Conatus Pharmaceuticals (CNAT)

SunTrust Robinson Humphrey

Clinical Development Plan on Track

2Q13 Results a Non-Event

Buy

Price Target: $17.00
Prior: $17.00

What's Incremental

CNAT reported a 2Q13 operating loss modestly better than our forecast with opex coming in below our expectations. Our opex & cash burn estimates remain unchanged. The focus is the initiations of the HCV-POLT & ACLF trials, which management expects to initiate in 2H13. However, management is delaying orphan drug filing for ACLF until after data is available in 1H14. CNAT is expected to host a meeting with investors at the upcoming AASLD meeting in November.

- **Lower expenses help moderate operating loss.** Net opex of $1.8M was below our $2M estimate with R&D coming in higher & G&A expense lower relative to our model. One-time net gains related to convertible preferred shares, bridge financing expenses & a lower share count resulted in EPS of $0.16 vs. our ($0.22) loss per share. Our operating expense forecast remains unchanged, but we assume a slightly higher net interest expense. Anticipated cash burn remains at $10M in 2013E & ~$25M in 2014E.

- **HCV-POLT the priority; pursuing orphan status for ACLF after data.** Management indicated its near-term priority is to initiate its Phase IIb/III HCV-POLT study. This should be followed by the ACLF trial shortly thereafter. However, the company is not expected to pursue its filing for orphan drug designation until after it evaluates the Phase IIb results which are expected in 1H14. The recent FDA/AASLD workshop on future NASH liver trial design resulted in no clear consensus apart from the significant unmet need, which does not affect long-term optionality in NASH and other potential indications.

- **Next catalyst is a CNAT analyst meeting at AASLD.** Management indicated it plans on hosting an analyst event for investors on Nov. 4th at the upcoming Liver Meeting/ AASLD in Washington, DC. We look for a top opinion leading hepatologist to provide greater insight into clinicians' perspective on the clinical trials that CNAT is pursuing. Other catalysts to look for include: 1) initiation of the Phase III HCV-POLT study, 2) initiation of the Phase IIb ACLF dosing study, and 3) ACLF data in 1H14.

Price (Sep. 6, 2013)	$8.77
52-Wk Range	$9.62-$8.77
Market Cap ($M)	$137
ADTV	139,771
Shares Out (M)	15.6
Short Interest Ratio/% Of Float	0.2%
Dividend/Yield	$0.00/
Yield	0.0%

	2012A	2013E		2014E	
		Curr.	Prior	Curr.	Prior
EPS					
1Q	(0.21)	(0.25)A	(0.25)	(0.36)	(0.34)
2Q	(1.81)	0.16A	(0.22)A	(0.39)	(0.37)
3Q	--	(0.19)	(0.18)	(0.46)	(0.43)
4Q	--	(0.26)	(0.25)	(0.44)	(0.42)
FY	(0.95)	(1.35)	(0.88)	(1.64)	(1.54)
P/E	(9.2)x	(6.5)x		(5.3)x	
Revenue ($M)					
FY	0	0	0	0	0
FYE Dec					

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Lower expenses help moderate operating loss

Net operating expense of $1.8 million was below our $2 million estimate with R&D expense coming in higher and G&A expense lower relative to our model (see Exhibit 1). Below the line, one-time net gains related to convertible preferred shares, bridge financing, and a lower share count resulted in EPS of $0.16 versus our ($0.22) loss per share. Our operating expense forecast remains unchanged though we now expect slightly higher net interest expense. Anticipated cash burn remains at $10 million this year and $25 million in 2014. Our updated model is in Exhibits 2-4.

Exhibit 1: CNAT 2Q13 Variance Analysis

Sales ($ thousands)	CNAT Actual 2Q13A	% Chg. YOY	STRH Estimated 2Q13E	% Chg. YOY	Variance Actual vs. STRH Estimate U.S. $	% Difference	EPS Impact	Consensus 2Q13E
Emricasan (Total)	$0	NM	$0	NM	$0	NM		$0

Income Statement	CNAT Actual 2Q13A	% Chg. YOY	STRH Estimated 2Q13E	% Chg. YOY	Variance Actual vs. STRH Estimate U.S. $	% Difference	EPS Impact	Consensus 2Q13E
Total Sales	**0**	**NM**	**0**	**NM**	**0**	**NM**	**$0.00**	**0**
COGS	0	NM	0	NM	0	NM	0.00	0
Gross Profit (Loss)	**0**	**NM**	**0**	**NM**	**0**	**NM**	**0.00**	**0**
R&D	1,117	0%	470	NM	647	138%	0.45	NA
General & Administrative	670	3%	1,540	NM	(870)	-56%	(0.60)	NA
Sales & Marketing	0	NM	0	NM	0	NM	0.00	NA
Operating Profit (Loss)	**(1,788)**	**1%**	**(2,010)**	**NM**	**222**	**-11%**	**0.15**	**(2,000)**
Interest Income	0	-100%	0	NM	(0)	-100%	(0.00)	NA
Interest Expense	(196)	1021%	(18)	NM	(179)	1021%	(0.12)	NA
Other Income (Expense)	(2,890)	5744%	0	NM	(2,890)	NM	(2.01)	NA
(Loss) gain on change in fair value of warrant liability	0	NM	0	NM	0	NM	0.00	NA
Pretax Income (Loss)	**(4,873)**	**167%**	**(2,027)**	**NM**	**(2,846)**	**140%**	**(1.98)**	**(1,990)**
Taxes (Benefit)	0	NM	0	NM	0	NM	0.00	NA
Tax Rate	NM	NM	NM	NM	NM	NM	NM	NA
Net Income (Loss)	**224**	**-112%**	**(2,027)**	**NM**	**2,251**	**-111%**	**1.56**	**(1,960)**
EPS (LPS)	**0.16**	**-109%**	**(0.22)**	**NM**	**0**	**-171%**	**$0.00**	**(0.21)**
Average Diluted Shares Outstanding	1,439	42%	9,299	0%	(7,860)	-85%		

Margin Analysis	CNAT Actual 2Q13A	% Chg. YOY	STRH Estimated 2Q13E	% Chg. YOY	Variance Actual vs. STRH Estimate Basis Points	2Q12A	EPS Impact	Consensus 2Q13E
Gross Margin	NM	NM	NM	NM	NM	NM		NM
R&D	NM	NM	NM	NM	NM	NM		NM
General & Administrative	NM	NM	NM	NM	NM	NM		NM
Sales & Marketing	NM	NM	NM	NM	NM	NM		NM
Operating Margin	NM	NM	NM	NM	NM	NM		NM
Pretax Margin	NM	NM	NM	NM	NM	NM		NM
Net Margin	NM	NM	NM	NM	NM	NM		NM

Source: SunTrust Robinson Humphrey estimates, Thomson First Call, company reports

HCV-POLT the priority; pursuing orphan status for ACLF after Phase IIb data

Management indicated the Phase IIb/III HCV-POLT study is on track and ready to start and will be the near-term priority with the ACLF Phase IIb trial to follow shortly thereafter. Additionally, it now appears pursuit of an orphan disease designation for ACLF will wait until after the Phase IIb results (still expected in 1H14). The recent FDA/AASLD workshop on future NASH liver trial design resulted in no clear consensus apart from recognition of the significant unmet need, which does not affect view that CNAT retains long-term optionality in fatty liver/NASH and other potential orphan indications.

Next catalyst is analyst meeting at AASLD

CNAT will hold an analyst event on Nov. 4th at the upcoming Liver Meeting/ AASLD in Washington, DC, which should provide greater insight into clinicians' perspective on CNAT's clinical trials. Other catalysts that could move CNAT share are: 1) initiation of the Phase III HCV-POLT study, 2) initiation of the Phase IIb ACLF dosing study, and 3) ACLF data in 1H14.

Exhibit 2: Conatus Pharmaceuticals Profit and Loss Model – 2011A to 2020E

($ in thousands, except per share data)	2011A	2012A	1Q13A	2Q13A	3Q13E	4Q13E	2013E	2014E	2015E	2016E	2017E	2018E	2019E	2020E
Total risk-adjusted revenue	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$6,843**	**$40,152**	**$81,136**	**$159,758**
Cost of goods sold ($20K/kilo)	0	0					0	0	0	0	1,026	6,023	12,170	23,964
Gross profit	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$5,816**	**$34,129**	**$68,966**	**$135,794**
Research & Development	9,487	5,528	968	1,117	1,485	2,455	6,025	18,400	19,380	15,350	5,474	5,822	6,897	6,390
Total SG&A	2,875	3,086	749	670	1,540	1,640	4,599	7,220	7,602	6,163	13,035	20,409	22,261	24,252
Total expenses	$12,361	$8,615	$1,717	$1,788	$3,025	$4,095	$10,624	$25,620	$26,982	$21,513	$18,509	$26,231	$29,158	$30,642
Operating Profit (Loss)	**($12,361)**	**($8,615)**	**($1,717)**	**($1,788)**	**($3,025)**	**($4,095)**	**($10,624)**	**($25,620)**	**($26,982)**	**($21,513)**	**($12,693)**	**$7,899**	**$39,808**	**$105,152**
Interest Income	$28	$26	0	0	38	38	$152	$220	$190	$171	$66	$30	$114	$404
Interest Expense	(114)	(70)	(18)	(196)	(40)	(40)	(276)	(160)	(160)	(160)	(160)	(160)	(120)	(40)
Other Income (Expense)	450	(90)	(563)	(2,890)			(3,452)	0	0	0	(6,000)	(6,000)	0	0
(Loss) gain on change in fair value of warrant liability	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Pretax Income (Loss)	**($11,997)**	**($8,749)**	**($2,297)**	**($4,873)**	**($3,027)**	**($4,097)**	**($14,201)**	**($25,560)**	**($26,952)**	**($21,502)**	**($18,787)**	**$1,769**	**$39,802**	**$105,516**
Tax Expense (Benefit)	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Net Income (Loss)	**($11,997)**	**($8,749)**	**($2,297)**	**$224**	**($3,027)**	**($4,097)**	**($14,201)**	**($25,560)**	**($26,952)**	**($21,502)**	**($18,787)**	**$1,769**	**$39,802**	**$105,516**
EPS - basic		($0.95)	($0.25)	$0.20	($0.19)	($0.26)	($1.36)	($1.64)	($1.36)	($1.08)	($0.95)	$0.09	$2.01	$5.32
EPS - diluted	**($1.44)**	**($0.95)**	**($0.25)**	**$0.16**	**($0.19)**	**($0.26)**	**($1.35)**	**($1.64)**	**($1.36)**	**($1.08)**	**($0.95)**	**$0.09**	**$2.01**	**$5.32**
Consensus			*($0.71)*	*$0.16*	*($0.23)*	*($0.29)*	*($1.04)*	*($1.42)*	*($1.69)*	*($1.82)*	*($1.76)*	*#N/A*	*#N/A*	*#N/A*
Basic share outstanding		9,255	9,299	1,139	15,608	15,608	10,413	15,608	19,818	19,818	19,818	19,818	19,818	19,818
Diluted shares outstanding	8,342	9,255	9,299	1,439	15,608	15,608	10,488	15,608	19,818	19,818	19,818	19,818	19,818	19,818

Margin analysis	**2011A**	**2012A**	**1Q13A**	**2Q13A**	**3Q13E**	**4Q13E**	**2013E**	**2014E**	**2015E**	**2016E**	**2017E**	**2018E**	**2019E**	**2020E**
Gross margin (on sales)	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	85.0%	85.0%	85.0%	85.0%
Research & Development	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	80.0%	14.5%	8.5%	4.0%
General & Administrative	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	94.5%	18.8%	10.8%	6.3%
Sales & Marketing	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	96.0%	32.0%	16.6%	8.9%
Total SG&A	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	190.5%	50.8%	27.4%	15.2%
Operating profit	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**-185.5%**	**19.7%**	**49.1%**	**65.8%**
Pretax income	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	-274.6%	4.4%	49.1%	66.0%
Effective tax rate	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	0.0%	0.0%	0.0%
Net income	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**-274.6%**	**4.4%**	**49.1%**	**66.0%**

YoY % change	**2011A**	**2012A**	**1Q13A**	**2Q13A**	**3Q13E**	**4Q13E**	**2013E**	**2014E**	**2015E**	**2016E**	**2017E**	**2018E**	**2019E**	**2020E**
Total risk-adjusted revenue	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**486.8%**	**102.1%**	**96.9%**
Gross Profit	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**486.8%**	**102.1%**	**96.9%**
Research & Development	NM	-41.7%	-16.7%	-0.2%	NM	NM	9.0%	205.4%	5.3%	-20.8%	-64.3%	6.4%	18.5%	-7.3%
General & Administrative	NM	7.4%	-0.2%	3.2%	NM	NM	49.0%	42.9%	6.0%	5.8%	18.0%	17.0%	16.0%	15.0%
Sales & Marketing	NM	NM	NM	NM	NM	NM	NM	NM	5.0%	0.0%	862.3%	95.5%	5.0%	5.0%
Total SG&A	NM	7.4%					49.0%	57.0%	5.3%	-18.9%	111.5%	56.6%	9.1%	8.9%
Operating profit	**NM**	**-30.3%**					**23.3%**	**141.1%**	**5.3%**	**-20.3%**	**-41.0%**	**-162.2%**	**404.0%**	**164.1%**
Pretax income	NM	-27.1%	20.7%	166.7%	NM	NM	62.3%	80.0%	5.4%	-20.2%	-12.6%	-109.4%	2150.5%	165.1%
Tax Expense (Benefit)	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM
Net Income (Loss)	NM	-27.1%	20.7%	-112.2%	NM	NM	62.3%	80.0%	5.4%	-20.2%	-12.6%	-109.4%	2150.5%	165.1%
EPS - diluted	**NM**	**-34.3%**	**20.2%**	**-108.6%**	**NM**	**NM**	**43.2%**	**21.0%**	**-17.0%**	**-20.2%**	**-12.6%**	**-109.4%**	**2150.5%**	**165.1%**

Source: STRH estimates, company reports

Exhibit 3: Conatus Pharmaceuticals Balance Sheet Model – 2011A to 2020E

($ in thousands except per share data)	2011A	2012A	2013E	2014E	2015E	2016E	2017E	2018E	2019E	2020E
Assets										
Cash and cash equivalents	$3,073	$4,036	$56,574	$31,359	$44,719	$23,548	$2,907	$8,920	$36,829	$124,599
Short-term investments	13,685	3,989	219	184	148	112	77	41	5	0
Accounts and trade receivables	0	0	0	0	0	0	3,079	16,061	28,398	47,927
Inventories	0	0	0	0	50	100	513	2,710	5,112	9,825
Prepaid and other current assets	165	76	76	76	76	76	137	803	1,623	3,195
Total current assets	**$16,923**	**$8,102**	**$56,870**	**$31,619**	**$44,993**	**$23,836**	**$6,713**	**$28,535**	**$71,966**	**$185,546**
Property and equipment, net	$21	$30	$19	$8	($3)	($13)	($24)	($67)	($155)	($327)
Deferred tax assets	0	0	0	0	0	0	0	0	0	0
Other noncurrent assets	14	14	40	40	40	40	7	40	81	160
Total noncurrent assets	$36	$44	$59	$48	$38	$27	($17)	($27)	($74)	($167)
Total assets	**$16,959**	**$8,146**	**$56,929**	**$31,667**	**$45,031**	**$23,863**	**$6,696**	**$28,508**	**$71,892**	**$185,379**
Liabilities and Stockholders' Equity										
Current Liabilities:										
Short-term debt	$0	0	0	0	0	0	0	0	1,000	0
Accounts payable & accrued expenses	$1,179	1,087	1,087	1,087	1,087	1,087	513	2,409	3,651	4,793
Accrued compensation	542	326	326	326	326	326	2,053	18,068	16,227	15,976
Total current liabilities	**$1,721**	**$1,413**	**$1,413**	**$1,413**	**$1,413**	**$1,413**	**$2,566**	**$20,477**	**$20,878**	**$20,768**
Preferred stock warrant liability	69	160	160	157	154	151	148	145	142	139
Note payable	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	0	0
Other	0	0	0	0	0	0	0	0	0	0
Total liabilities	**$2,790**	**$2,573**	**$2,573**	**$2,570**	**$2,567**	**$2,564**	**$3,714**	**$21,622**	**$21,020**	**$20,908**
Stockholders' Equity:										
Common Stock (Series A)	$32,209	$32,209	$91,367	$91,541	$131,733	$131,944	$132,286	$134,294	$138,350	$146,338
Common Stock (Series B)	31,700	31,700	31,700	31,700	31,700	31,700	31,700	31,700	31,700	31,700
Common Stock	1	1	1	1	1	1	1	1	1	1
Additional paid-in capital	323	470	470	470	470	470	470	470	470	470
Accumulated other comprehensive income (deficit)	(4)	1	1	1	1	1	1	1	1	1
(Deficit)/Earnings accumulated	(50,058)	(58,808)	(69,183)	(94,615)	(121,441)	(142,816)	(161,476)	(159,580)	(119,650)	(14,038)
Total stockholders' equity (deficit)	**$14,169**	**$5,573**	**$54,356**	**$29,097**	**$42,464**	**$21,299**	**$2,982**	**$6,885**	**$50,872**	**$164,471**
Total liabilities and stockholders' equity (deficit)	**$16,959**	**$8,146**	**$56,929**	**$31,667**	**$45,031**	**$23,863**	**$6,696**	**$28,508**	**$71,892**	**$185,379**

Source: STRH estimates, company reports

Exhibit {XX}: Conatus Pharmaceuticals Statement of Cash Flows Model - – 2011A to 2020E

($ in thousands except per share data)	2011A	2012A	2013E	2014E	2015E	2016E	2017E	2018E	2019E	2020E
Cash flows from operating activities:										
Net Income (loss)	($11,997)	($8,749)	($14,201)	($25,560)	($26,952)	($21,502)	($18,787)	$1,769	$39,802	$105,516
Depreciation and amortization	294	181	20	46	46	46	46	99	164	257
Stock-based compensation expense	160	144	158	174	192	211	342	2,008	4,057	7,988
Loss (gain) on changes in fair value of warrant liability			0	(3)	(3)	(3)	(3)	(3)	(3)	(3)
Deferred income taxes			0	0	0	0	0	0	0	0
Change in lease liability			0	0	0	0	0	0	0	0
Other	(455)	92	92	92	92	92	92	92	92	92
Changes in assets and liabilities:										
Short term investments			3,770	36	36	36	36	36	36	5
Accounts and trade receivables			0	0	0	0	(3,079)	(12,982)	(12,337)	(19,530)
Inventories			0	0	(50)	(50)	(413)	(2,197)	(2,401)	(4,713)
Prepaid expenses & other current assets	(68)	89	0	0	0	0	(61)	(666)	(820)	(1,572)
Deferred tax assets			0	0	0	0	0	0	0	0
Other non-current assets	102	0	(26)	0	0	0	33	(33)	(41)	(79)
Accounts payable and other current liabilities	176	(92)	0	0	0	0	1,153	17,911	(599)	890
Other long-term liabilities	(308)	(229)	0	0	0	0	0	0	0	0
Net cash generated (used) in operating activities	**($12,096)**	**($8,564)**	**($10,187)**	**($25,215)**	**($26,640)**	**($21,171)**	**($20,641)**	**$6,033**	**$27,949**	**$88,849**
Cash flows from investing activities:										
Maturities of investments	$18,936	$19,838	$3,725	$0	$0	$0	$0	$0	$0	$0
Purchases of investments	(32,908)	(10,309)	0	0	0	0	0	0	0	0
Capital Expenditures	(16)	(18)	0	0	0	0	0	(20)	(41)	(80)
Net cash generated (used) in investing activities	**($13,989)**	**$9,511**	**$3,725**	**$0**	**$0**	**$0**	**$0**	**($20)**	**($41)**	**($80)**
Cash flows from financing activities:										
Short-term borrowings	$0	$0	$0	$0	$0	$0	$0	$0	$1,000	($1,000)
Proceeds from issuance of common stock	0	16	59,000	0	40,000	0	0	0	0	0
Proceeds from exercise of stock options / warrants (net of costs)	26,424	0	0	0	0	0	0	0	0	0
Share repurchase		0	0	0	0	0	0	0	0	0
Proceeds from issuance of debt		0	0	0	0	0	0	0	(1,000)	0
Repayment of debt		0	0	0	0	0	0	0	0	0
Repayment of finance leases		0	0	0	0	0	0	0	0	0
Dividends		0	0	0	0	0	0	0	0	0
Other		0	0	0	0	0	0	0	0	0
Net cash flow provided (used) by financing activities	**$26,424**	**$16**	**$59,000**	**$0**	**$40,000**	**$0**	**$0**	**$0**	**$0**	**($1,000)**
Impact from Foreign Exchange		0	0	0	0	0	0	0	0	0
Net increase (decrease) in cash and cash equivalents	**$340**	**$963**	**$52,538**	**($25,215)**	**$13,360**	**($21,171)**	**($20,641)**	**$6,013**	**$27,909**	**$87,769**
Cash and cash equivalents, beginning of period	$2,733	$3,073	$4,036	$56,574	$31,359	$44,719	$23,548	$2,907	$8,920	$36,829
Cash and cash equivalents, end of period	**$3,073**	**$4,036**	**$56,574**	**$31,359**	**$44,719**	**$23,548**	**$2,907**	**$8,920**	**$36,829**	**$124,599**

Source: STRH estimates, company reports

Company Description

Conatus Pharmaceuticals, Inc. is a clinical-stage biotechnology company focused on developing drugs to treat liver diseases. The company's lead compound, emricasan, is a first-in-class, orally active pan-caspase inhibitor designed to reduce inflammation and cell death, thereby disrupting the pathway leading to liver fibrosis and cirrhosis. The company is currently focused on developing emricasan for the treatment of patients with acute-on-chronic liver failure (ACLF), chronic liver failure (CLF), and HCV-related post-orthotopic liver transplants (HCV-POLT). In 2005, Pfizer acquired emricasan from Idun Pharmaceuticals (Conatus's predecessor company). In 2010, Conatus re-acquired emricasan from Pfizer and is continuing to develop it through the clinical stage process.

Investment Thesis

We rate CNAT a Buy with a $17 price target given its attractive risk-reward based on our conservative revenue and DCF assumptions. Our valuation analysis applies a significant discount rate appropriate for early clinical-stage companies to our heavily risk adjusted revenue and cash flow estimates, which suggests that CNAT's shares are undervalued. We view CNAT as a pioneer in the development of its 1st-in-class oral caspase protease inhibitor, emricasan, for treating liver disease & fibrosis. We view the clinical development and regulatory risks as high due to the challenging patient population. CNAT has attempted to minimize this risk through the favorable histological data that it has presented and pre-clinical studies that have had some conflicting results in key biomarkers for cell death and inflammation. On the regulatory front, there is uncertainty on the use of surrogate endpoints in liver disease clinical trials and their potential clinical utility in a patient population that frequently has other co-morbidities and high mortality rates. In Europe, regulators have expressed greater acceptance of surrogate endpoints in orphan liver trials, while in the US Conatus remains in ongoing discussions with the FDA regarding clinical trial design for emricasan. Our model assumes initial EU launches in chronic liver failure (CLF) & acute-on-chronic liver failure (ACLF) in 2017E, & Hepatitis C virus-related post-orthotopic liver transplant (HCV-POLT) in 2018E. In the US, we assume a CLF launch in 2018E, ACLF in 2019E & HCV-POLT in 2020E. However, given that lack of a clear pathway to US approval, Conatus could potentially be required to conduct additional trials which would not only result in longer timelines than we have modeled but also greater capital requirements. We view the commercial risk as low and offering a high degree of operating leverage since only 16/12 US/EU sales representatives would be needed to cover >90% of the liver transplant centers. In addition, the three potential orphan disease populations targeted have a high unmet medical need and represent a large market opportunity through the US/EU exclusivity periods of 2028/2027 withstanding any patent challenges and excluding any extensions. If Conatus is able to navigate the clinical and regulatory risks for emricasan, our 15 % risk adjustment to our $430M revenue assumption in 2028E could prove to be overly conservative. Consequently, any upward revision to our sales forecast would have material upside to Conatus's earnings power as well as its intrinsic value.

Valuation and Risks

Valuation

Conatus is a clinical stage company unlikely to achieve either revenues or profitability until the latter part of the decade, so we primarily value the company using a discounted cash flow (DCF) analysis. Also, the paucity of 2018+ consensus revenue and profitability estimates for most clinical stage and orphan disease companies makes valuing CNAT shares difficult; hence we do not include a peer group comparison in our valuation analysis. In our DCF we apply an estimated WACC of 16.7% and terminal growth rate of 1.0% to Conatus’s projected free cash flows from the present through its 2028 exclusivity period. The present value of Conatus’s 2013E-2028E cash flows are approximately $140 million and the present value of its estimated terminal value is $105 million. Adjusted for its average 2012A/2013E net cash position, our discounted cash flow valuation analysis of CNAT shares suggests an intrinsic value of approximately $17 per share. We have also tested our DCF assumptions below by varying our estimated WACC and terminal growth rates in 50 basis points (bps) increments. Each 50 bps deviation from our WACC changes the intrinsic value by approximately 8%, whereas each 50 bps increment in the assumed terminal growth rate changes the intrinsic value by approximately 2%.

We would note that a significant portion of our estimate is derived from: 1) projected cash flows for 2018E and beyond which is the earliest timeframe that we forecast Conatus to become cash flow positive, and 2) the estimated present value of terminal value accounts for a large portion of our intrinsic value. Our model also assumes that Conatus will utilize its existing $105M and anticipated

net operating losses (NOLs) to offset future tax expenses. Additionally, the projected cash flows in our model could differ materially from our estimate should Conatus fail to garner initial EU and US approval or other subsequent indications for emricasan.

Risks

Downside risks to our price target (PT) include: 1) regulatory risk since no drugs are approved in the liver diseases Conatus is targeting (acute-on-chronic liver failure (ACLF), chronic liver failure (CLF), and HCV-related post-orthotopic liver transplant (HCV-POLT), and regulators could require trial designs that increase the risk of securing approval (especially in the US); 2) clinical development risk since the endpoints in planned clinical trials have not demonstrated benefits in these populations; 3) uncertainty over the acceptability and predictive power of blood markers for inflammation and cell death used in future clinical trials. This risk is heightened by conflicting preclinical data that showed conflicting results in liver enzyme reduction, which creates risk for future clinical studies of emricasan; 4) dilution risk given future capital requirements to advance emricasan through the clinical, regulatory and commercial phases of the products life cycle. Upside risks to our PT includes overly conservative risk adjustments to the probability of clinical trial success for emricasan. If emricasan successfully advances through the clinical, regulatory and commercial stages, our estimates could prove conservative and provide upside to our PT.

Analyst Certification

I, John T. Boris , hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

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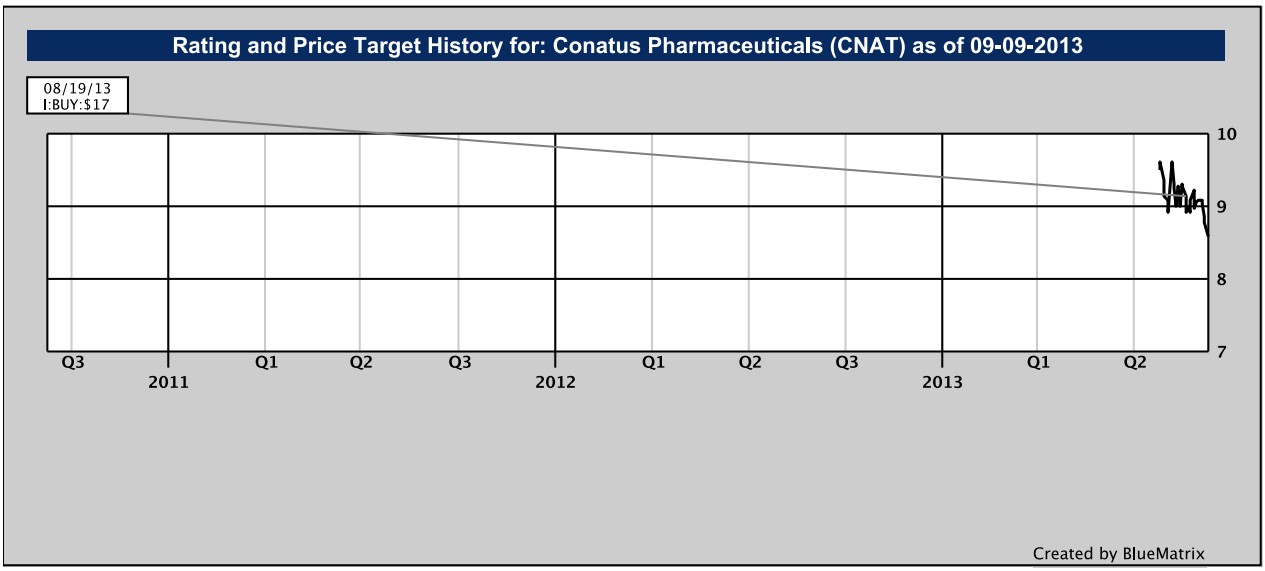

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Stock Ratings
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*Total return (price appreciation + dividends)
**Price targets are within a 12-month period, unless otherwise noted
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Legend for Rating and Price Target History Charts:
D = drop coverage
I = initiate coverage
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