

Otonomy

3Q Snapshot & Model Update

We are updating our OTIC model based on the company's 3Q results (there was no conference call). After its initial public offering in August, the quarterly update was largely incremental. We continue to believe that OTIC is attractively positioned with one de-risked asset in AuriPro for the treatment of middle ear effusion in pediatric patients requiring TTP surgery (positive Ph3 data in hand; NDA expected in 1H15), important upcoming data for OTO-104 in Ménière's disease (Phase 2b results in 1H15e), and longer-term upside optionality in OTO-311 for tinnitus (a blockbuster opportunity). Maintain OW.

- **Upcoming events.** In the next 6-12 months, the key upcoming catalysts include Phase 2b data from the ongoing Phase 2b trial of OTO-104 in Ménière's disease in 1H15. Otonomy also plans to submit an NDA for AuriPro in 1H15 for potential approval and launch in 2016. We also expect the company to file an IND and initiate clinical development of OTO-311 in tinnitus in 2015.
- **3Q results.** 3Q EPS was (\$1.23) vs. JPMe of (\$0.77), largely driven by post-IPO share counts. 3Q OpEx of \$9.4M was lower than JPMe of \$13.7M (due to lower than expected R&D of \$7.4M vs. JPMe of \$11.6M). That said, OTIC is not yet an earnings story.
- **Estimate changes.** We have updated our model for 3Q results; changes were minimal. We are maintaining our YE15 target of \$32.
- **Balance sheet update.** OTIC ended 3Q with ~\$165M in cash (and no debt) after completing an IPO in August (J.P. Morgan acted as a joint book-runner) generating ~\$104M in net proceeds.

Overweight

OTIC, OTIC US

Price: \$23.68

Price Target: \$32.00

Biotechnology

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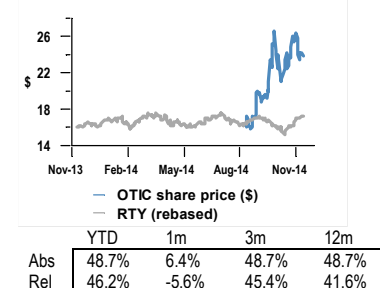
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Price Performance



Otonomy, Inc. (OTIC;OTIC US)

FYE Dec	2012A	2013A	2014E	2014E	2015E	2015E	2016E	2016E
			(Prev)	(Curr)	(Prev)	(Curr)	(Prev)	(Curr)
EPS Reported (\$)								
Q1 (Mar)	-	(1.04)	(3.65)A	(3.65)A	-	-	-	-
Q2 (Jun)	-	-	(3.40)A	(3.40)A	-	-	-	-
Q3 (Sep)	-	-	(0.77)	(1.23)A	-	-	-	-
Q4 (Dec)	-	-	(0.75)	(0.76)	-	-	-	-
FY	(3.38)	(7.64)	(4.51)	(5.33)	(3.09)	(3.11)	(3.11)	(3.12)

Source: Company data, Bloomberg, J.P. Morgan estimates.

Company Data

Price (\$)	23.68
Date Of Price	12 Nov 14
52-week Range (\$)	28.20-15.19
Market Cap (\$ mn)	501.38
Fiscal Year End	Dec
Shares O/S (mn)	21
Price Target (\$)	32.00
Price Target End Date	31-Dec-15

See page 6 for analyst certification and important disclosures.

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Pipeline

Figure 1: OTIC Pipeline

Product Pipeline Highlights

Program	P/C	Ph 1	Ph 2	Ph 3	FDA	Mkt.	Partner	Comments
AuriPro Middle ear effusion								ciprofloxacin
OTO-104 Ménière's disease								dexamethasone
OTO-311 Tinnitus								gacyclidine

Source: Company reports and J.P. Morgan estimates.

Upcoming Events

Figure 2: OTIC Upcoming Events

Anticipated Newsflow Highlights

Program	Event	Expected Timing	Significance
AuriPro	Submit NDA	1H15	Medium
	Initiate clinical trials in other indications	2015	Low
	Potential US Launch	2016	High
OTO-104	Phase 2b results in Ménière's disease	1H15	Medium
	Initiate single-dose Phase 3 study	2H15	Medium
	Initiate multiple-dose safety studies	4Q14	Medium
OTO-311	File IND	2015	Medium
	Initiate Phase 1b study	2015	Medium

Source: Company reports and J.P. Morgan estimates

Figure 3: OTIC Income Statement

Otonomy Income Statement												
Cory Kasimov cory.w.kasimov@jpmorgan.com 212.622.5266												
	2012A	2013A	1Q14A	2Q14A	3Q14A	4Q14E	2014E	2015E	2016E	2017E	2018E	2019E
AuriPro Revenues								-	6.9	31.7	63.8	106.6
OTO-104 Revenues								-	-	-	10.7	68.2
Total Product Revenue							-	-	6.9	31.7	74.6	174.8
License & Milestone	-	-	-	-	-	-	-	-	-	-	-	-
Contract, Grant & Collaboration	-	-	-	-	-	-	-	-	-	-	-	-
Total Revenues	-	-	-	-	-	-	-	-	6.9	31.7	74.6	174.8
COGS		-						-	1.0	4.1	8.2	15.7
R&D	8.5	16.3	9.0	8.3	7.4	13.6	38.2	49.1	50.6	55.7	60.7	68.3
SG&A	2.4	3.5	1.6	1.6	2.0	2.6	7.8	18.5	34.0	47.6	52.8	54.2
Total Operating Expenses	10.9	19.9	10.6	9.8	9.4	16.2	46.0	67.6	85.6	107.4	121.7	138.3
Operating Income	(10.9)	(19.9)	(10.6)	(9.8)	(9.4)	(16.2)	(46.0)	(67.6)	(78.7)	(75.7)	(47.2)	36.6
Other income (expense)	(0.4)	(2.5)	0.1	(0.8)	(2.6)	0.2	(3.1)	0.3	0.2	0.2	0.2	0.4
Change in fair value of convertible pref. stock	3.8	2.8	(0.3)	(0.0)	-	-	(0.3)	-	-	-	-	-
Income Tax (benefit)		-	-	-	-	-	-	-	-	-	-	-
GAAP Net Income	(7.6)	(19.6)	(10.717)	(10.615)	(12.0)	(16.0)	(49.4)	(67.3)	(78.5)	(75.5)	(47.0)	37.0
Accretion to redemption value of convertible pref. stock	(0.8)	(0.5)	(0.0)	(0.0)	(0.0)	(0.0)	(0.75)	(3.06)	(3.07)	(2.58)	(1.41)	1.14
GAAP Net Income attributable to common stockholders	(8.4)	(20.1)	(10.7)	(10.6)	(12.0)	(16.0)	(49.4)	(67.3)	(78.5)	(75.5)	(47.0)	37.0
Non-GAAP Net Income	(8.4)	(20.1)	(10.6)	(10.4)	(11.6)	(15.8)	(48.3)	(66.2)	(77.2)	(73.8)	(44.7)	39.5
GAAP Basic EPS	(3.38)	(7.64)	(3.65)	(3.40)	(1.23)	(0.76)	(5.33)	(3.11)	(3.12)	(2.64)	(1.49)	1.07
GAAP Diluted EPS	(3.38)	(7.64)	(3.65)	(3.40)	(1.23)	(0.76)	(5.33)	(3.11)	(3.12)	(2.64)	(1.49)	1.00
Non-GAAP Basic EPS			(3.59)	(3.32)	(1.18)	(0.75)	(5.21)	(3.06)	(3.07)	(2.58)	(1.41)	1.14
Non-GAAP Diluted EPS			(3.59)	(3.32)	(1.18)	(0.75)	(5.21)	(3.06)	(3.07)	(2.58)	(1.41)	1.07
Basic Shares Outstanding	2.5	2.6	2.9	3.1	9.8	21.2	9.3	21.6	25.1	28.6	31.6	34.6
Diluted Shares Outstanding	2.5	2.6	2.9	3.1	9.8	21.2	9.3	21.6	25.1	28.6	31.6	36.8
Margin Analysis:												
Gross margin	NM	NM	NM	NM	NM	NM	NM	NM	85%	87%	89%	91%
Operating margin	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	20.91%
Net margin	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	21.14%
Tax Rate	0%	0.0%	0%	0%	0%	0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Cost Analysis:												
COGS as % of tot. prod. sales	NM	NM	NM	NM	NM	NM	NM	0.00%	15.00%	13.00%	11.00%	9.00%
R&D as % of tot. revenue	NM	NM	NM	NM	NM	NM	NM	NM	734.34%	175.41%	81.48%	39.08%
SG&A as % of tot. revenue	NM	NM	NM	NM	NM	NM	NM	NM	492.85%	150.06%	70.82%	31.01%
Year-over-year growth:												
Total revenue		NM	NM	NM	NM	NM	NM	NM	NM	360.50%	134.89%	134.51%
R&D Expense		91.67%	189.57%	NM	NM	NM	133.94%	28.37%	3.17%	10.00%	9.10%	12.47%
SG&A Expense		45.93%	119.50%	NM	NM	NM	121.09%	138.13%	83.62%	40.21%	10.85%	2.69%
Total operating expenses		81.59%	176.48%	NM	NM	NM	131.66%	46.91%	26.73%	25.48%	13.32%	13.58%
Operating income		NM	NM	NM	NM	NM	131.66%	46.91%	16.53%	-3.86%	-37.66%	-177.48%
Net income		NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM
EPS		NM	NM	NM	NM	NM	-30.32%	-41.58%	0.43%	-15.55%	-43.69%	-167.52%
Basic Shares		6.28%	14.14%	NM	NM	NM	252.81%	133.06%	16.19%	13.93%	10.48%	9.49%
Diluted Shares		NM	NM	NM	NM	NM	#DIV/0!	51.74%	2.34%	29.72%	1.76%	19.05%

Source: J.P. Morgan estimates, Company data.

Investment Thesis, Valuation and Risks

Otonomy (Overweight; Price Target: \$32.00)

Investment Thesis

We have an OW rating on OTIC based on the potential of its two lead pipeline candidates: AuriPro (sustained exposure antibiotic) and OTO-104 (sustained exposure steroid). AuriPro has successfully completed Phase 3 trials in TTP surgery (ear tube placement); an NDA is expected in 1H15 and we expect a 2016 launch with peak sales of \$250M. OTO-104 is in a Phase 2b trial in Ménière's disease; data is expected in 1H15 and we assume launch in 2018 with peak sales of ~\$500M.

Valuation

Our Dec 2015 price target of \$32 is based on a blended average of our proprietary probability-adjusted scenario analysis (50%) and a risk-adjusted NPV model (50%).

OTIC Valuation Summary

Otonomy Valuation Summary			
Discount rate	13%		
4Q15 Fully Diluted Shares (mm)	23.8		
Main value drivers	Prob of approval	Peak WW sales est (avg. scenario)	Avg peak yr
US AuriPro	85%	\$ 273	2022
US OTO-104	70%	\$ 497	2023
Valuation methodology	Value / share	Weighting	Adj. value/ share
Real options scenario analysis	\$ 35.91	50%	17.95
Risk adjusted NPV analysis	\$ 28.19	50%	14.10
Total			\$ 32.05
Catalyst/liquidity discount			0%
YE15 Price Target			\$ 32

Source: J.P. Morgan estimates.

Risks to Rating and Price Target

OTIC is susceptible to the standard risks that apply to the entire biotech industry, including development, regulatory, commercial, manufacturing, financing, and IP pitfalls. More specific risks to the downside include clinical setbacks for the key pipeline product OTO-104 and pre-clinical candidate OTO-311, regulatory hurdles, and commercial setbacks.

Otonomy: Summary of Financials

Income Statement - Annual	FY13A	FY14E	FY15E	FY16E	Income Statement - Quarterly	1Q14A	2Q14A	3Q14A	4Q14E
Revenues	0	0	0	7	Revenues	0A	0A	0A	0
Cost of products sold	0	0	0	(1)	Cost of products sold	0A	0A	0A	0
Gross profit	-	-	-	-	Gross profit	-	-	-	-
SG&A	(4)	(8)	(19)	(34)	SG&A	(2)A	(2)A	(2)A	(3)
R&D	(16)	(38)	(49)	(51)	R&D	(9)A	(8)A	(7)A	(14)
Operating income	(20)	(46)	(68)	(79)	Operating income	(11)A	(10)A	(9)A	(16)
EBITDA	(20)	(46)	(68)	(79)	EBITDA	(11)A	(10)A	(9)A	(16)
Net interest (income) / expense	-	-	-	-	Net interest (income) / expense	-	-	-	-
Other income / (expense)	(3)	(3)	0	0	Other income / (expense)	0A	(1)A	(3)A	0
Income taxes	0	0	0	0	Income taxes	0A	0A	0A	0
Net income - GAAP	(20)	(49)	(67)	(78)	Net income - GAAP	(11)A	(11)A	(12)A	(16)
Net income - recurring	(20)	(49)	(67)	(78)	Net income - recurring	(11)A	(11)A	(12)A	(16)
Diluted shares outstanding	3	9	22	25	Diluted shares outstanding	3A	3A	10A	21
EPS - excluding non-recurring	(7.64)	(5.33)	(3.11)	(3.12)	EPS - excluding non-recurring	(3.65)A	(3.40)A	(1.23)A	(0.76)
EPS - recurring	(7.64)	(5.33)	(3.11)	(3.12)	EPS - recurring	(3.65)A	(3.40)A	(1.23)A	(0.76)
Balance Sheet and Cash Flow Data	FY13A	FY14E	FY15E	FY16E	Ratio Analysis	FY13A	FY14E	FY15E	FY16E
Cash and cash equivalents	37	142	75	97	Sales growth	-	-	-	-
Accounts receivable	-	-	-	-	EBIT growth	81.6%	131.7%	46.9%	16.5%
Inventories	-	-	-	-	EPS growth - recurring	125.9%	(30.3%)	(41.6%)	0.4%
Other current assets	2	2	2	2	Gross margin	-	-	-	-
Current assets	39	144	77	100	EBIT margin	-	-	-	(1142.2%)
PP&E	1	1	1	1	EBITDA margin	-	-	-	(1142.2%)
Total assets	40	144	78	101	Tax rate	0.0%	0.0%	0.0%	0.0%
Total debt	0	0	0	0	Net margin	-	-	-	(1138.8%)
Total liabilities	4	3	3	4	Net Debt / EBITDA	187.8%	308.2%	111.0%	123.6%
Shareholders' equity	36	141	75	97	Net Debt / Capital (book)	3365.0%	32435.9%	18315.4%	25652.5%
Net income (including charges)	(20)	(49)	(67)	(78)	Return on assets (ROA)	(88.0%)	(53.6%)	(60.5%)	(87.9%)
D&A	0	0	0	0	Return on equity (ROE)	(133.3%)	(55.7%)	(62.3%)	(91.5%)
Change in working capital	(0)	0	0	0	Enterprise value / sales	-	-	-	58.6
Other	(0)	1	1	1	Enterprise value / EBITDA	NM	NM	NM	NM
Cash flow from operations	(19)	(48)	(66)	(77)	Free cash flow yield	(32.0%)	(22.2%)	(13.0%)	(13.1%)
Capex	(0)	(0)	(0)	(0)					
Free cash flow	(20)	(49)	(67)	(78)					
Cash flow from investing activities	(1)	(0)	(0)	(0)					
Cash flow from financing activities	53	153	0	100					
Dividends	-	-	-	-					
Dividend yield	-	-	-	-					

Source: Company reports and J.P. Morgan estimates.

Note: \$ in millions (except per-share data). Fiscal year ends Dec

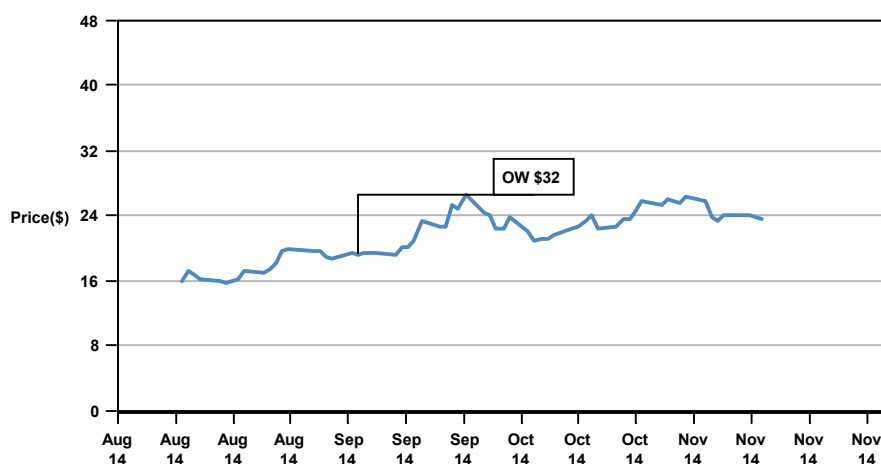
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Otonomy (OTIC, OTIC US) Price Chart



Date	Rating	Share Price (\$)	Price Target (\$)
08-Sep-14	OW	19.39	32.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Sep 08, 2014.

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