Conatus Pharmaceuticals (CNAT)

1Q14 Postview - Forward Progress

Clinical trial programs advancing; all eyes on ACLF

Buy

Price Target: $17.00
Prior: $17.00

Price (May 13, 2014)	$5.34
52-Wk Range	$14.25-$5.32
Market Cap ($M)	$82
ADTV	437,828
Shares Out (M)	15.4
Short Interest Ratio/% Of Float	21.4%
Dividend/Yield	$0.00/0.0%
TR to Target	218.4%

Total Debt	$1.0
BV/Share	$3.45
Cash And Equivalents ($M)	$56.3

	2013A	2014E		2015E	
		Curr.	Prior	Curr.	Prior
EPS					
1Q	($0.25)	($0.34)A	($0.38)	--	
2Q	$0.16	($0.40)	($0.42)	--	
3Q	($0.28)	($0.47)	($0.48)	--	
4Q	($0.33)	($0.51)	($0.47)	--	
FY	($0.63)	($1.72)	($1.75)	($1.33)	($1.31)
P/E	NM	NM		NM	
Revenue ($M)					
FY	$0	$0	$0	$0	$0
FYE Dec					

What's Incremental

CNAT posted a smaller than expected 1Q loss of ($0.34) vs. our ($0.38) and the Street's ($0.33). More important, CNAT showed progress on its emricasan clinical development program. With additional trial sites added, the ACLF Ph-2b data should top line in 2H14. CNAT is focused on an end of Ph-2 meeting with regulators, which could potentially lay the foundation for an accelerated review (contingent on ACLF data) and move it closer to commercialization. We expect CNAT to exit 2014 with $30M in cash. We reiterate our Buy & $17 PT.

ACLF top line results on track for 2H14

The modified Ph-2b ACLF trial continues to enroll patients in the US & UK with additional sites added in 1Q14. This sets the stage for ACLF top line results in 2H14. CNAT emphasized its priority remains preparing the data for an end of Ph-2 meeting with the FDA vs. organizing a presentation for the AASLD meeting or other conference. In our follow-up conference call, we were encouraged by management's decision tree regarding its timing/ urgency around the high unmet medical need & short treatment duration for the ACLF population. We believe the Ph-2 ACLF data could potentially form the basis (assuming good data) for an accelerated regulatory pathway (esp. in the UK/Germany) & advance it toward commercialization. Separately, CNAT also initiated its Ph-2b HCV-POLT trial that treats patients with a SVR with emricasan for 2 years. Initial HCV-POLT biomarker data is expected in 1H15.

AASLD meeting could increase acceptance of biomarkers

In June, the American Association for the Study of Liver Disease (AASLD) hosts a Meeting on Antifibrotic Drug Trials in an effort to generate a consensus on biomarker & other clinical endpoints. Given the significant industry investment by GILD & CNAT into fibrosis, greater acceptance of biomarkers as endpoints could potentially increase the validity of CNAT's recently initiated Ph-2b trial & provide more clarity on a NASH regulatory pathway. As a proxy for NASH, GILD recently updated its co-primary endpoint in its Ph-2B simtuzumab trial that assesses the mean change in hepatic venous pressure gradient (HVPG) from baseline to week 96 & Event Free Survival (EFS) up to 240 weeks assessed by time to first liver-related event or death, whichever occurs first.

1Q14 largely in line; cash burn at expected rate (see Exhibit 1)

CNAT reported a 1Q14 loss of ($0.34) vs. our ($0.38) & the Street's ($0.33). Lower G&A costs & Other Income each provided a +$0.02 benefit. Our 2014 op ex assumptions are mostly unchanged given a well mapped out clinical & operating plan. We trimmed our 2014E loss to ($1.72) vs. prior ($1.75) to reflect 1Q upside and a slightly higher share count. We expect CNAT to finish 2014 with $30M in cash or at the mid-point of its $28M to $32M range.
(see page 2 for 2014 Catalysts and 1Q variance analysis & pages 3 to 5 for CNAT's financial statements).

John T. Boris
212-319-5645
john.t.boris@suntrust.com

SEE PAGE 6 FOR REQUIRED DISCLOSURE INFORMATION

Catalysts in 2014

1) The AASLD's Emerging Trends in Antifibrotic Drug meeting in Chicago from June 21st-22nd; 2) ACLF data in 2H14; 3) NAFLD/NASH data in 2H14; 4) initiations of the CLF trial in 2H14; and 5) the annual AASLD meeting in Boston from November 7-11.

Exhibit 1: CNAT 1Q14 Variance Analysis

	CNAT Actual		STRH Estimates		Variance vs. STRH		EPS	Consensus	Actual
($ thousands)	1Q14A	% Chg. YOY	1Q14E	% Chg. YOY	U.S. $	% Difference	Impact	1Q14E	1Q13A
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	3,651	277%	3,800	293%	(149)	-4%	0.01	NA	968
General & Administrative	1,595	113%	1,643	119%	(47)	-3%	0.00	NA	749
Sales & Marketing	0	NM	100	NM	(100)	-100%	0.01	NA	0
Operating Profit (Loss)	**(5,246)**	**206%**	**(5,543)**	**223%**	**297**	**5%**	**0.02**	**(5,330)**	**(1,717)**
Interest Income	21	15637%	20	15052%	1	4%	0.00	NA	0
Interest Expense	(18)	0%	(18)	0%	0	0%	0.00	NA	(18)
Other Income (Expense)	(1)	-100%	(300)	-47%	299	-100%	0.02	NA	(563)
(Loss) gain on warrant fair value	0	NM	0	NM	0	NM	0.00	NA	0
Pretax Income (Loss)	**(5,243)**	**128%**	**(5,840)**	**154%**	**597**	**10%**	**0.04**	**(5,350)**	**(2,297)**
Taxes (Benefit)	0	NM	0	NM	0	NM	0.00	NA	0
Net Income (Loss)	**(5,243)**	**128%**	**(5,840)**	**154%**	**597**	**10%**	**0.04**	**(5,350)**	**(2,297)**
EPS (LPS)	**(0.34)**	**38%**	**(0.38)**	**54%**	**0.04**	**11%**		**(0.33)**	**(0.25)**
Average Diluted Shares Outstanding	15,412	66%	15,353	65%	59	0%	(0.00)	NA	9,299

Source: STRH Research, company reports, Thomson One Analytics.

Exhibit 2: CNAT Income Statement 2011-2020E

($ in thousands, except per share data)	2011A	2012A	2013A	1Q14A	2Q14E	3Q14E	4Q14E	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	6,947	3,651	4,447	5,465	5,837	19,400	19,380	15,350	5,474	3,328	4,712	4,247
Total SG&A	2,875	3,086	4,651	1,595	1,679	1,843	1,990	7,107	8,216	8,653	14,160	15,874	18,624	20,109
Total expenses	$12,361	$8,615	$11,598	$5,246	$6,126	$7,308	$7,827	$26,507	$27,596	$24,003	$19,634	$19,202	$23,335	$24,355
Operating Profit (Loss)	**($12,361)**	**($8,615)**	**($11,598)**	**($5,246)**	**($6,126)**	**($7,308)**	**($7,827)**	**($26,507)**	**($27,596)**	**($24,003)**	**($13,818)**	**$308**	**$23,782**	**$65,892**
Interest Income	$28	$26	$22	21	19	17	15	$72	$174	$175	$87	$46	$70	$203
Interest Expense	(114)	(70)	(463)	(18)	(18)	(18)	(18)	(70)	(70)	(70)	(70)	(70)	(70)	(35)
Other Income (Expense)	450	(90)	(3,578)	(1)	(1)	(1)	(1)	(3)	0	0	(6,000)	(6,000)	0	0
(Loss) gain on warrant liability	0	0	11,016	0	0	0	0	0	0	0	0	0	0	0
Pretax Income (Loss)	**($11,997)**	**($8,749)**	**($4,600)**	**($5,243)**	**($6,125)**	**($7,309)**	**($7,830)**	**($26,508)**	**($27,492)**	**($23,898)**	**($19,800)**	**($5,716)**	**$23,782**	**$66,059**
Tax Expense (Benefit)	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Net Income (Loss)	**($11,997)**	**($8,749)**	**($4,600)**	**($5,243)**	**($6,125)**	**($7,309)**	**($7,830)**	**($26,508)**	**($27,492)**	**($23,898)**	**($19,800)**	**($5,716)**	**$23,782**	**$66,059**
EPS - basic		($8.60)	($0.63)	($0.34)	($0.40)	($0.47)	($0.51)	($1.72)	($1.33)	($1.16)	($0.96)	($0.28)	$1.15	$3.20
EPS - diluted	**($1.44)**	**($8.60)**	**($0.63)**	**($0.34)**	**($0.40)**	**($0.47)**	**($0.51)**	**($1.72)**	**($1.33)**	**($1.16)**	**($0.96)**	**($0.28)**	**$1.15**	**$3.20**
Basic share outstanding		1,017	7,358	15,412	15,412	15,412	15,412	15,412	20,676	20,676	20,676	20,676	20,676	20,676
Diluted shares outstanding	8,342	1,017	7,358	15,412	15,412	15,412	15,412	15,412	20,676	20,676	20,676	20,676	20,676	20,676

Margin analysis	**2011A**	**2012A**	**2013A**	**1Q14A**	**2Q14E**	**3Q14E**	**4Q14E**	**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	-289.4%	-24.9%	42.9%	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**	**-289.4%**	**-24.9%**	**42.9%**	**62.2%**

YoY % change	**2011A**	**2012A**	**2013A**	**1Q14A**	**2Q14E**	**3Q14E**	**4Q14E**	**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%	25.7%	277.2%	298.1%	189.8%	96.1%	179.2%	-0.1%	-20.8%	-64.3%	-39.2%	41.6%	-9.9%
General & Administrative	NM	7.4%	50.7%	113.0%	150.4%	66.4%	-6.3%	52.8%	6.0%	5.8%	9.1%	-33.1%	38.6%	11.9%
Sales & Marketing	NM	NM	NM	NM	NM	NM	NM	NM	NM	0.0%	700.8%	84.1%	5.0%	5.0%
Total SG&A	NM	7.4%	50.7%	113.0%	150.4%	66.4%	-6.3%	52.8%	15.6%	5.3%	63.6%	12.1%	17.3%	8.0%
Operating profit	**NM**	**-30.3%**	**34.6%**					**128.5%**	**4.1%**	**-13.0%**	**-42.4%**	**-102.2%**	**7628.4%**	**177.1%**
Pretax income	NM	-27.1%	-47.4%	128.3%	25.7%	120.1%	52.8%	476.3%	3.7%	-13.1%	-17.1%	-71.1%	-516.0%	177.8%
Tax Expense (Benefit)	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM
Net Income (Loss)	NM	-27.1%	-47.4%	128.3%	-2837.2%	120.1%	52.8%	476.3%	3.7%	-13.1%	-17.1%	-71.1%	-516.0%	177.8%
EPS - diluted	**NM**	**498.3%**	**-92.7%**	**37.7%**	**-355.6%**	**66.6%**	**52.2%**	**175.1%**	**-22.7%**	**-13.1%**	**-17.1%**	**-71.1%**	**-516.0%**	**177.8%**

Source: STRH Research, company reports.

Exhibit 3: CNAT Consolidated Balance Sheet 2011-2020E

($ in thousands)	2011A	2012A	2013A	1Q14E	2Q14E	3Q14E	4Q14E	2014E	2015E	2016E	2017E	2018E	2019E	2020E
Assets														
Cash and cash equivalents	$3,073	$4,036	$4,159	$4,880	$2,896	$3,408	$2,969	$2,969	$3,774	$4,205	$3,122	$3,222	$15,137	$69,507
Short-term investments	13,685	3,989	52,194	46,194	40,194	34,194	26,194	26,194	48,194	24,194	4,194	4,194	4,194	4,194
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	546	546	546	546	546	546	546	546	137	459	1,109	2,123
Total current assets	**$16,923**	**$8,102**	**$56,898**	**$51,620**	**$43,635**	**$38,148**	**$29,709**	**$29,709**	**$52,564**	**$29,044**	**$10,994**	**$16,139**	**$40,395**	**$112,772**
Property and equipment, net	$21	$30	$23	$23	$23	$23	$23	$23	$23	$24	$33	$35	$90	$197
Deferred tax assets	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Other noncurrent assets	14	14	14	14	14	14	14	14	14	14	7	23	55	106
Total noncurrent assets	$36	$44	$37	$37	$37	$37	$38	$38	$38	$38	$40	$58	$146	$303
Total assets	**$16,959**	**$8,146**	**$56,936**	**$51,657**	**$43,673**	**$38,185**	**$29,747**	**$29,747**	**$52,602**	**$29,082**	**$11,034**	**$16,197**	**$40,541**	**$113,075**
Liabilities and Stockholders' Equity														
Current Liabilities:														
Short-term debt / Current portion of LT debt	$0	0	0	0	0	0	0	0	0	0	0	0	1,000	0
Accounts payable & accrued expenses	$1,179	1,087	1,494	1,494	1,494	1,494	1,494	1,494	1,494	1,494	770	2,410	3,326	3,185
Accrued compensation	542	326	1,323	1,323	1,323	1,323	1,323	1,323	1,323	1,323	3,421	11,476	8,315	10,617
Total current liabilities	**$1,721**	**$1,413**	**$2,817**	**$2,817**	**$2,817**	**$2,817**	**$2,817**	**$2,817**	**$2,817**	**$2,817**	**$4,191**	**$13,887**	**$12,641**	**$13,803**
Preferred stock warrant liability	69	160	0	0	0	0	0	0	0	0	0	0	0	0
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**	**$3,817**	**$3,817**	**$3,817**	**$3,817**	**$3,817**	**$3,817**	**$3,817**	**$3,817**	**$5,191**	**$14,887**	**$12,641**	**$13,803**
Stockholders' Equity:														
Common Stock (Series A)	$32,209	$32,209	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
Common Stock (Series B)	31,700	31,700	0	0	0	0	0	0	0	0	0	0	0	0
Common Stock	1	1	2	2	2	2	2	2	2	2	2	2	2	2
Additional paid-in capital	323	470	127,536	127,536	127,536	127,536	127,536	127,536	177,536	177,536	177,536	177,536	177,536	177,536
Accumulated other comprehensive income (deficit)	(4)	1	11	11	11	11	11	11	11	11	11	11	11	11
(Deficit)/Earnings accumulated	(50,058)	(58,808)	(74,430)	(79,650)	(85,771)	(92,997)	(100,655)	(100,655)	(127,836)	(151,391)	(170,849)	(175,418)	(148,864)	(77,496)
Total stockholders' equity (deficit)	**$14,169**	**$5,573**	**$53,119**	**$47,899**	**$41,779**	**$34,553**	**$26,894**	**$26,894**	**$49,713**	**$26,158**	**$6,700**	**$2,131**	**$28,685**	**$100,053**
Total liabilities and stockholders' equity (deficit)	**$16,959**	**$8,146**	**$56,936**	**$51,657**	**$43,673**	**$38,185**	**$29,747**	**$29,747**	**$52,602**	**$29,082**	**$11,034**	**$16,197**	**$40,541**	**$113,075**

Source: STRH Research, company reports.

Exhibit 4: CNAT Statement of Cash Flows 2011-2020E

($ in thousands)	2011A	2012A	2013	1Q14E	2Q14E	3Q14E	4Q14E	2014E	2015E	2016E	2017E	2018E	2019E	2020E
Cash flows from operating activities:														
Net Income (loss)	($11,997)	($8,749)	($15,616)	($5,243)	($6,125)	($7,309)	($7,830)	($26,508)	($27,492)	($23,898)	($19,800)	($5,716)	$23,782	$66,059
Depreciation and amortization	294	181	210	12	12	12	12	46	46	46	46	59	91	111
Stock-based compensation expense	160	144	257	24	5	83	172	283	312	343	342	1,148	2,772	5,309
Loss (gain) on changes in fair value of warrant liability			0	(708)	(4,104)	0	0	0	0	0	0	0	0	0
Deferred income taxes			0	0	0	0	0	0	0	0	0	0	0	0
Change in lease liability			0	0	0	0	0	0	0	0	0	0	0	0
Other	(455)	92	3,618	(1,000)	0	0	0	(1,000)	0	0	0	0	0	0
Changes in assets and liabilities:														
Short term investments			0	0	0	0	0	0	0	0	0	0	0	0
Accounts and trade receivables			0	0	0	0	0	0	0	0	(3,079)	(3,807)	(9,744)	(15,222)
Inventories			0	0	0	0	0	0	(50)	(50)	(362)	(915)	(1,949)	(1,770)
Prepaid expenses & other current assets	(68)	89	(469)	(462)	(388)	68	0	0	0	0	409	(322)	(650)	(1,015)
Deferred tax assets			0	0	0	0	0	0	0	0	0	0	0	0
Other non-current assets	102	0	0	26	1,525	0	0	0	0	0	8	(16)	(32)	(51)
Accounts payable and other current liabilities	176	(92)	1,369	2,076	1,093	1,661	0	0	0	0	1,374	9,695	(2,246)	2,162
Other long-term liabilities	(308)	(229)	0	0	0	0	0	0	0	0	0	0	0	0
Net cash generated (used) in operating activities	**($12,096)**	**($8,564)**	**($10,632)**	**($5,276)**	**($7,982)**	**($5,485)**	**($7,647)**	**($27,178)**	**($27,184)**	**($23,559)**	**($21,062)**	**$125**	**$12,025**	**$55,582**
Cash flows from investing activities:														
Maturities of investments	$18,936	$19,838	$4,725	$6,000	$6,000	$6,000	$8,000	$26,000	$28,000	$24,000	$20,000	$0	$0	$0
Purchases of investments	(32,908)	(10,309)	(53,118)	0	0	0	0	0	(50,000)	0	0	0	0	0
Capital Expenditures	(16)	(18)	(4)	(3)	(3)	(3)	(3)	(11)	(11)	(11)	(20)	(25)	(111)	(212)
Net cash generated (used) in investing activities	**($13,989)**	**$9,511**	**($48,397)**	**$5,997**	**$5,997**	**$5,997**	**$7,997**	**$25,989**	**($22,011)**	**$23,989**	**$19,980**	**($25)**	**($111)**	**($212)**
Cash flows from financing activities:														
Short-term borrowings	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$1,000	($1,000)
Proceeds from issuance of common stock	0	16	58,608	0	0	0	0	0	50,000	0	0	0	0	0
Proceeds from exercise of stock options / warrants (net of costs)	26,424	0	41	0	0	0	0	0	0	0	0	0	0	0
Share repurchase		0	0	0	0	0	0	0	0	0	0	0	0	0
Proceeds from issuance of debt		0	1,001	0	0	0	0	0	0	0	0	0	(1,000)	0
Repayment of debt		0	0	0	0	0	0	0	0	0	0	0	0	0
Repayment of finance leases		0	0	0	0	0	0	0	0	0	0	0	0	0
Dividends		0	(500)	0	0	0	0	0	0	0	0	0	0	0
Other		0	0	0	0	0	0	0	0	0	0	0	0	0
Net cash flow provided (used) by financing activities	**$26,424**	**$16**	**$59,151**	**$0**	**$0**	**$0**	**$0**	**$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**	**$123**	**$721**	**($1,984)**	**$512**	**$350**	**($1,189)**	**$805**	**$430**	**($1,082)**	**$100**	**$11,914**	**$54,370**
Cash and cash equivalents, beginning of period	$2,733	$3,073	$4,036	$4,159	$4,880	$2,896	$3,408	$4,159	$2,969	$3,774	$4,205	$3,122	$3,222	$15,137
Cash and cash equivalents, end of period	**$3,073**	**$4,036**	**$4,159**	**$4,880**	**$2,896**	**$3,408**	**$2,969**	**$2,969**	**$3,774**	**$4,205**	**$3,122**	**$3,222**	**$15,137**	**$69,507**

Source: STRH Research, 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 (GILD, $80.30, 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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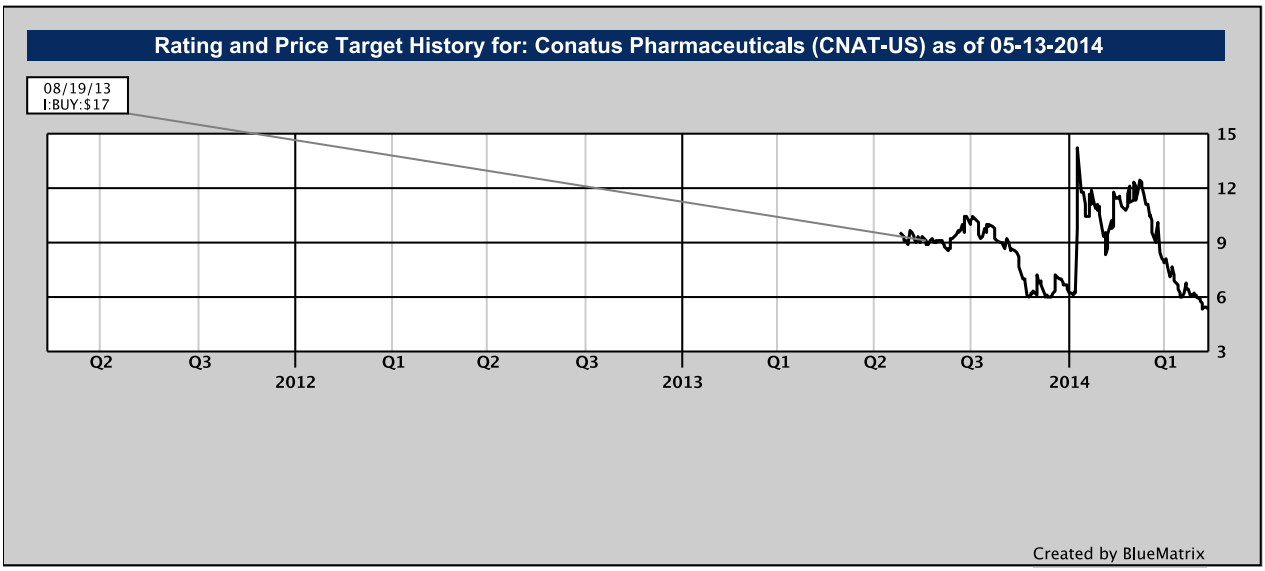

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- **Reduce** – total return ≤ negative 10% (5% for low Beta securities)
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- **CS** – Coverage Suspended

*Total return (price appreciation + dividends)
**Price targets are within a 12-month period, unless otherwise noted
***Low Beta defined as securities with an average Beta of 0.8 or less, using Bloomberg's 5-year average Beta

Legend for Rating and Price Target History Charts:
D = drop coverage
I = initiate coverage
T = transfer coverage

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