

Otonomy, Inc. (OTIC)

Overweight

Otonomy: Q4 Earnings And Update

CONCLUSION

OTIC reported Q4 2014 earnings Wednesday after the close. The company continues to advance its pipeline in the ear disease space with several important events this year, including the Phase 2b readout in Q2 for OTO-104, and the potential approval of AuriPro later this year as well as several additional pipeline events. The company ended the quarter with cash and cash equivalents of ~\$156M, but raised an additional ~\$80M from a follow-on in January. We continue to believe that OTIC offers an attractive risk and reward profile in the small-cap space, even following the recent run-up in the shares. We reiterate our OW rating and following minor model adjustments and rolling the DCF 1 year forward, the PT remains \$46.

- **Lead Program On Track:** OTIC filed an NDA for AuriPro, the lead program for pediatric patients with middle ear infections who require TTP, back in February, positioning AuriPro for a potential 2H 2015 approval. In our view, AuriPro represents at least a \$200M market opportunity in the US alone. If approved, the company expects to launch the drug in 1Q 2016, with a targeted sales force of ~40 reps calling on ~2500 ENTs who are collectively responsible for 80% of the 1M TTP procedures in the US. We note there are other opportunities for AuriPro (e.g., recurrent ear infection, etc.), and OTIC plans to investigate the possibility in one additional indication sometime in 1H 2015.
- **Pipeline Advancing Nicely As Well:** The second program, OTO-104 for Ménière's disease, is progressing well with P2b data due 2Q 2015. We believe there is meaningful upside if successful and are optimistic given the current use of steroids in the literature. If successful, OTIC plans to initiate another study highly similar to this one, but may make minor adjustments based on powering. For OTO-311 for tinnitus, OTIC continues to monitor the news flow to help inform development plans. We note that tinnitus is a complex problem, with a complex etiology that may change over longer durations. This program is expected to enter the clinic sometime in 2015.

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\$38.50

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)	—	0.0
FY16E Rev (mil)	—	13.0
FY15E EPS	(2.84)	(2.93)
FY16E EPS	(3.85)	(3.63)

52-Week High / Low	US\$41.99 / US\$15.19
Shares Out (mil)	9.8
Market Cap. (mil)	US\$377.3
Avg Daily Vol (000)	204
Book Value/Share	US\$7.26
Net Cash Per Share	US\$7.37
Debt to Total Capital	0%
Div (ann)	US\$0.00
Fiscal Year End	Dec

Price Performance - 1 Year



Source: Bloomberg

YEAR	REVENUE (m)						EARNINGS PER SHARE ()					
	Mar	Jun	Sep	Dec	FY	FY RM	Mar	Jun	Sep	Dec	FY	FY P/E
2014E	0.0A	0.0A	0.0A	0.0A	0.0A	NA	(5.07)A	(3.86)A	(1.23)A	(0.46)	(5.46)	NM
2015E	0.0	0.0	0.0	0.0	0.0	NA	(0.57)	(0.61)	(0.77)	(0.97)	(2.93)	NM
2016E	—	—	—	—	13.0	29.0X	—	—	—	—	(3.63)	NM

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Key Events For OTIC				
Program	Disorder	Type	Event	Expected Timing
AuriPro	TTP	Regulatory	File NDA with the FDA	Completed
		Regulatory	FDA Approval	2H 2015
	New Indication	Clinical	Initiate trial in one more additional indications	1H 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)	901
Terminal Growth Rate (%)	3.0%
Implied Terminal Year FCF Multiple	13.7x
NPV of FCFF	\$1,215
Terminal Value as % of total	25.8%
Add: Net Cash	165
Shares Outstanding 2017E (million)	30
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	\$40	\$37	\$34
	3.0%	\$50	\$46	\$41	\$38
	4.0%	\$59	\$53	\$47	\$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%	86%	70%	55%	43%
	3.0%	113%	93%	75%	60%
	4.0%	150%	123%	101%	82%
	5.0%	201%	165%	135%	111%
	6.0%	277%	225%	183%	150%

Source: Company Reports and Piper Jaffray.

OTIC Annual P&L	2013A	Q1 14A	Q2 14A	Q3 14A	Q4 14A	2014A	Q1 15E	Q2 15E	Q3 15E	Q4 15E	2015E
Total U.S. Product Sales (000s)	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0
ex-US royalty	\$0	0.0	0.0	0.0	0.0	\$0	0.0	0.0	0.0	0.0	\$0
Total Revenues	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Costs & Expenses:											
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	11.0	12.0	13.0	15.0	\$51
% 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	3.0	3.0	6.0	9.0	\$21
% 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	14.0	15.0	19.0	24.0	\$72
Operating Income (loss)	(\$20)	(10.6)	(9.8)	(9.4)	(9.9)	(\$40)	(14.0)	(15.0)	(19.0)	(24.0)	(\$72)
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
Pretax Income (Loss)	(\$20)	(\$11)	(\$10)	(\$12)	(\$10)	(\$43)	(\$14)	(\$15)	(\$19)	(\$24)	(\$71)
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%
Net Income, adjusted (GAAP)	(\$20)	(10.8)	(10.2)	(12.0)	(9.8)	(\$43)	(13.9)	(14.9)	(18.9)	(23.9)	(\$72)
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)	(14.4)	(15.4)	(19.4)	(24.4)	(\$74)
Diluted EPS (Non-GAAP)	(\$4.51)	(\$4.95)	(\$3.76)	(\$1.20)	(\$0.42)	(\$5.24)	(\$0.59)	(\$0.63)	(\$0.79)	(\$0.99)	(\$3.01)
Diluted EPS, GAAP	(\$4.47)	(\$5.07)	(\$3.86)	(\$1.23)	(\$0.46)	(\$5.46)	(\$0.57)	(\$0.61)	(\$0.77)	(\$0.97)	(\$2.93)
Diluted Shares Outstanding (MM)	4.5	2.1	2.6	9.8	21.2	7.9	24.2	24.4	24.5	24.7	24

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. March 18, 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
Total AuriPro revenue, U.S. (mm) For TTP	\$0	\$0	\$0	\$0	\$13	\$30	\$56	\$75	\$92	\$112	\$135
AuriPro revenue, Other (mm)	\$0	\$0	\$0	\$0	\$0	\$0	\$10	\$25	\$40	\$55	\$65
Total AuriPro revenue, U.S. (mm)	\$0	\$0	\$0	\$0	\$13	\$30	\$66	\$100	\$132	\$167	\$200
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
OTO-104 revenue/yr, U.S. (mm)	\$0	\$0	\$0	\$0	\$0	\$0	\$20	\$107	\$232	\$300	\$380

Source: Company reports, PJC estimates

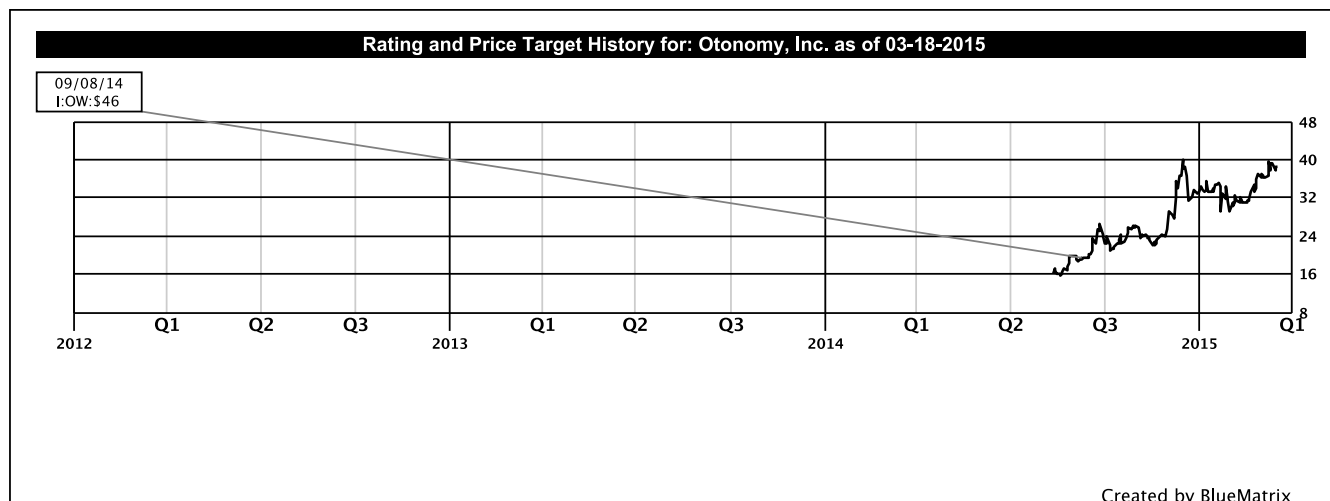
OTIC Annual P&L	2012A	2013A	2014A	2015E	2016E	2017E	2018E	2019E	2020E	2021E	2022E
Total U.S. Product Sales (000s)	\$0	\$0	\$0	\$0	\$13	\$30	\$85	\$207	\$364	\$467	\$580
ex-US royalty	\$0	\$0	\$0	\$0	\$0	\$5	\$15	\$25	\$30	\$35	\$50
Total Revenues	\$0	\$0	\$0	\$0	\$13	\$35	\$100	\$232	\$394	\$502	\$630
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	\$51	\$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	\$21	\$70	\$85	\$100	\$120	\$150	\$165	\$165
% Revenue	N/A	N/A	N/A	N/A	N/A	N/A	99.5%	51.7%	38.1%	32.9%	26.2%
Total Operating Expenses	\$10.9	\$19.9	\$40	\$72	\$121	\$138	\$164	\$196	\$261	\$287	\$303
Operating Income (loss)	(10.9)	(19.9)	(\$40)	(\$72)	(\$108)	(\$103)	(\$63)	\$36	\$132	\$216	\$327
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
Pretax Income (Loss)	(\$8)	(\$20)	(\$43)	(\$71)	(\$107)	(\$102)	(\$62)	\$37	\$133	\$217	\$328
Income Taxes (Benefit)	0.0	0.0	\$0	\$0	\$0	\$0	\$0	\$11	\$40	\$65	\$98
Tax rate	0%	0%	0%	0%	0%	0%	0%	30%	30%	30%	30%
Net Income, adjusted (GAAP)	(8.37)	(20.1)	(\$43)	(\$72)	(\$107)	(\$102)	(\$62)	\$26	\$93	\$152	\$230
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)	(\$70)	(\$105)	(\$99)	(\$59)	\$31	\$101	\$162	\$242
Diluted EPS (Non-GAAP)	(\$3.46)	(\$4.51)	(\$5.24)	(\$2.85)	(\$3.56)	(\$3.28)	(\$1.78)	\$0.90	\$2.87	\$4.42	\$6.38
Diluted EPS, GAAP	(\$3.38)	(\$4.47)	(\$5.46)	(\$2.93)	(\$3.63)	(\$3.38)	(\$1.88)	\$0.77	\$2.64	\$4.14	\$6.05
Diluted Shares Outstanding (MM)	2.5	4.5	7.9	24.5	29.5	30.3	33.0	34.1	35.3	36.6	38.0

Source: Company Reports and Piper Jaffray.

Cash Flow Statement	2012A	2013A	2014A	2015E	2016E	2017E	2018E	2019E	2020E	2021E	2022E
Net Income (Loss)	-8.4	-20.1	-42.8	-71.6	-107.0	-102.4	-62.1	26.2	93.2	151.6	229.8
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)	(32.9)
Cash From Operations	(10.8)	(19.5)	(35.1)	(70.1)	(105.7)	(103.7)	(74.8)	(3.8)	62.1	136.3	212.5
Capex	(0.2)	(0.5)	(0.8)	(2.0)	(2.5)	(3.0)	(3.5)	(3.5)	(5.9)	(7.5)	(9.5)
FCF	(11.0)	(20.0)	(35.9)	(72.1)	(108.2)	(106.7)	(78.3)	(7.3)	56.2	128.8	203.0
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
Cash From Financing	8.0	52.6	154.7	80.0	200.0	0.0	100.0	0.0	0.0	0.0	0.0
Net increase in cash and cash equivalents	(3.0)	32.6	118.8	7.9	91.8	(106.7)	21.7	(7.3)	56.2	128.8	203.0
Cash/equivalents at beginning	7.7	4.7	37.3	156.1	164.0	255.8	149.2	170.9	163.6	219.8	348.5
Cash/equivalents at end	4.7	37.3	156.1	164.0	255.8	149.2	170.9	163.6	219.8	348.5	551.6

Proprietary to Piper Jaffray & Co. March 18, 2015

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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
BUY [OW]	372	60.00	102	27.42
HOLD [N]	234	37.74	18	7.69
SELL [UW]	14	2.26	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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- **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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