Conatus Pharmaceuticals (CNAT)

3Q13 Post View – ACLF is the Focus

ACLF is the focal point, as CNAT delays its HCV-POLT trial

Buy

Price Target: $17.00
Prior: $17.00

What's Incremental

CNAT reported a 3Q13 operating loss of -$3.0M, in line with our -$3.0M est. & below consensus of -$2.8M. CNAT is enrolling its UK Phase IIb ACLF trial; however CNAT delayed its Phase IIb/III HCV-POLT trial given likely difficulty in recruiting patients & maintaining emricasan compliance. We assume the $22M in HCV-POLT trial costs are partially redeployed to accelerate ACLF enrollment, rollout the CLF trial in 2H14 & further explore NAFLD/NASH. The HCV-POLT delay provides CNAT an incremental cash cushion. The next catalysts are ACLF trial completion & data readout in 1H14 & 2H14, respectively.

3Q13 Op Ex in line with forecast (Exhibit 1 for our variance analysis)

R&D expense of $1.9M was +27% above our $1.5M estimate while G&A expense of $1.1M was -28% below our $1.5M estimates. CNAT's operating loss of -$3.0M was in line with our forecast but modestly worse than the -$2.8M consensus expectation. Below the line, interest expense and financing costs were higher than anticipated, which combined with a lower share count resulted in a LPS of -$0.28 vs. our -$0.19 estimate and consensus of -$0.27. CNAT finished 3Q with $59M in cash and investments, reflecting its net post-IPO proceeds.

Emricasan development cadence shifted with HCV-POLT delay

With Gilead's (GILD, $68.98, NR) sofosbuvir reporting an SVR4 of 77%, CNAT announced it is delaying the start of its Phase IIb/III HCV-POLT trial that had been planned for 2H13 given anticipated difficulties in patient recruiting and compliance. We view this as a practical strategic decision given multiple promising oral direct acting anti-viral therapies on the horizon that are expected to significantly reduce the addressable HCV population. As a result of CNAT's decision, our model assumes HCV-POLT is delayed by 2-years. More important, the ACLF Phase IIb dosing trial (n=60) being conducted at 15-17 study centers in the UK (with possible additions) is underway, which should shape the Phase III discussion with US/EU regulators in 2H14. While we still expect the Phase IIb CLF trial to begin in 2H14, we suspect CNAT will redeploy some of $22M budgeted to HCV-POLT into the ongoing ACLF study & to push ahead with CLF. We also view accelerated exploration of NAFLD/NASH subpopulations as probable though definition of endpoints and trial design remain moving targets following the recent AASLD/FDA workshop.

Catalysts through YE13/1H14

1) Completion of ACLF enrollment in 1H14; 2) data readout from ACLF in 2H14,; 3) initiation of the CLF trial in 2H14; and 4) clarification of the Phase III ACLF trial design in 2H14/1H15.

Price (Nov. 14, 2013)	$8.25
52-Wk Range	$10.49-$8.25
Market Cap ($M)	$129
ADTV	35,322
Shares Out (M)	15.6
Short Interest Ratio/% Of Float	3.1%
Dividend/Yield	$0.00/0.0%
TR to Target	106.1%

Total Debt	$1.0
BV/Share	$4.98
Cash And Equivalents ($M)	$59.0

	2012A	2013E		2014E	
		Curr.	Prior	Curr.	Prior
EPS					
1Q	($0.21)	($0.25)A	($0.25)	($0.27)	($0.36)
2Q	($1.81)	$0.16A	$0.16	($0.30)	($0.39)
3Q	--	($0.28)A	($0.19)	($0.37)	($0.46)
4Q	--	($0.28)	($0.26)	($0.35)	($0.44)
FY	($0.95)	($0.65)	($1.35)	($1.29)	($1.64)
P/E	NM	NM		NM	
Revenue ($M)					
FY	$0	$0	$0	$0	$0
FYE Dec					

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Exhibit 1: CNAT 3Q13 Variance Analysis

Sales ($ thousands)	CNAT Actual 3Q13A	% Chg. YOY	STRH Estimates 3Q13E	% Chg. YOY	Variance vs. STRH U.S. $	% Difference	EPS Impact	Consensus 3Q13E	Actual 3Q12A
Emricasan (Total)	$0	NM	$0	NM	$0	NM		$0	$0

Income Statement	CNAT Actual 3Q13A	% Chg. YOY	STRH Estimates 3Q13E	% Chg. YOY	Variance vs. STRH U.S. $	% Difference	EPS Impact	Consensus 3Q13E	Actual 3Q12A
Total Sales	**0**	**NM**	**0**	**NM**	**0**	**NM**	**0.00**	**0**	**0**
COGS	0	NM	0	NM	0	NM	0.00	0	0
Gross Profit (Loss)	**0**	**NM**	**0**	**NM**	**0**	**NM**	**0.00**	**0**	**0**
R&D	1,886	6%	1,485	NM	401	27%	0.03	NA	1,774
General & Administrative	1,108	50%	1,540	NM	(432)	-28%	(0.04)	NA	737
Sales & Marketing	0	NM	0	NM	0	NM	0.00	NA	0
Operating Profit (Loss)	**(2,993)**	**19%**	**(3,025)**	**NM**	**32**	**1%**	**0.00**	**(2,820)**	**(2,512)**
Interest Income	8	37%	38	NM	(30)	-80%	(0.00)	NA	6
Interest Expense	(204)	1065%	(40)	NM	(164)	-410%	(0.01)	NA	(18)
Other Income (Expense)	(131)	115%	0	NM	(131)	NM	(0.01)	NA	(61)
Pretax Income (Loss)	**(3,321)**	**28%**	**(3,027)**	**NM**	**(294)**	**-10%**	**(0.03)**	**(2,750)**	**(2,585)**
Taxes (Benefit)	0	NM	0	NM	0	NM	0.00	NA	0
Net Income (Loss)	**(3,321)**	**28%**	**(3,027)**	**NM**	**(294)**	**-10%**	**(0.03)**	**(2,480)**	**(2,585)**
EPS (LPS)	**(0.28)**	**-89%**	**(0.19)**	**NM**	**(0.09)**	**-47%**		**(0.27)**	**(2.55)**
Average Diluted Shares Outstanding	11,664	1052%	15,608	69%	(3,943)	-25%	(0.07)		1,012

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

Exhibit 2: Conatus Pharmaceuticals Income Statement – 2011 - 2020E

($ in thousands, except per share data)	2011A	2012A	1Q13A	2Q13A	3Q13A	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**	**$22,953**	**$55,432**	**$106,173**
Cost of goods sold ($20K/kilo)	0	0					0	0	0	0	1,026	3,443	8,315	15,926
Gross profit	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$5,816**	**$19,510**	**$47,118**	**$90,247**
Research & Development	9,487	5,528	968	1,117	1,886	2,455	6,425	12,900	14,380	11,550	5,474	3,328	4,712	4,247
Total SG&A	2,875	3,086	749	670	1,108	1,640	4,167	7,220	7,647	8,051	14,160	15,874	18,624	20,109
Total expenses	$12,361	$8,615	$1,717	$1,788	$2,993	$4,095	$10,592	$20,120	$22,027	$19,601	$19,634	$19,202	$23,335	$24,355
Operating Profit (Loss)	**($12,361)**	**($8,615)**	**($1,717)**	**($1,788)**	**($2,993)**	**(4,095)**	**($10,592)**	**($20,120)**	**($22,027)**	**($19,601)**	**($13,818)**	**$308**	**$23,782**	**$65,892**
Interest Income	$28	$26	0	0	8	30	$38	$110	$131	$154	$56	$7	$38	$205
Interest Expense	(114)	(70)	(18)	(196)	(204)	(150)	(550)	(70)	(70)	(70)	(70)	(70)	(70)	(35)
Other Income (Expense)	450	(90)	(563)	(2,890)	(131)	(100)	(3,684)	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)**	**($3,321)**	**($4,315)**	**($14,806)**	**($20,080)**	**($21,966)**	**($19,517)**	**($19,832)**	**($5,755)**	**$23,750**	**$66,062**
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**	**($3,321)**	**($4,315)**	**($9,709)**	**($20,080)**	**($21,966)**	**($19,517)**	**($19,832)**	**($5,755)**	**$23,750**	**$66,062**
EPS - basic		($0.95)	($0.25)	$0.20	($0.28)	($0.28)	($0.61)	($1.29)	($1.05)	($0.94)	($0.95)	($0.28)	$1.14	$3.17
EPS - diluted	**($1.44)**	**($0.95)**	**($0.25)**	**$0.16**	**($0.28)**	**($0.28)**	**($0.65)**	**($1.29)**	**($1.05)**	**($0.94)**	**($0.95)**	**($0.28)**	**$1.14**	**$3.17**
Basic share outstanding		9,255	9,299	1,139	11,664	15,608	9,427	15,608	20,871	20,871	20,871	20,871	20,871	20,871
Dluted shares outstanding	8,342	9,255	9,299	1,439	11,664	15,608	9,503	15,608	20,871	20,871	20,871	20,871	20,871	20,871

Margin analysis	**2011A**	**2012A**	**1Q13A**	**2Q13A**	**3Q13A**	**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	127.1%	25.3%	14.5%	8.5%
Sales & Marketing	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	79.9%	43.8%	19.1%	10.4%
Total SG&A	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	206.9%	69.2%	33.6%	18.9%
Operating profit	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**-201.9%**	**1.3%**	**42.9%**	**62.1%**
Pretax income	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	-289.8%	-25.1%	42.8%	62.2%
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**	**-289.8%**	**-25.1%**	**42.8%**	**62.2%**

YoY % change	**2011A**	**2012A**	**1Q13A**	**2Q13A**	**3Q13A**	**4Q13E**	**2013E**	**2014E**	**2015E**	**2016E**	**2017E**	**2018E**	**2019E**	**2020E**
Total risk-adjusted revenue	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**235.4%**	**141.5%**	**91.5%**
Gross Profit	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**NM**	**235.4%**	**141.5%**	**91.5%**
Research & Development	NM	-41.7%	-16.7%	-0.2%	6.3%	66.7%	16.2%	100.8%	11.5%	-19.7%	-52.6%	-39.2%	41.6%	-9.9%
General & Administrative	NM	7.4%	-0.2%	3.2%	50.2%	72.7%	35.0%	57.7%	6.0%	5.8%	18.0%	-33.1%	38.6%	11.9%
Sales & Marketing	NM	NM	NM	NM	NM	NM	NM	NM	5.0%	0.0%	700.8%	84.1%	5.0%	5.0%
Total SG&A	NM	7.4%					35.0%	73.3%	5.9%	5.3%	75.9%	12.1%	17.3%	8.0%
Operating profit	**NM**	**-30.3%**					**23.0%**	**89.9%**	**9.5%**	**-11.0%**	**-29.5%**	**-102.2%**	**7628.4%**	**177.1%**
Pretax income	NM	-27.1%	20.7%	166.7%	28.5%	77.2%	69.2%	35.6%	9.4%	-11.1%	1.6%	-71.0%	-512.7%	178.2%
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%	28.5%	77.2%	11.0%	106.8%	9.4%	-11.1%	1.6%	-71.0%	-512.7%	178.2%
EPS - diluted	**NM**	**-34.3%**	**20.2%**	**-108.6%**	**-88.9%**	**-107.6%**	**-31.0%**	**97.1%**	**-18.2%**	**-11.1%**	**1.6%**	**-71.0%**	**-512.7%**	**178.2%**

Source: STRH estimates, company reports

Exhibit 3: Conatus Pharmaceuticals Consolidated Balance Sheet – 2011 - 2020E

($ in thousands except per share data)	2011A	2012A	1Q13A	2Q13A	3Q13A	4Q13E	2013E	2014E	2015E	2016E	2017E	2018E	2019E	2020E
Assets														
Cash and cash equivalents	$3,073	$4,036	$4,840	$3,281	$35,135	$36,842	$36,842	$17,106	$45,453	$26,268	$6,259	$6,472	$18,594	$73,280
Short-term investments	13,685	3,989	255	255	24,457	219	219	184	148	112	77	41	5	0
Accounts and trade receivables	0	0	0	0	0	0	0	0	0	0	3,079	6,886	16,630	31,852
Inventories	0	0	0	0	0	0	0	0	50	100	462	1,377	3,326	5,096
Prepaid and other current assets	165	76	83	158	614	76	76	76	76	76	137	459	1,109	2,123
Total current assets	**$16,923**	**$8,102**	**$5,179**	**$3,694**	**$60,206**	**$37,137**	**$37,137**	**$17,366**	**$45,727**	**$26,556**	**$10,014**	**$15,235**	**$39,662**	**$112,352**
Property and equipment, net	$21	$30	$27	$24	$22	$20	$20	$9	($2)	($13)	($24)	($48)	($108)	($222)
Deferred tax assets	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Other noncurrent assets	14	14	40	1,539	14	40	40	40	40	40	7	23	55	106
Total noncurrent assets	$36	$44	$67	$1,564	$36	$60	$60	$49	$38	$28	($17)	($25)	($53)	($116)
Total assets	**$16,959**	**$8,146**	**$5,246**	**$5,257**	**$60,242**	**$37,197**	**$37,197**	**$17,415**	**$45,765**	**$26,584**	**$9,997**	**$15,209**	**$39,610**	**$112,235**
Liabilities and Stockholders' Equity														
Current Liabilities:														
Short-term debt	$0	0	0	975	0	0	0	0	0	0	0	0	1,000	0
Accounts payable & accrued expenses	$1,179	1,087	390	1,354	775	1,087	1,087	1,087	1,087	1,087	770	2,410	3,326	3,185
Accrued compensation	542	326	351	370	381	326	326	326	326	326	3,421	11,476	8,315	10,617
Total current liabilities	**$1,721**	**$1,413**	**$741**	**$2,699**	**$1,156**	**$1,413**	**$1,413**	**$1,413**	**$1,413**	**$1,413**	**$4,191**	**$13,887**	**$12,641**	**$13,803**
Preferred stock warrant liability	69	160	708	4,104	0	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	1,000	1,000	1,000	1,000	0	0
Other	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Total liabilities	**$2,790**	**$2,573**	**$2,448**	**$7,803**	**$2,156**	**$2,573**	**$2,573**	**$2,570**	**$2,567**	**$2,564**	**$5,339**	**$15,031**	**$12,783**	**$13,942**
Stockholders' Equity:														
Common Stock (Series A)	$32,209	$32,209	$32,209	$24,709	$0	$91,367	$91,367	$91,541	$141,733	$141,944	$142,286	$143,434	$146,205	$151,514
Common Stock (Series B)	31,700	31,700	31,700	26,681	0	31,700	31,700	31,700	31,700	31,700	31,700	31,700	31,700	31,700
Common Stock	1	1	0	0	2	1	1	1	1	1	1	1	1	1
Additional paid-in capital	323	470	0	12,050	127,378	470	470	470	470	470	470	470	470	470
Accumulated other comprehensive income (deficit)	(4)	1	0	0	12	1	1	1	1	1	1	1	1	1
(Deficit)/Earnings accumulated	(50,058)	(58,808)	(61,111)	(65,984)	(69,305)	(64,691)	(64,691)	(84,644)	(106,482)	(125,871)	(145,576)	(151,203)	(127,326)	(61,168)
Total stockholders' equity (deficit)	**$14,169**	**$5,573**	**$2,798**	**($2,545)**	**$58,086**	**$58,848**	**$58,848**	**$39,069**	**$67,422**	**$48,244**	**$28,882**	**$24,402**	**$51,051**	**$122,518**
Total liabilities and stockholders' equity (deficit)	**$16,959**	**$8,146**	**$5,246**	**$5,257**	**$60,242**	**$61,421**	**$61,421**	**$41,639**	**$69,989**	**$50,808**	**$34,221**	**$39,433**	**$63,834**	**$136,459**

Source: STRH estimates, company reports.

Exhibit 4: Conatus Pharmaceuticals Statement of Cash Flows - – 2012 to 2020E

($ in thousands except per share data)	2011A	2012A	1Q13A	2Q13A	3Q13A	4Q13E	2013E	2014E	2015E	2016E	2017E	2018E	2019E	2020E
Cash flows from operating activities:														
Net Income (loss)	($11,997)	($8,749)	($2,297)	($4,873)	($3,321)	($4,315)	($9,709)	($20,080)	($21,966)	($19,517)	($19,832)	($5,755)	$23,750	$66,062
Depreciation and amortization	294	181	12	3	2	2	19	46	46	46	46	72	123	172
Stock-based compensation expense	160	144	21	4	75	57	158	174	192	211	342	1,148	2,772	5,309
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	547	2,895	219	(3,569)	92	92	92	92	92	92	92	92
Changes in assets and liabilities:														
Short term investments						3,770	3,770	36	36	36	36	36	36	5
Accounts and trade receivables							0	0	0	0	(3,079)	(3,807)	(9,744)	(15,222)
Inventories							0	0	(50)	(50)	(362)	(915)	(1,949)	(1,770)
Prepaid expenses & other current assets	(68)	89	(7)	(75)	(456)	537	0	0	0	0	(61)	(322)	(650)	(1,015)
Deferred tax assets						0	0	0	0	0	0	0	0	0
Other non-current assets	102	0	(26)	26	0	(26)	(26)	0	0	0	33	(16)	(32)	(51)
Accounts payable and other current liabilities	176	(92)	(697)	71	305	322	0	0	0	0	2,778	9,695	(2,246)	2,162
Other long-term liabilities	(308)	(229)	15	(15)	18	(18)	0	0	0	0	0	0	0	0
Net cash generated (used) in operating activities	**($12,096)**	**($8,564)**	**($2,431)**	**($1,965)**	**($3,157)**	**($3,239)**	**($5,696)**	**($19,735)**	**($21,653)**	**($19,185)**	**($20,009)**	**$224**	**$12,149**	**$55,739**
Cash flows from investing activities:														
Maturities of investments	$18,936	$19,838	$3,725	$0	$0	$0	$3,725	$0	$0	$0	$0	$0	$0	$0
Purchases of investments	(32,908)	(10,309)	0	0	(24,224)	0	(24,224)	0	0	0	0	0	0	0
Capital Expenditures	(16)	(18)	0	0	0	0	0	0	0	0	0	(11)	(28)	(53)
Net cash generated (used) in investing activities	**($13,989)**	**$9,511**	**$3,725**	**$0**	**($24,224)**	**$0**	**($20,499)**	**$0**	**$0**	**$0**	**$0**	**($11)**	**($28)**	**($53)**
Cash flows from financing activities:														
Short-term borrowings	$0	$0	$0	$1,001	$0		$0	$0	$0	$0	$0	$0	$1,000	($1,000)
Proceeds from issuance of common stock	0	16	11	3	61,408	(2,421)	59,000	0	50,000	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	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	0	0	0	0
Other		0	(500)	(599)	(2,172)		0	0	0	0	0	0	0	0
Net cash flow provided (used) by financing activities	**$26,424**	**$16**	**($489)**	**$405**	**$59,236**	**($2,422)**	**$59,000**	**$0**	**$50,000**	**$0**	**$0**	**$0**	**$0**	**($1,000)**
Impact from Foreign Exchange		0	0	0	0	0	0	0	0	0	0	0	0	0
Net increase (decrease) in cash and cash equivalents	**$340**	**$963**	**$804**	**($1,560)**	**$31,855**	**($5,661)**	**$32,806**	**($19,735)**	**$28,347**	**($19,185)**	**($20,009)**	**$213**	**$12,122**	**$54,686**
Cash and cash equivalents, beginning of period	$2,733	$3,073	$4,036	$4,840	$3,281	$35,135	$4,036	$36,842	$17,106	$45,453	$26,268	$6,259	$6,472	$18,594
Cash and cash equivalents, end of period	**$3,073**	**$4,036**	**$4,840**	**$3,281**	**$35,135**	**$36,842**	**$36,842**	**$17,106**	**$45,453**	**$26,268**	**$6,259**	**$6,472**	**$18,594**	**$73,280**

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.

Companies Mentioned in This Note

Gilead Sciences Inc. (GILD, $68.98 , Not Rated)

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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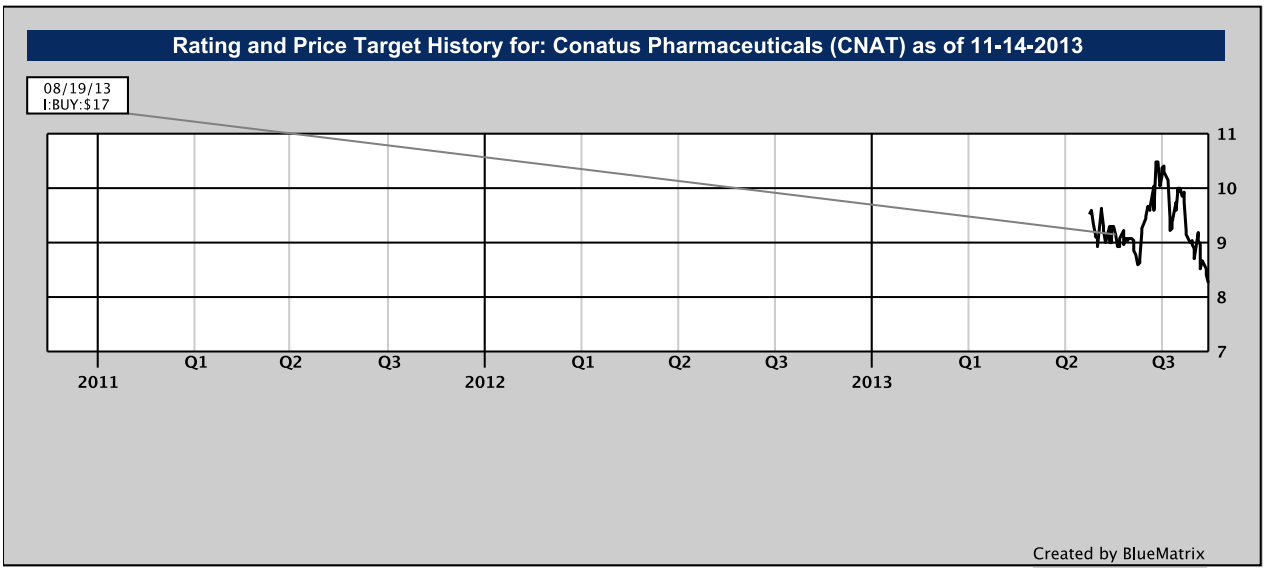

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3 designations based on total returns* within a 12-month period**

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- **CS** – Coverage Suspended

*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
T = transfer coverage

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