Aratana Therapeutics, Inc. (PETX)

Raising Price Target to Reflect Veterinary Oncology Opportunity

MARKET OUTPERFORM | Price: $25.57 | Target Price: $38.00

MARKET DATA

Price	$25.57
52-Week Range:	$6.56 - $29.32
Shares Out. (M):	21.9
Market Cap ($M):	$559.7
Average Daily Vol. (000):	61.0

Source: Thomson Reuters and JMP Securities LLC

FY DEC		2013E	2014E	2015E
Revenue ($M)	1Q	$0.0A	$0.0	--
	2Q	$0.0A	$0.0	--
	3Q	$0.0	$0.0	--
	4Q	$0.0	$0.0	--
	FY	**$0.0**	**$0.0**	**$0.0**
EPS	1Q	($0.24)A	($0.30)	--
	2Q	($4.62)A	($0.28)	--
	3Q	($0.14)	($0.27)	--
	4Q	($0.16)	$0.12	--
	FY	**($5.15)**	**($0.72)**	**($0.65)**
	P/E	NM	NM	NM

Source: Company reports and JMP Securities LLC

STOCK PRICE PERFORMANCE

INVESTMENT HIGHLIGHTS

We reiterate our Market Outperform rating on shares of Aratana and raise our price target from $16 to $38. Last week, Aratana Therapeutics acquired Vet Therapeutics, making the company the leader in small molecule and monoclonal antibody development for the companion animal market. The acquired pipeline at least doubles (if not triples) the number of compounds that may be approved by 2016. Our revised model assumes multiple conditional licenses by the end of 2016, two full licenses, and three small molecule approvals. We assume a slow ramp beginning in 2016 for the conditional licenses, but conservatively, we believe that the company will obtain full licenses from the USDA by the end of 2019. Our DCF model suggests that Aratana should deliver $775M million in enterprise value (vs. $369M previously). Our relative valuation model assumes PETX can trade at 5x EV/2025 revenue of $608.5M (vs. $301M previously), discounted at 12%. Our new $38 price target is based on a blend of our DCF analysis ($37) and relative valuation ($38) methodologies.

Oncology opportunity significant. According to the National Cancer Institute, there are approximately 6M dogs diagnosed with cancer every year. Of these, approximately 750,000 undergo some form of treatment including chemotherapy, surgery, and/or radiation. Approximately 250,000 of these animals will undergo some form of chemotherapy, at an average cost of $8,000 for a complete treatment. Lymphoma remains the most substantial near-term opportunity, as lymphomas represent 20% of all canine cancers. Given that 70% of canine lymphomas are T-cell in origin, the T-cell lymphoma antibody product currently being reviewed by the USDA represents a $311M market opportunity.

Multiple approvals expected by 2016. We leave our assumptions for small molecules in the pipeline unchanged. Namely, we expect AT-001, 002, and 003 to all be approved in the U.S. by the end of 2016. Our oncology franchise revenue model assumes a combination of a full approval for the T-cell and B-cell products and conditional approvals for the Mast cell, a Dx for lymphoma, feline lymphoma, and atopic dermatitis. We have not included any sales of the B or T-cell product for the next two years; management has yet to disclose B-cell lymphoma royalty revenues to date, and we do not expect significant sales of the T-cell product until the company obtains a full license in 2016.

Oncology models assume low penetration in first 24 months, followed by rapid adoption thereafter. A conditional license from the USDA will allow the company to begin marketing an antibody. However, we assume that no more than a few hundred dogs per year, per product, are treated with the antibody in the first two years of the launch. The company will be working closely with veterinarians to determine where the products fit into the treatment regimen during the first two years, so the "hockey stick" will not really begin until year three.

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We have assumed less than a 1% penetration within the first two years of a conditional license, but believe that the products can achieve peak penetration of 15-20% in their respective categories. We view this as conservative, given that Aratana's products are likely to be the only data-driven, species-specific treatments on the market. We have not assumed any sales into the feline oncology market.

VALUATION

Given the infancy of the animal health industry, we utilize several methodologies in valuing PETX, including discounted cash flow (DCF), EV to revenue, and peer comparables. Our target price of $38 is based on the average of our discounted cash flow analysis (DCF) valuation of $37 and our relative valuation of $38, using an enterprise value to revenue valuation methodology.

Enterprise Value to Revenue Methodology

We find EV/revenue an appropriate basis given Aratana's incremental revenue growth profile expectation and product development in coming years. We supplement the EV/sales methodology with peer valuation comparisons to our basis for deriving Aratana's price target, as we believe progress on development milestones relative to peer performance can drive the valuation of the company in the near term.

From a comparable standpoint, there are not many large, publicly traded, animal health companies - Zoetis (ZTS) and French-based Virbac (VIRP) are the only other public names in the space, and there is no single direct comp group for Aratana Therapeutics, Inc. However, we looked across the healthcare sector for companies with similarities to Aratana's profile. This included cash pay businesses with minimal patent exposure and similar longer-term macro drivers in the growing middle class. With that, we view Allergan (AGN, MO, $115 PT), Perrigo (PRGO, NC), Monsanto (MON, NC), and Mead Johnson (MJN; a 2009 spin-off of Bristol Meyers, NC) as the best comps against which to value Aratana. Overall, the group is trading at 4x EV/2014 revenue. Our relative valuation target assumes PETX can trade at 5x EV/2025 revenue, discounted at 12%. We believe the premium is substantially warranted due to the uniqueness of the pipeline and the potential for the company to have near-monopoly status as a veterinary drug development company.

Discounted Cash Flow Methodology

We value Aratana based on our revenue and expense forecasts for various compounds currently under development (AT-001, AT-002, and AT-003) using a DCF analysis through 2025, assuming product launch in the U.S. in 2016. We believe a DCF analysis represents an appropriate valuation methodology, as it takes into account pet therapeutics industry growth expectations driven by increased pet ownership among the growing middle class and the growth in discretionary spending from emerging economies. We apply a terminal growth rate of 4% to reflect industry growth expectations, and a 12% discount rate to account for technology and execution risk. Based on that, our DCF model suggests Aratana should deliver $775M million in enterprise value (sum of cumulative cash flows). After adjusting for cash and debt, we arrive at a fair value of approximately $35-$39 per share.

FIGURE 1. DCF Model

Aratana Therapeutics, Inc.
Commercial P&L
($'s in 000's)

		Aratana Therapeutics Projections												
		2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Revenue														
AT-001 Indication A&B		$0	$0	$0	$10,235	$26,326	$44,636	$66,644	$95,420	$115,842	$127,582	$135,198	$143,304	$151,929
AT-001 Cat OA		0	0	0	0	0	0	0	0	0	0	0	0	0
AT-002 Indication A&B		0	0	0	$11,617	$25,627	$40,510	$54,194	$67,871	$83,155	$93,367	$106,267	$116,467	$121,899
AT-002 Indication C		0	0	0	0	0	0	0	0	0	0	0	0	0
AT-003		0	0	0	$5,132	$15,481	$19,893	$24,355	$28,869	$34,629	$40,556	$45,739	$51,067	$56,545
AT-004		0	0	0	0	22,253	34,663	47,914	63,413	77,097	86,297	94,777	102,577	109,023
Oncology		0	0	0	6,462	10,966	12,284	18,196	46,325	70,764	120,106	171,237	249,117	380,539
Total Wholesale Revenue		$0	$0	$0	$33,445	$100,653	$151,986	$211,303	$301,898	$381,487	$467,908	$553,217	$662,532	$819,935
Distributor Margin & ISO		0	0	0	7,216	21,970	33,358	46,396	65,773	82,776	100,559	118,052	140,117	171,344
Gross Revenue		0	0	0	26,229	78,683	118,628	164,907	236,124	298,711	367,349	435,166	522,415	648,590
Total Discounts and Rebates		0	0	0	2,225	4,350	5,713	6,126	6,211	6,269	6,328	6,386	6,444	6,502
Net Revenue		0	0	0	24,004	74,333	112,914	158,780	229,913	292,442	361,021	428,780	515,972	642,088
Total Royalties & Adjustments		500	5,500	3,500	2,095	7,056	10,578	14,394	18,807	22,918	25,927	28,667	31,253	33,519
Revenue after Royalties		(500)	(5,500)	(3,500)	21,910	67,277	102,336	144,386	211,106	269,524	335,094	400,113	484,718	608,569
% Revenue Growth		*n/a*	*n/a*	*n/a*	*n/a*	*207%*	*52%*	*41%*	*46%*	*28%*	*24%*	*19%*	*21%*	*26%*
Total COGs		0	0	0	3,347	11,133	17,363	24,017	31,802	38,667	43,272	47,519	51,422	54,642
Gross Profit (US)		(500)	(5,500)	(3,500)	18,562	56,144	84,973	120,369	179,303	230,856	291,822	352,594	433,297	553,927
Milestones & Royalties (OUS)		454	7,900	10,684	9,674	6,542	9,879	13,735	19,623	24,797	30,414	35,959	43,065	53,296
Gross Margin		(46)	2,400	7,184	28,236	62,686	94,852	134,104	198,927	255,653	322,236	388,554	476,361	607,223
% Gross Margin		*n/a*	*n/a*	*n/a*	*129%*	*93%*	*93%*	*93%*	*94%*	*95%*	*96%*	*97%*	*98%*	*100%*
Sales Force		0	1,465	2,604	5,800	8,825	14,465	20,105	20,608	21,123	21,651	22,192	22,747	23,316
Advertising and Promotion		0	0	2,400	13,630	17,653	18,934	18,888	16,787	16,905	17,022	17,140	17,258	15,615
Marketing & Other		878	1,862	2,690	2,238	2,518	3,358	3,958	4,057	4,159	4,263	4,369	4,479	4,591
Total S&M		878	3,327	7,693	21,668	28,996	36,757	42,952	41,452	42,186	42,936	43,701	44,483	43,521
% of Revenue		*n/a*	*n/a*	*n/a*	*99%*	*43%*	*36%*	*30%*	*20%*	*16%*	*13%*	*11%*	*9%*	*7%*
Total R&D		7,797	12,980	12,716	7,470	8,637	9,575	10,603	11,814	12,885	13,605	14,269	14,880	15,384
% of Revenue		*n/a*	*n/a*	*n/a*	*34%*	*13%*	*9%*	*7%*	*6%*	*5%*	*4%*	*4%*	*3%*	*3%*
Total G&A		4,196	2,568	2,696	2,750	3,438	5,081	7,145	10,346	13,160	16,246	19,295	23,219	28,894
% of Revenue		*n/a*	*n/a*	*n/a*	*13%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*
Total Operating Expenses		12,871	18,875	23,106	31,888	41,071	51,414	60,700	63,612	68,231	72,787	77,266	82,581	87,800
Operating Income		**($12,917)**	**($16,475)**	**($15,922)**	**($3,651)**	**$21,615**	**$43,439**	**$73,404**	**$135,314**	**$187,422**	**$249,448**	**$311,288**	**$393,780**	**$519,423**
		DCF Valuation												
Operating Income		(12,917)	(16,475)	(15,922)	(3,651)	21,615	43,439	73,404	135,314	187,422	249,448	311,288	393,780	519,423
Less: Income Taxes	35%	-	-	-	-	-	-	24,323	47,360	65,598	87,307	108,951	137,823	181,798
After-Tax Operating Income		(12,917)	(16,475)	(15,922)	(3,651)	21,615	43,439	49,081	87,954	121,824	162,141	202,337	255,957	337,625
Less: Net Change in W/C		-	-	-	(2,400)	(5,033)	(3,858)	(4,587)	(7,113)	(6,253)	(6,858)	(6,776)	(8,719)	(12,612)
Unlevered Free Cash Flow (FCF)		(12,917)	(16,475)	(15,922)	(6,052)	16,583	39,581	44,495	80,841	115,571	155,284	195,561	247,238	325,013
PV of FCF		(12,045)	(13,359)	(11,226)	(3,711)	8,841	18,350	17,938	28,340	35,230	41,162	45,077	49,555	56,647

Equity Value Per Share		Perpetuity Growth Rate		
		1.5%	4.0%	6.5%
Discount Rate	10.0%	$46	$54	$69
	11.0%	$39	$46	$56
	12.0%	$34	$39	$46
	13.0%	$29	$33	$38
	14.0%	$26	$28	$32

Equity Value Per Share		Perpetuity Growth Rate		
		3.2x	4.0x	4.8x
Discount Rate	10.0%	$38	$43	$49
	11.0%	$34	$39	$44
	12.0%	$31	$35	$40
	13.0%	$28	$32	$36
	14.0%	$25	$29	$32

Source: JMP Securities LLC Estimates

Company Description

Founded in 2010, Aratana is a development-stage biopharmaceutical company focused on the licensing, development, and commercialization of prescription medications for companion animals (i.e., pet therapeutics). The companion animal market represents a sizable opportunity with a number of therapeutic and medical needs that have yet to be fully realized or met. Aratana has an active in-licensing effort focused on identifying human therapeutics for development and commercialization as pet therapeutics. This model enables human health-focused pharma and biotech companies to extend drug candidates to the companion animal market. With a focus on both cats and dogs, a single, in-licensed drug candidate can offer two therapeutic programs, each of which can potentially offer its own arrangement with specific development milestones and royalties. Additionally, Aratana is developing its own commercial operations to potentially bring its current and future in-licensed drugs to market.

Investment Risks

Limited operating history and significant losses. The company is a development-stage company with a limited operating history and significant losses since its inception. Aratana is expected to continue to incur losses in the short- to medium-term, as it continues the development of product candidates. Previous losses, combined with expected future losses, will continue to have an adverse effect on stockholders' equity and working capital.

Dependence on the success of the three compounds currently in development. Aratana currently has no products approved for commercial distribution. To date, the company has invested much of its efforts and financial resources in the in-licensing, research, and development of AT-001, AT-002, and AT-003, which are currently the only product candidates and are still in development. If Aratana is not successful in commercializing one or more product candidates, operating results will be negatively impacted.

Regulatory environment. The denial or delay of regulatory approval (e.g., FDA, EMA) for Aratana's existing and future product candidates would delay commercialization efforts and adversely impact the potential to generate revenue and operating results.

Market acceptance/commercial success. Even if current or future product candidates obtain regulatory approval, they may fail to achieve market acceptance and commercial success, which would adversely affect the company's operating and financial results.

Financing risk. On June 27, 2013, Aratana completed an initial public offering, issuing 5.8 million shares of common stock at a price of $6.00/share, resulting in net proceeds of $35 million. The company plans to use the net proceeds of the offering to: (i) in-license and develop additional product candidates; (ii) commercialize its current and future product candidates; (iii) establish a direct sales organization in the U.S.; and (iv) for general corporate and working capital purposes. Cash on hand should be enough to fund clinical efforts for AT-001, AT-002, and AT-003 to completion. However, the company will need to raise additional capital in order to successfully commercialize these products and expand its product pipeline.

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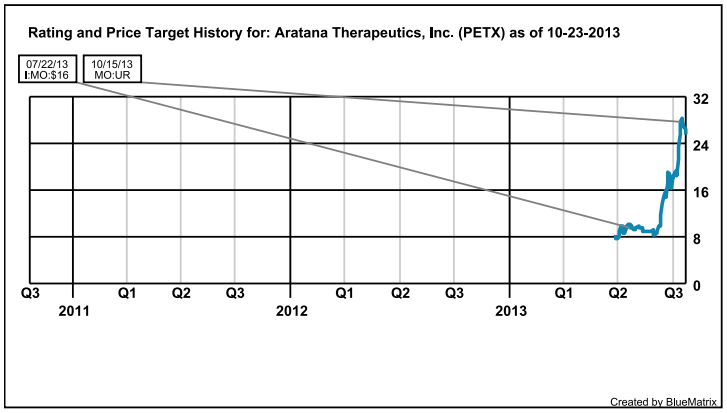
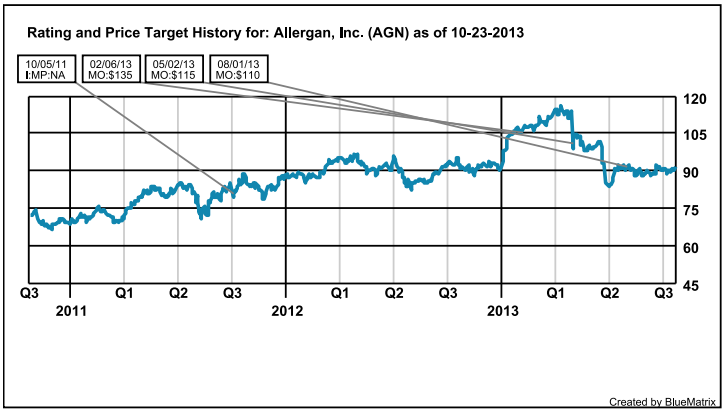
MARKET OUTPERFORM	Buy	249	*61.48%*	Buy	249	*61.48%*	78	*31.33%*
MARKET PERFORM	Hold	150	*37.04%*	Hold	150	*37.04%*	23	*15.33%*
MARKET UNDERPERFORM	Sell	6	*1.48%*	Sell	6	*1.48%*	0	*0%*
TOTAL:		405	*100%*		405	*100%*	101	*24.94%*

Stock Price Chart of Rating and Target Price Changes:

Note: First annotation denotes initiation of coverage or 3 years, whichever is shorter. If no target price is listed, then the target price is N/A. In accordance with NASD Rule 2711, the chart(s) below reflect(s) price range and any changes to the rating or price target as of the end of the most recent calendar quarter. The action reflected in this note is not annotated in the stock price chart. Source: JMP Securities.





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