

# Otonomy, Inc. (OTIC)

Overweight

Reports 1Q, OTO-104 Data Approaching; Reiterate Overweight

## CONCLUSION

After the close, OTIC reported 1Q15 results, with spending and share count coming in a little less than projected; we are adjusting our estimates accordingly. The company is fast approaching release of P2b results for OTO-104, dexamethasone gel depot for treatment of Meniere's Disease, expected in 2Q. We increasingly see this as a 'buy on the news' event, as success will position the company with two promising ear-targeting therapeutics, whereas investors continue to underestimate the commercial potential of AuriPro and the longer term value of the pipeline.

- **Eyes on ears:** The P2b study of OTO-104 for Meniere's Disease remains on track for data release in 2Q15. While this marks an important binary event for the company, there is meaningful downside protection from the more advanced AuriPro program, which has been filed with the FDA and has a Dec 25th PDUFA data. The company continues efforts to expand the AuriPro label to maximize the commercial opportunity, and we believe this program alone may ultimately justify more than the current valuation of the company. Consultants are quite optimistic for OTO-104 prospects, but there is background 'noise' in Meniere's which creates some uncertainty on the outcome. As such, we believe the data readout will mark an attractive buying opportunity for shares.
- **Defending their turf:** OTO has requested a patent interference with the USPTO over a patent application filed by EARS to cover long-acting formulations for ear therapies. This patent does not threaten OTIC's freedom to operate, but does provide an opportunity to limit potential claims of a competitor. OTIC is well ahead of EARS on sustained-release delivery for the ear (no easy task given the need for small gauge needles).
- **Minor adjustments:** We are making minor adjustments to our spending/share count assumptions which do not impact our OTIC price target.

## RISKS TO ACHIEVEMENT OF PRICE TARGET

Development candidates may face clinical, regulatory or commercial setbacks.

## COMPANY DESCRIPTION

OTIC is developing drugs to treat a variety of ear conditions.

**PRICE: US\$30.25**

Price as of the close May 12, 2015

**TARGET: US\$46.00**

DCF thru 2022, 10.5% discount rate, 3.0% terminal growth rate

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Changes	Previous	Current
Rating	—	Overweight
Price Tgt	—	US\$46.00
FY15E Rev (mil)	—	US\$0.0
FY16E Rev (mil)	—	US\$13.0
FY15E EPS	US\$(2.93)	US\$(2.98)
FY16E EPS	US\$(3.63)	US\$(3.76)
52-Week High / Low	US\$41.99 / US\$15.19	
Shares Out (mil)	24.2	
Market Cap. (mil)	US\$732.1	
Avg Daily Vol (ooo)	175	
Book Value/Share	US\$7.26	
Net Cash Per Share	US\$7.37	
Debt to Total Capital	0.0%	
Div (ann)	US\$0.00	
Fiscal Year End	Dec	

## Price Performance - 1 Year



Source: Bloomberg

YEAR	REVENUE (US\$ m)						EARNINGS PER SHARE (US\$)					
	Mar	Jun	Sep	Dec	FY	FY RM	Mar	Jun	Sep	Dec	FY	FY P/E
2014A	0.0	0.0	0.0	0.0	0.0	NA	(5.07)	(3.86)	(1.23)	(0.46)	(5.46)	NM
2015E	0.0A	0.0	0.0	0.0	0.0	NA	(0.52)A	(0.64)	(0.80)	(1.01)	(2.98)	NM
2016E	—	—	—	—	13.0	56.3x	—	—	—	—	(3.76)	NM

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Key Events For OTIC				
Program	Disorder	Type	Event	Expected Timing
AuriPro	TTP	Regulatory	FDA Approval	2H 2015
	AOMT	Clinical	P2 results	2015/2016
	New Indication	Clinical	Initiate trials in additional indications	2015
OTO-104	Ménière's disease	Clinical	Phase 2b data readout	2Q 2015
		Clinical	Initiate 2nd pivotal trial	2H 2015
OTO-311	Tinnitus	Preclinical	File IND and initiate P1b study	2015
		Competitive/ validating	Auris Medical P3 data for AM-101	1H 2016

Source: Company reports and Piper Jaffray

OTIC Discounted Cash Flow (DCF) and Equity Valuation (\$ M):	
Assumed Discount Rate (%)	10.5%
Discounted Net Cash Flow (2014-'20)	846
Terminal Growth Rate (%)	3.0%
Implied Terminal Year FCF Multiple	13.7x
NPV of FCFF	\$1,145
Terminal Value as % of total	26.1%
Add: Net Cash	201
Shares Outstanding 2017E (million)	29
Price Target	\$46

Source: Company Reports and Piper Jaffray.

OTIC DCF Valuation Analysis					
Discount Rate					
Terminal Growth		10.0%	10.5%	11.0%	11.5%
	2.0%	\$44	\$41	\$37	\$34
	3.0%	\$51	\$46	\$42	\$38
	4.0%	\$59	\$53	\$48	\$43
	5.0%	\$71	\$63	\$56	\$50
	6.0%	\$89	\$77	\$67	\$59

Source: Company Reports and Piper Jaffray.

OTIC Potential Upside Vs Current					
Discount Rate					
Terminal Growth		10.0%	10.5%	11.0%	11.5%
	2.0%	24%	14%	4%	(4%)
	3.0%	42%	29%	17%	7%
	4.0%	65%	48%	34%	21%
	5.0%	98%	75%	56%	40%
	6.0%	148%	114%	87%	65%

Source: Company Reports and Piper Jaffray.

<b>OTIC Annual P&amp;L</b>	<b>2013A</b>	<b>Q1 14A</b>	<b>Q2 14A</b>	<b>Q3 14A</b>	<b>Q4 14A</b>	<b>2014A</b>	<b>Q1 15A</b>	<b>Q2 15E</b>	<b>Q3 15E</b>	<b>Q4 15E</b>	<b>2015E</b>
<b>Total U.S. Product Sales (000s)</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>
ex-US royalty	\$0	0.0	0.0	0.0	0.0	\$0	0.0	0.0	0.0	0.0	\$0
<b>Total Revenues</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>
<b>Costs &amp; Expenses:</b>											
Cost of Goods Sold	\$0	0.0	0.0	0.0	0.0	\$0	0.0	0.0	0.0	0.0	\$0
% Product sales	0	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%
R&D	\$16	9.0	8.3	7.4	7.2	\$32	8.6	12.0	13.0	15.0	\$49
% Revenue	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
SG&A	\$4	1.6	1.6	2.0	2.7	\$8	3.5	3.0	6.0	9.0	\$22
% Revenue	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Total Operating Expenses	\$20	10.6	9.8	9.4	9.9	\$40	12.1	15.0	19.0	24.0	\$70
<b>Operating Income (loss)</b>	<b>(\$20)</b>	<b>(10.6)</b>	<b>(9.8)</b>	<b>(9.4)</b>	<b>(9.9)</b>	<b>(\$40)</b>	<b>(12.1)</b>	<b>(15.0)</b>	<b>(19.0)</b>	<b>(24.0)</b>	<b>(\$70)</b>
Interest and Other Income, Net	\$0	(0.3)	(0.3)	(2.6)	0.1	(\$3)	0.1	0.1	0.1	0.1	\$1
Accretion, convertible preferred	(\$1)	(0.0)	(0.0)	(0.0)	0.0	(\$0)	0.0	0.0	0.0	0.0	\$0
<b>Pretax Income (Loss)</b>	<b>(\$20)</b>	<b>(\$11)</b>	<b>(\$10)</b>	<b>(\$12)</b>	<b>(\$10)</b>	<b>(\$43)</b>	<b>(\$12)</b>	<b>(\$15)</b>	<b>(\$19)</b>	<b>(\$24)</b>	<b>(\$69)</b>
Income Taxes (Benefit)	\$0	0.0	0.0	0.0	0.0	\$0	0.0	0.0	0.0	0.0	\$0
Tax rate	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
<b>Net Income, adjusted (GAAP)</b>	<b>(\$20)</b>	<b>(10.8)</b>	<b>(10.2)</b>	<b>(12.0)</b>	<b>(9.8)</b>	<b>(\$43)</b>	<b>(12.0)</b>	<b>(14.9)</b>	<b>(18.9)</b>	<b>(23.9)</b>	<b>(\$70)</b>
Stock option expenses	0	0.3	0.3	0.3	0.9	2	1	1	1	1	2
% Revenue	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Net Income, non-GAAP	(\$20)	-10.6	-9.9	-11.8	-8.9	(\$41)	(12.5)	(15.4)	(19.4)	(24.4)	(\$72)
Diluted EPS (Non-GAAP)	(\$4.51)	(\$4.95)	(\$3.76)	(\$1.20)	(\$0.42)	(\$5.24)	(\$0.54)	(\$0.66)	(\$0.83)	(\$1.03)	(\$3.06)
<b>Diluted EPS, GAAP</b>	<b>(\$4.47)</b>	<b>(\$5.07)</b>	<b>(\$3.86)</b>	<b>(\$1.23)</b>	<b>(\$0.46)</b>	<b>(\$5.46)</b>	<b>(\$0.52)</b>	<b>(\$0.64)</b>	<b>(\$0.80)</b>	<b>(\$1.01)</b>	<b>(\$2.98)</b>
Diluted Shares Outstanding (MM)	4.5	2.1	2.6	9.8	21.2	7.9	23.2	23.3	23.5	23.6	23

Source: Company Reports and Piper Jaffray.

Current disclosure information for this company can be found at <http://www.piperjaffray.com/researchdisclosures>.

Proprietary to Piper Jaffray & Co. May 12, 2015

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OTIC Product Model	2012A	2013A	2014A	2015E	2016E	2017E	2018E	2019E	2020E	2021E	2022E
TTP Procedures/Yr, U.S. (000s)	1,000	1,000	1,000	1,005	1,010	1,015	1,020	1,025	1,030	1,036	1,041
% children	90%	90%	90%	90%	90%	90%	90%	90%	90%	90%	90%
# children TTP procedures/yr, U.S. (000s)	900	900	900	905	909	914	918	923	927	932	937
% of market without payor obstacles	55%	55%	55%	55%	55%	55%	55%	55%	55%	55%	55%
% penetration, low barrier population	0%	0%	0%	0%	10%	20%	30%	35%	40%	45%	50%
% penetration, high barrier population	0%	0%	0%	0%	2%	5%	15%	20%	25%	30%	35%
# adult TTP procedures/yr, U.S. (000s)	100	100	100	101	101	102	102	103	103	104	104
% penetration, adults	0%	0%	0%	0%	1%	5%	15%	35%	40%	50%	50%
AuriPro treatments/yr, U.S. (000s)	\$0	\$0	\$0	\$0	\$59	126	229	297	350	408	457
Cost/treatment	\$225	\$225	\$225	\$225	\$225	234	243	253	263	274	285
<b>Total AuriPro revenue, U.S. (mm) For TTP</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$13</b>	<b>\$30</b>	<b>\$56</b>	<b>\$75</b>	<b>\$92</b>	<b>\$112</b>	<b>\$135</b>
<b>AuriPro revenue, Other (mm)</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$10</b>	<b>\$25</b>	<b>\$40</b>	<b>\$55</b>	<b>\$65</b>
<b>Total AuriPro revenue, U.S. (mm)</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$13</b>	<b>\$30</b>	<b>\$66</b>	<b>\$100</b>	<b>\$132</b>	<b>\$167</b>	<b>\$200</b>
Meniere's patients, U.S. (000s)	650	650	650	663	676	697	717	746	776	807	839
% OTO-104 penetration	0%	0%	0%	0%	0%	0%	1%	3%	5%	6%	7%
OTO-104 ears treated, U.S. (000s)	0	0	0	0	0	0	4	19	39	48	59
Cost/yr	\$5,000	\$5,000	\$5,000	\$5,000	\$5,150	\$5,305	\$5,517	\$5,737	\$5,967	\$6,206	\$6,454
<b>OTO-104 revenue/yr, U.S. (mm)</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$20</b>	<b>\$107</b>	<b>\$232</b>	<b>\$300</b>	<b>\$380</b>

Source: Company reports, PJC estimates

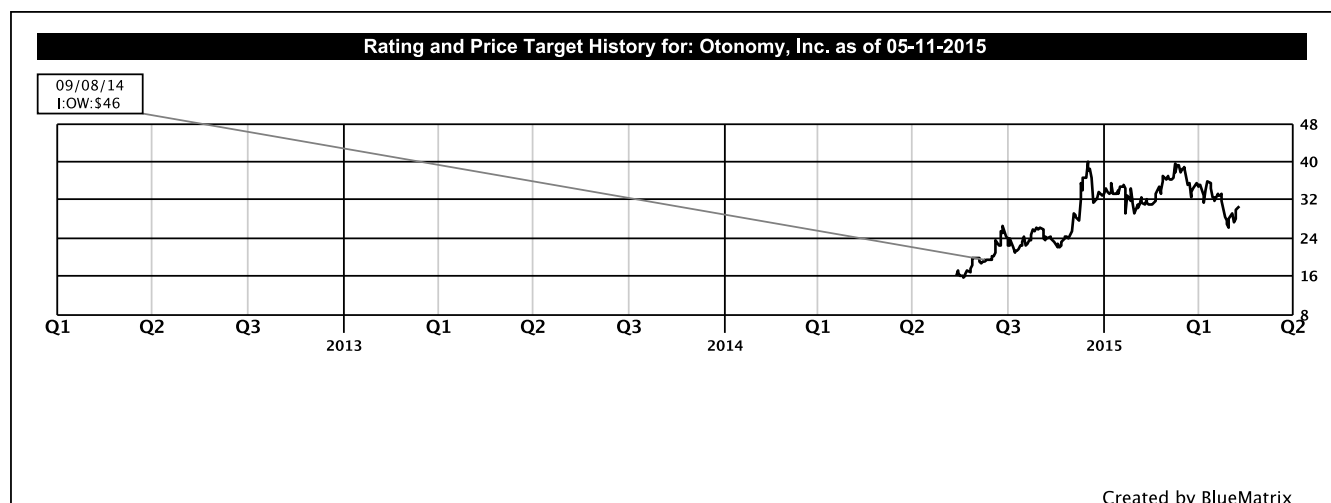
<b>OTIC Annual P&amp;L</b>	<b>2012A</b>	<b>2013A</b>	<b>2014A</b>	<b>2015E</b>	<b>2016E</b>	<b>2017E</b>	<b>2018E</b>	<b>2019E</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
<b>Total U.S. Product Sales (000s)</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$13</b>	<b>\$30</b>	<b>\$85</b>	<b>\$207</b>	<b>\$364</b>	<b>\$467</b>	<b>\$580</b>
ex-US royalty	\$0	\$0	\$0	\$0	\$0	\$5	\$15	\$25	\$30	\$35	\$50
<b>Total Revenues</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$13</b>	<b>\$35</b>	<b>\$100</b>	<b>\$232</b>	<b>\$394</b>	<b>\$502</b>	<b>\$630</b>
Cost of Goods Sold	\$0	\$0	\$0	\$0	\$1	\$3	\$9	\$21	\$36	\$47	\$58
% Product sales	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%
R&D	\$8.5	\$16.3	\$32	\$49	\$50	\$50	\$55	\$55	\$75	\$75	\$80
% Revenue	N/A	N/A	N/A	N/A	N/A	N/A	54.7%	23.7%	19.1%	14.9%	12.7%
SG&A	\$2.4	\$3.5	\$8	\$22	\$70	\$85	\$100	\$120	\$150	\$165	\$180
% Revenue	N/A	N/A	N/A	N/A	N/A	N/A	99.5%	51.7%	38.1%	32.9%	28.6%
Total Operating Expenses	\$10.9	\$19.9	\$40	\$70	\$121	\$138	\$164	\$196	\$261	\$287	\$318
<b>Operating Income (loss)</b>	<b>(10.9)</b>	<b>(19.9)</b>	<b>(\$40)</b>	<b>(\$70)</b>	<b>(\$108)</b>	<b>(\$103)</b>	<b>(\$63)</b>	<b>\$36</b>	<b>\$132</b>	<b>\$216</b>	<b>\$312</b>
Interest and Other Income, Net	\$3.4	\$0.3	(\$3)	\$1	\$1	\$1	\$1	\$1	\$1	\$1	\$1
Accretion, convertible preferred	(0.8)	(0.5)	(\$0)	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0
<b>Pretax Income (Loss)</b>	<b>(\$8)</b>	<b>(\$20)</b>	<b>(\$43)</b>	<b>(\$69)</b>	<b>(\$107)</b>	<b>(\$102)</b>	<b>(\$62)</b>	<b>\$37</b>	<b>\$133</b>	<b>\$217</b>	<b>\$313</b>
Income Taxes (Benefit)	0.0	0.0	\$0	\$0	\$0	\$0	\$0	\$11	\$40	\$65	\$94
Tax rate	0%	0%	0%	0%	0%	0%	0%	30%	30%	30%	30%
<b>Net Income, adjusted (GAAP)</b>	<b>(8.37)</b>	<b>(20.1)</b>	<b>(\$43)</b>	<b>(\$70)</b>	<b>(\$107)</b>	<b>(\$102)</b>	<b>(\$62)</b>	<b>\$26</b>	<b>\$93</b>	<b>\$152</b>	<b>\$219</b>
Stock option expenses	0	0	2	2	2	3	4	5	8	10	13
% Revenue	N/A	N/A	N/A	N/A	N/A	N/A	N/A	2%	2%	2%	2%
Net Income, non-GAAP	(\$8.6)	(\$20.3)	(\$41)	(\$68)	(\$105)	(\$99)	(\$59)	\$31	\$101	\$162	\$232
Diluted EPS (Non-GAAP)	(\$3.46)	(\$4.51)	(\$5.24)	(\$2.89)	(\$3.69)	(\$3.40)	(\$1.83)	\$0.93	\$2.95	\$4.55	\$6.28
<b>Diluted EPS, GAAP</b>	<b>(\$3.38)</b>	<b>(\$4.47)</b>	<b>(\$5.46)</b>	<b>(\$2.98)</b>	<b>(\$3.76)</b>	<b>(\$3.50)</b>	<b>(\$1.94)</b>	<b>\$0.79</b>	<b>\$2.72</b>	<b>\$4.27</b>	<b>\$5.94</b>
Diluted Shares Outstanding (MM)	2.5	4.5	7.9	23.4	28.5	29.3	31.9	33.0	34.2	35.5	36.9

Source: Company Reports and Piper Jaffray.

<b>Cash Flow Statement</b>	<b>2012A</b>	<b>2013A</b>	<b>2014A</b>	<b>2015E</b>	<b>2016E</b>	<b>2017E</b>	<b>2018E</b>	<b>2019E</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
Net Income (Loss)	-8.4	-20.1	-42.8	-69.7	-107.0	-102.4	-62.1	26.2	93.2	151.6	219.3
Accretion to RV of convert	0.8	0.5	(0.0)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Depreciation and amortization	0.2	0.3	0.2	0.5	1.0	1.2	1.3	1.4	2.0	2.5	3.0
Stock-based compensation	0.2	0.2	1.7	2.0	2.0	3.0	3.5	4.6	7.9	10.0	12.6
Non cash interest exp	0.4	2.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Change in FV of convert	(3.8)	(2.8)	3.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Deferred rent	0.3	(0.0)	(0.1)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Changes in operating assets and liability	(0.6)	(0.0)	2.6	(1.0)	(1.7)	(5.4)	(17.5)	(36.0)	(41.0)	(27.8)	(32.8)
<b>Cash From Operations</b>	<b>(10.8)</b>	<b>(19.5)</b>	<b>(35.1)</b>	<b>(68.2)</b>	<b>(105.7)</b>	<b>(103.7)</b>	<b>(74.8)</b>	<b>(3.8)</b>	<b>62.1</b>	<b>136.3</b>	<b>202.1</b>
Capex	(0.2)	(0.5)	(0.8)	(2.0)	(2.5)	(3.0)	(3.5)	(3.5)	(5.9)	(7.5)	(9.5)
<b>FCF</b>	<b>(11.0)</b>	<b>(20.0)</b>	<b>(35.9)</b>	<b>(70.2)</b>	<b>(108.2)</b>	<b>(106.7)</b>	<b>(78.3)</b>	<b>(7.3)</b>	<b>56.2</b>	<b>128.8</b>	<b>192.7</b>
Proceeds from convertible notes	8.0	7.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Proceeds from issuance of conv pref stocks	0.0	45.6	49.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Proceeds from issuance of common stocks	0.0	0.0	104.1	80.0	200.0	0.0	100.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	1.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Cash From Financing</b>	<b>8.0</b>	<b>52.6</b>	<b>154.7</b>	<b>80.0</b>	<b>200.0</b>	<b>0.0</b>	<b>100.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>
Net increase in cash and cash equivalents	(3.0)	32.6	118.8	9.8	91.8	(106.7)	21.7	(7.3)	56.2	128.8	192.7
Cash/equivalents at beginning	7.7	4.7	37.3	156.1	165.9	257.7	151.1	172.8	165.5	221.7	350.4
Cash/equivalents at end	4.7	37.3	156.1	165.9	257.7	151.1	172.8	165.5	221.7	350.4	543.1

Proprietary to Piper Jaffray & Co. May 12, 2015

## IMPORTANT RESEARCH DISCLOSURES



Notes: The boxes on the Rating and Price Target History chart above indicate the date of the Research Note, the rating, and the price target. Each box represents a date on which an analyst made a change to a rating or price target, except for the first box, which may only represent the first Note written during the past three years.

### Legend:

I: Initiating Coverage  
R: Resuming Coverage  
T: Transferring Coverage  
D: Discontinuing Coverage  
S: Suspending Coverage  
OW: Overweight  
N: Neutral  
UW: Underweight  
NA: Not Available  
UR: Under Review

Distribution of Ratings/IB Services Piper Jaffray				
Rating	Count	Percent	IB Serv./Past 12 Mos.	
			Count	Percent
<b>BUY [OW]</b>	380	61.59	102	26.84
<b>HOLD [N]</b>	222	35.98	14	6.31
<b>SELL [UW]</b>	15	2.43	0	0.00

Note: Distribution of Ratings/IB Services shows the number of companies currently in each rating category from which Piper Jaffray and its affiliates received compensation for investment banking services within the past 12 months. FINRA rules require disclosure of which ratings most closely correspond with "buy," "hold," and "sell" recommendations. Piper Jaffray ratings are not the equivalent of buy, hold or sell, but instead represent recommended relative weightings. Nevertheless, Overweight corresponds most closely with buy, Neutral with hold and Underweight with sell. See Stock Rating definitions below.

**Analyst Certification — Joshua E. Schimmer, MD, Sr Research Analyst**

— Jerry Yang, Ph.D., Research Analyst

— Steven P. Breazzano, Ph.D., Research Analyst

The views expressed in this report accurately reflect my personal views about the subject company and the subject security. In addition, no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in this report.



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- **Overweight (OW):** Anticipated to outperform relative to the median of the group of stocks covered by the analyst.
- **Neutral (N):** Anticipated to perform in line relative to the median of the group of stocks covered by the analyst.
- **Underweight (UW):** Anticipated to underperform relative to the median of the group of stocks covered by the analyst.

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