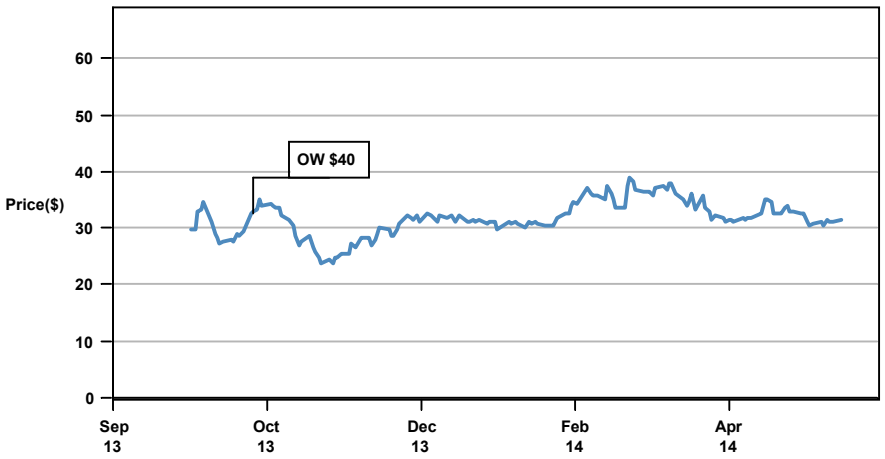
Ophthotech (OPHT, OPHT US) Price Chart



Date	Rating	Share Price ($)	Price Target ($)
21-Oct-13	OW	32.67	40.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Oct 21, 2013.

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