

Aratana Therapeutics, Inc.

Observations From Travels With Management; Valuation Looks Increasingly Attractive

Conclusion

We attended investor meetings this week with Steven St. Peter, M.D., president and CEO of Aratana Therapeutics. We came away from the discussions quite impressed with the company's encouraging progress on several fronts. We continue to view the recent combination with Vet Therapeutics as transformational for the story and thus consider the recent weakness in shares, which is presumably related to the recent lock-up expiration, an attractive buying opportunity. We reiterate our Outperform rating on Aratana and are not changing any of our estimates. We believe that the visibility of the animal health space and of Aratana in particular is increasing, and expect 2014 to be an important year for clinical validation for the company's portfolio.

Meeting Highlights

- Management was quite upbeat about the portfolio's progress. The small-molecule products appear to be progressing on plan, with favorable top-line results from AT-001 Dog reported last month, greater conviction of the potential for AT-001 Cat to treat chronic pain at lower doses, a dose-ranging study underway for AT-003 in both dogs and cats (for postsurgical pain), and a pivotal study about to begin in AT-002 Dog (for appetite stimulation). Management continues to point to 2016 as an approval and launch target for all six identified products in the small-molecule portfolio.
- Feasibility testing of the three option products (indications not disclosed) is ongoing; a decision is expected in the first quarter of next year. We assume management will most likely select one of these three products to in-license, given its goal of adding one new development project each year.
- Turning to the Vet Therapeutics' biologic portfolio, the B-cell lymphoma product is being sold on a conditional basis by partner Novartis (NVS \$78.06) in the United States while Aratana waits for full licensure by the USDA (timing is unclear, but sometime in 2014 seems likely). Despite this potential, it sounds like Aratana and Novartis will take a cautious approach to launching this product until they have a broader clinical database to take to the 1,000 oncologist specialists in the United States. We assume the B-cell product will generate less than \$1 million in royalties for Aratana in 2014.
- The T-cell lymphoma product is awaiting conditional licensure by the USDA. Aratana has full rights to this product in the United States, so modest sales are possible for this product as well in 2014, although our model does not assume any contribution until 2015, with \$7 million in sales estimated. Similar to the B-cell product, we expect limited marketing of the T-cell product until the clinical database is larger.

Aratana is a specialty biopharmaceutical company focused solely on the companion-animal market. The company was founded in Kansas City, Kansas, in 2010 to pursue in-licensing, development, and commercialization of novel therapeutics for cats and dogs. The company has three molecules focused on osteoarthritis pain, lack of appetite, and post-surgical pain in both dogs and cats, which, if effective, could reach the market by 2016.

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December 19, 2013

Stock Rating: **Outperform**
Company Profile: **Aggressive Growth**

Symbol: PETX (NASDAQ)
Price: \$16.88 (52-Wk.: \$7-\$29)
Market Value (mil.): \$402
Fiscal Year End: December
Long-Term EPS Growth Rate:
Dividend/Yield: None

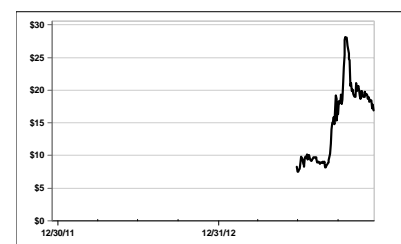
	2012A	2013E	2014E
Estimates			
EPS FY	\$-0.91	\$-0.95	\$-1.29
CY		\$-0.95	\$-1.29

Valuation			
FY P/E	NM	NM	NM
CY P/E		NM	NM

Trading Data (FactSet)	
Shares Outstanding (mil.)	21
Float (mil.)	3
Average Daily Volume	89,104

Financial Data (FactSet)	
Long-Term Debt/Total Capital (MRQ)	0.1
Book Value Per Share (MRQ)	2.1
Enterprise Value (mil.)	303.8
EBITDA (TTM)	0.0
Enterprise Value/EBITDA (TTM)	0.0x
Return on Equity (TTM)	-40.6

Two-Year Price Performance Chart



Sources: FactSet, William Blair & Company estimates

- We believe that Aratana's strategy is to become more aggressive commercially in 2016, when the company could take several products to market at once—assuming all can make it through the FDA (for small molecules) or USDA (for biologics). We believe that the Vet Therapeutics addition has given Aratana an impressive lineup for oncologists. In addition to the B-cell and T-cell lymphoma products, both 002 and 003 are also expected to be used heavily by oncologists (if effective), given that a significant percentage of pets with cancer lose their appetite and/or require surgery. With 1,000 oncologists in the United States treating companion animals, the company believes it can effectively reach this market with about 100 eventual sales reps. We also expect the company to work closely with the large vet distributors—MWI Veterinary Supply (MWIV \$170.13; Outperform), Henry Schein (HSIC \$113.15; Outperform), and Patterson (PDCO \$40.63; Market Perform)—to more efficiently penetrate the general practice vet community.
- Aratana's commercialization strategy is becoming clearer now following the Vet Therapeutics purchase. Management expects to hire 6 field reps in 2014 (13 total sales professionals) and another 6 in 2015 (12 professionals in total). Our model assumes 15 reps are added in 2014 and another 15 in 2015, suggesting that our SG&A spending ramp-up might be too high. We assume SG&A spending jumps from \$5.4 million in 2013 to \$15.7 million in 2014, driving a full-year loss of \$29 million, compared with a loss of \$18 million in 2013.
- Beyond the clinical programs that will be proceeding in 2014, we expect management to make progress with the non-U.S. strategy. We expect the company to partner and out-license European rights to some or all of its products in the coming year. This could provide a nice addition to the company's cash balance, which management reiterated should be \$45 million-\$50 million at year end. Management also repeated that this cash should be adequate to fund operations through the end of 2015.

Stock Thoughts

Aratana's shares have more than doubled since the company's June IPO, but have come under pressure as of late (declining 15% since the end of October and 42% from a \$29 peak). We are not aware of any negative developments within the portfolio and thus believe the recent weakness is primarily driven by the lock-up expiration on December 9 for 4 million shares, as well as the lower valuation of the recently priced competitor Kindred Bio (KIN \$12.00). Kindred's valuation is roughly \$200 million, compared with Aratana's market capitalization of \$350 million. We note that the final lock-up expiration for the remaining 14 million shares is scheduled to take place in mid-January, so we would not be surprised by further volatility in Aratana's stock over the coming month.

However, given the encouraging progress on the company's small-molecule portfolio and the significant expansion of the model with the addition of Vet Therapeutics (biologics, manufacturing, intellectual property, and four additional compounds beyond the B-cell and T-cell products), we view Aratana's current valuation as compelling and reiterate our Outperform rating. We view the high-teens as an attractive entry point for a portfolio that we believe can support a per-share valuation in the low \$20s, with upside driven by additional compound in-licensing and acquisitions. A summary of the company's portfolio follows in exhibit 1, followed by our unchanged model in exhibit 2.

Exhibit 1. Program Status for Portfolio

AT-001			
<u>Dog</u>		<u>Cat</u>	
September	December	September	December
- Pivotal Field Study initiated in 2012, Topline results expected in mid-2014 - Topline results from dose-ranging study expected in November 2013 - 2016 Launch	- Pivotal study expected to be initiated in 2014 - 2016 Launch	- No update; previously expected to pursue acute pain indication	- Pursuing chronic pain indication
AT-002			
<u>Dog</u>		<u>Cat</u>	
September	December	September	December
- Pivotal Field Study expected to be initiated in late 2013, Topline results expected in early 2015 - 2016 Launch	- Agreement on Pivotal Field Study design reached; expected to be initiated in late 2013 - 2016 Launch	- Pivotal Field Study expected to be initiated in late 2014, Topline results expected in late 2015 - 2017 Launch	- Pivotal Field Study expected to be initiated in mid 2014, Topline results expected in late 2015 - 3-week treatment term and final formulation selected; further proof of concept work to be done; results expected in first half 2014
AT-003			
<u>Dog</u>		<u>Cat</u>	
September	December	September	December
- Pivotal Field Study expected to be initiated in mid-2014, Top line results expected in mid-2015 - 2016 Launch	- Pivotal Field Study expected to be initiated in mid-2014, Top line results expected in mid-2015 - Continued dose-ranging study in laboratory animals - 2016 Launch	-Pivotal Field Study expected to be initiated in mid-2014, Top line results expected in mid-2015 - 2016 Launch	-Pivotal Field Study expected to be initiated in mid-2014, Top line results expected in mid-2015 - Initiated dose-ranging study in laboratory animals in late 2013
B-cell Lymphoma - dog only			
October	December		
- Received conditional license from USDA	- Completed submission for full license; expected within next 12-18 months		
T-cell Lymphoma - dog only			
October	December		
- Initial data submitted to USDA; expect conditional license in 2014 and full license in 2015	- Initial data submitted to USDA; expect conditional license in 2014 and full license in 2016		
Option Programs			
October	December		
- Three programs still being evaluated, company will advance at least program but likely not all following a decision in early 2014.	- Three programs still being evaluated, company will advance at least one program but likely not all following a decision in the first quarter 2014.		
Other Vet Therapeutics Compounds for Mast Cell Tumors, Atpopic Dermatitis, and Feline Lymphoma			
October	December		
- N/A	- Studies in two unspecified products expected to begin in 2014 and be completed by 2015; conditional licenses expected in mid-2015 for two products and a third product in 2016		

Note: Shaded areas suggest updated language
Source: William Blair & Company L.L.C.

Exhibit 2. Aratana Income Statement (2011 to 2020E)

Income Statement																		
	2,011	2012	Q1A	Q2A	Q3A	Q4E	2013E	Q1E	Q2E	Q3E	Q4E	2014E	2015E	2016E	2017E	2018E	2019E	2020E
Revenues																		
AT-001						-	-	-	-	-	-	-	-	9,174,000	18,104,320	25,105,600	37,128,000	56,867,200
% growth (y/y)						-	-	-	-	-	-	-	-	-	39%	39%	48%	53%
AT-002						-	-	-	-	-	-	-	-	11,051,800	19,294,880	32,417,360	48,584,200	70,468,200
% growth (y/y)						-	-	-	-	-	-	-	-	-	68%	59%	45%	45%
AT-003						-	-	-	-	-	-	-	-	1,970,000	11,000,000	19,800,000	29,800,000	40,186,000
% growth (y/y)						-	-	-	-	-	-	-	-	-	80%	51%	35%	35%
B-Cell Revenue						-	-	210,000	210,000	210,000	210,000	840,000	4,200,000	8,400,000	12,600,000	16,800,000	19,320,000	21,000,000
% growth (y/y)						-	-	-	-	-	-	-	-	-	59%	50%	45%	45%
T-Cell Revenue						-	-	-	-	-	-	-	7,200,000	11,250,000	16,200,000	21,600,000	25,200,000	27,900,000
% growth (y/y)						-	-	-	-	-	-	-	-	-	80%	51%	35%	35%
Total Net Product Revenues						-	-	210,000	210,000	210,000	210,000	840,000	11,400,000	41,845,800	77,199,200	115,722,960	160,032,000	216,421,400
Royalty Revenue (E.U.)						-	-	-	-	-	-	-	-	1,970,000	7,006,250	13,093,750	19,191,413	25,919,791
Total Net Revenues	-	0.0	0.0	0.0	0.0	0.0	0	210,000	210,000	210,000	210,000	840,000	11,400,000	43,815,800	84,205,450.0	128,816,710.0	179,223,413	242,340,191
% growth (y/y)														92%	53%	39%	35%	35%
Expenses																		
COGS	-	-				0	0	6,720	6,720	6,720	6,720	26,880	1,934,400	7,717,460	15,233,040	23,382,192	33,000,640	45,169,880
R&D expense	2,196,000	8,791,000	2,114,000	2,469,000	3,234,000	3,557,400	11,374,400	3,412,320	3,412,320	3,412,320	3,412,320	13,649,280	16,788,614	20,146,337	23,571,215	27,578,321	31,439,286	37,098,358
% growth (y/y)			20.7%	28.0%	95.1%	3.0%	29%	61.4%	38.2%	5.5%	-4.1%	20%	23%	20%	17%	14%	18%	18%
SG&A expense	1,274,000	2,987,000	1,226,000	1,258,000	1,427,000	1,455,540	5,366,540	3,929,675	3,929,675	3,929,675	3,929,675	15,718,700	23,933,367	29,558,041	36,428,468	46,313,616	57,746,795	70,197,072
% growth (y/y)																		
In-process R&D	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Total Operating Expenses	3,470,000	11,778,000	3,340,000	3,727,000	4,661,000	5,012,940	16,740,940	7,348,715	7,348,715	7,348,715	7,348,715	29,394,859.8	42,656,381.1	57,421,838	75,232,743	97,274,129	122,186,721	152,465,310
Operating (loss)/profit	(3,470,000)	(11,778,000)	(3,340,000)	(3,727,000)	(4,661,000)	(5,012,940)	(16,740,940)	(7,138,715)	(7,138,715)	(7,138,715)	(7,138,715)	(28,554,860)	(31,256,381.1)	(13,606,038)	(8,972,707)	(31,542,581)	(57,036,691)	(89,874,881)
Interest income	6,000	21,000	3,000	22,000	26,000	32,691	83,691	31,584	29,020	25,223	20,152	105,979	55,859.5	102,543	91,398	134,695	224,226	347,406
Interest expense	-	-	(24,000)	(78,000)	(80,000)	(206,250)	(388,250)	(239,814)	(239,814)	(239,814)	(239,814)	(959,255)	(959,255.0)	(959,255)	(959,255)	(959,255)	(959,255)	(959,255)
Other Income	-	121,000	68,000	343,000	44,000	50,000	505,000	25,000.0	25,000.0	25,000.0	25,000.0	100,000.0	100,000	100,000	100,000	100,000	100,000	100,000
Total Other Income	6,000	142,000	47,000	287,000	(10,000)	(123,559)	200,441	(183,230)	(185,793)	(189,591)	(194,662)	(753,276)	(803,395.5)	(756,712)	(767,857)	(724,560.1)	(635,029)	(511,849)
Net loss and comprehensive loss	(3,464,000)	(11,636,000)	(3,293,000)	(3,440,000)	(4,671,000)	(5,136,499)	(16,540,499)	(7,321,945)	(7,324,508)	(7,328,306)	(7,333,377)	(29,308,135)	(32,059,777)	(14,362,751)	8,204,850	30,818,020	56,401,662	89,363,032
Modifications of Series A convertible pref. stock	(276,000)	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Unaccreted dividends on convertible pref. stock	(902,000)	(2,035,000)	(773,000)	(808,000)	-	-	(1,581,000)	-	-	-	-	-	-	-	-	-	-	-
Net income loss (gain) attributable to common stockholders, basic and diluted	(4,642,000)	(13,671,000)	(4,066,000)	(4,248,000)	(4,671,000)	(5,136,499)	(18,121,499)	(7,321,945)	(7,324,508)	(7,328,306)	(7,333,377)	(29,308,135)	(32,059,777)	(14,362,751)	8,204,849.737	30,818,020	56,401,662	89,363,032
Provision for income taxes	-	-	-	-	-	-	-	-	-	-	-	-	-	-	2,953,746	11,094,487	20,304,598	32,170,692
Effective tax rate	NM	NM	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	36%	36%	36%	36%
Net Income (loss)	(4,642,000)	(13,671,000)	(4,066,000)	(4,248,000)	(4,671,000)	(5,136,499)	(18,121,499)	(\$7,321,945)	(\$7,324,508.4)	(\$7,328,305.9)	(\$7,333,376.6)	(29,308,135)	(\$32,059,777)	(\$14,362,751)	\$5,251,104	\$19,723,533	\$36,097,064	\$57,192,341
EPS	(0.31)	(\$0.91)	(\$0.27)	(\$0.23)	(\$0.22)	(\$0.23)	(\$0.95)	(\$0.32)	(\$0.32)	(\$0.32)	(\$0.32)	(\$1.29)	(\$1.36)	(\$0.57)	\$0.21	\$0.77	\$1.40	\$2.20
Weighted average shares outstanding (basic)	14,972,266	14,972,266	14,972,266	18,805,599	20,806,352	22,665,727	19,312,486	22,720,727	22,775,727	22,830,727	22,885,727	22,803,227	23,510,727	25,210,727	25,410,727	25,610,727	25,810,727	26,010,727
Weighted average shares outstanding (diluted)	14,972,266	14,972,266	14,972,266	19,964,402	20,806,352	22,665,727	19,602,187	22,720,727	22,775,727	22,830,727	22,885,727	22,803,227	23,510,727	25,210,727	25,410,727	25,610,727	25,810,727	26,010,727
MARGIN ANALYSIS:																		
Gross Profit														82%	82%	82%	82%	81%
SG&A														67%	43%	43%	32%	29%
R&D														46%	28%	21%	15%	15%
Operating Income														NA	11%	24%	32%	37%
Tax Rate														0%	36%	36%	36%	36%
Net Income														NA	6%	15%	20%	24%
GROWTH METRICS:																		
Total Revenue															92%	53%	39%	35%
Gross Profit															91%	53%	39%	35%
SG&A			146%	102%	34%	82%	80%	221%	212%	175%	170%	193%	52%	24%	23%	27%	25%	22%
R&D			21%	28%	95%	3%	29%	61%	38%	6%	-4%	20%	23%	20%	17%	17%	14%	18%
Operating Income																252%	81%	58%
Net Income																276%	83%	58%
EPS																273%	82%	57%
Diluted Shares Outstanding		0%	0%	33%	39%	51%	31%	52%	14%	10%	1%	1%	3%	0%	0%	0%	0%	1%

E = William Blair & Company, L.L.C. estimate

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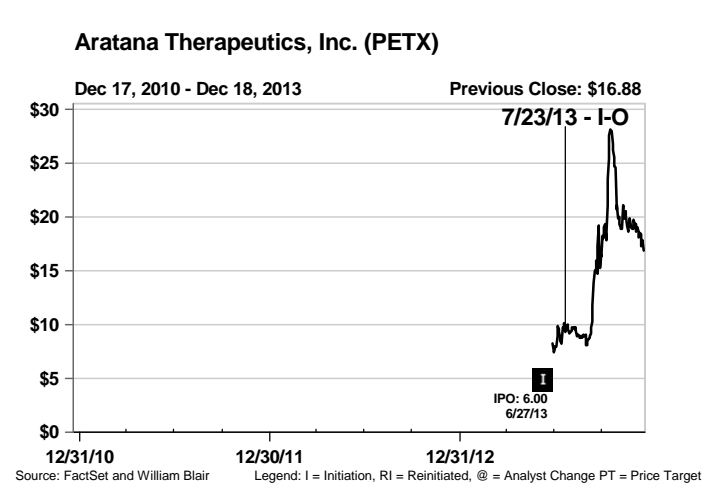
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DOW JONES: 16,167.97

S&P 500: 1,810.65

NASDAQ: 4,070.06



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Market Perform (Hold)	35	Market Perform (Hold)	1
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