

## DepoMed Inc.

NYSE:DEPO

**Analyst:** Skyler Scavone

**Sector:** Healthcare

**BUY**

Price Target: \$33.29

### Key Statistics as of 5/2/2015

Market Price:	\$23.86
Industry:	Pharmaceuticals
Market Cap:	\$1.42b
52-Week Range:	\$9.85-28.16
Beta:	1.71

### Thesis Points:

- Improving and encouraging management team
- Specialized product portfolio
- Continued acquisition success
- Financial overview

### Company Description:

Depomed, Inc., a specialty pharmaceutical company, develops products for pain and other central nervous system conditions in the United States. It offers Gralise (gabapentin), an once-daily product for the management of post herpetic neuralgia; Cambia (diclofenac potassium for oral solution), a non-steroidal anti-inflammatory drug indicated for acute treatment of migraine attacks in adults; Zipsor (diclofenac potassium) liquid filled capsule, a non-steroidal anti-inflammatory drug for the treatment of mild to moderate acute pain in adults; and Lazanda (fentanyl) nasal spray, an intranasal fentanyl drug used to manage breakthrough pain in adults. The next addition to the product line which will occur in 2015 will be Nucynta (tapentadol) and Nucynta ER; the former is an immediate release version of tapentadol, and is used for management of moderate to severe acute pain in adults, the latter extended release tablets are used in management of pain severe enough to require daily, around-the-clock, long-term opioid treatment. The company was founded in 1995 and is headquartered in Newark, California.







## Knowledgeable, encouraging management team

Led by President and CEO James Schoeneck, the Depomed shareholders are in good hands. Mr. Schoeneck joined Depomed as president and chief executive officer in April 2011 and has served on the company's Board of Directors since December 2007. He has broad pharmaceutical experience including three years as president and COE of Prometheus Laboratories Inc., where he led the company to profitability and rapid revenue growth, increasing annual sales from \$6 million to over \$70 million (in three years) leading to its recognition as the third fast-growing private company in America. August Moretti was named CFO and Senior VP in January 2012, and with him he brings a hearty resume. Past experience includes CFO at two other pharmaceutical companies, a JD from Harvard and a BA in economics from Princeton. In Q2 2014 the firm named a new CMO, Srinivas Rao. Rao has extensive experience and background in pain and central nervous system diseases. He was the Founder and Chief Executive Officer of Kyalin Biosciences, a privately held biotechnology company developing a potential breakthrough therapy for autism, from its formation in 2011 through to its sale to Retrophin, Inc in 2013. He was the innovator behind Savella, a drug approved by the FDA in 2009. He received his MD from Yale School of Medicine and his PhD in neurobiology from Yale Graduate School.

## Specialized product portfolio:

Depomed, Inc. currently boasts a diversified product portfolio within the specialized pain and central nervous system market. The specialized nature of DEPO's products allows for synergistic benefits among prescribers. As highlighted in the company overview its four main revenue drivers are Gralise (>52% of product sales in 2014), Cambia (19%), Zipsor (22.07%), and Lazanda (6.13%). This robust portfolio of pain related medications\*\* allowed product sales in 2014 to climb to \$114.2 million or 96% higher than in 2013. A visual comparison of each product and its growth provided by the company presentation is below:

Product				
Indication	Management of Postherpetic Neuralgia	Acute Treatment of Migraine Attacks	Breakthrough Cancer Pain	Mild to Moderate Acute Pain
Differentiation	1x daily with less dizziness and somnolence	Only single agent in its therapeutic class for acute migraine attacks	Only fentanyl product delivered nasally	Rapidly dispersed, low dose version of diclofenac
Q4 Annualized Sales	\$72MM	\$25MM	\$10MM	\$27MM
Year over Year Sales Growth	54%	52%	245%	20%
IP	August 2014 D.Ct. ANDA victory upholds patents; exclusivity expected to 2024	ANDA settlement with exclusivity expected to January 2023	Patents out to October 2024	Patents out to February 2029
Sales Reps	188 Sales Representatives and expanding to approximately 300 by June 2015 <sup>(1)</sup>			

One can note the year over year sales growth on all fronts, the product differentiation and exclusivity of the products, as well as the expanding sales team. The table below further breaks down the segmental growth of products over the past year:

Product Sales	Gralise	Cambia*	Zipsor†	Lazanda**	Total
<b>2014</b>	<b>60.4</b>	<b>21.7</b>	<b>25.2</b>	<b>7.0</b>	<b>114.2</b>
vs. 2013	67%		24%	472%	59%
<b>Q4</b>	<b>18.1</b>	<b>6.3</b>	<b>6.8</b>	<b>2.7</b>	<b>33.9</b>
v. Q3	11%	9%	11%	19%	11%
vs. Q4 2013	55%		19%	244%	80%
<b>Q3</b>	<b>16.3</b>	<b>5.8</b>	<b>6.1</b>	<b>2.3</b>	<b>30.6</b>
v. Q2	8%	16%	-10%	68%	8%
vs. Q3 2013	66%		2%	412%	88%
<b>Q2</b>	<b>15.1</b>	<b>5.0</b>	<b>6.8</b>	<b>1.4</b>	<b>28.2</b>
v. Q1	39%	9%	28%	99%	31%
vs. Q2 2013	76%		21%		100%
<b>Q1</b>	<b>10.9</b>	<b>4.6</b>	<b>5.3</b>	<b>0.7</b>	<b>21.5</b>

\*Acquired in December 2013, relaunched February 2014  
\*\*Acquired in July and relaunched October 2013  
†Acquired in 2012 for \$26 million

As one can see DEPO has made a habit of acquiring products and relaunching them successfully, as evidenced in the table above. A little more color on the current pipeline:

**Gralise:** The oral once-a-day prescription medication for postherpetic neuralgia, or after-shingles pain, Gralise (gabapentin) has been solid revenue driver for DEPO posting over 52% of product sales in 2014. Gralise had 17 million in revenues in 2012, to 36 million in 2013, to 60 million in 2014; the firm’s main product has displayed impressive growth. One can also notice the exponential growth through each quarter this year. Gralise is benefiting from price and volume increases. Prescriptions written in 2014 were up 21% from 2014 and 121% from 2012. Tablets sold were up 25% (compared to 21% scripts) this year, so doctors are prescribing the drug more times and at higher volumes. The drug is covered at the tier-2 level (preferred brand-name drugs) at the top three pharmacy benefit managers, CVS Caremark, Express Scripts / Medco, and Catamaran. Also driving growth is a new program called “Simple Script” was launched in the second half of 2014 to make access to its drugs easier. Price increases are also driving growth with an 11% and 13% increase just this year, but it is still cheaper than a competing drug called Lyrica. This year the firm won a major country victory versus Actavis which now exclusivity of Gralise from generics is expected to last until 2024. Competitive advantages for Gralise moving forward include the fact that it’s taken once per day, its favorable tolerability and lesser side effects than replacements.

**Zipsor:** Zipsor (diclofenac potassium) is a liquid filled capsule for the treatment of mild to moderate acute pain in adults. This product was acquired by DEPO in Q2 2012 for \$26.2 million, since its acquisition the drug has produced net sales of \$55 million with a gross margin over 95%. Full year sales of 25.2 million in 2014 are up 24% compared to the previous year, and Q4 2014 sales growth of 20% was up from 2% in the third quarter. Sales growth of Zipsor should not accelerate excessively, but growth will be had with pricing increases (recently an 11% increase). Furthermore, a new acquisition will cause sales representatives at the firm to shift focus. With that being said, the drug remains a cash generating asset with patent protection until 2029.

**Cambia:** Diclofenac potassium for oral solution, or Cambia, is used for acute treatment of migraine attacks with or without aura in adults 18 years of age or older. Cambia was acquired in December of 2013 and relaunched in Q1 2014. From Q1 to Q4 sales grew from 4.6m to 6.3m (37%) and prescriptions increased 33% over that period, indicating increasing prescriber comfort. Cambia being the only non-triptan NSAID for the acute treatment of migraine attacks; coupled with synergistic marketing with Gralise and Nucynto/ER (will be discussed later) should produce solid growth going forward. In February 2015, the American Headache Society published an evidenced-based assessment of acute migraine treatments which led to diclofenac potassium being established as an effective (Level A) treatment for acute migraine attacks. Exclusivity for this drug is expected until 2023.

**Lazanda:** Depomed’s drug called Lazanda (fentanyl) is a nasal spray for the management of breakthrough pain in cancer patients, 18 years of age and older, who are tolerant to regular opioid therapies for their underlying persistent cancer pain. This product generated 6.3% of revenues in 2014, and was acquired in December 2013 while being relaunched in Q1 2014. Fourth quarter sales in 2014 were up 16% over the previous quarter, and 292% compared to quarter one. The sales force of this product has been expanded to 24 from 15 in 2015. Also, Express Scripts as of 1/1/14 has made Lazanda the

only branded fentanyl for the breakthrough pain on its national formulary; this led to market share for Express Scripts to climb to 12.9% from 2% in just two months. The first six weeks of sales has generated an annualized rate of sales equated to \$20m, up 60% from the same period a year ago.

The combined sales of Gralise, Cambia, Lazanda and Zipsor in 2014 were \$114.2 million, almost doubling 2013 product revenue and a more than fourfold increase from 2012. Product sales were \$33.9 million for the fourth quarter of 2014, an increase of 80% over the fourth quarter of 2013. These impressive growth numbers across all products are encouraging when the most recent acquisition, Nucynta/ER will be the flagship product moving forward.

## New acquisition creating synergy, transforming the company

The newest installment to the already impressive offerings of Depomed is NUCYNTA and NUCYNTA extended release. Nucynta was approved in November 2008. The extended-release version, which was formulated by Depomed, was approved in August 2011. Before acquiring the product the firm was receiving low single-digit royalty on sales of Nucynta ER from J&J. The product is patent protected until 2022, with potential to extend into 2023 with a pediatric label. This product will increase annual product revenues by around 2.5x with \$114 million in Depomed products plus \$176 million in Nucynta/ER in 2014. This product should create nice synergies for the firm because according to management, the prescriber overlap in pain, neurology, and primary care is roughly 70% with Nucynta / ER and Gralise, Cambia, and Zipsor. This number is only the span in which J&J promoted the product. Depomed plans to increase the current size of the sales representative to around 250, over three times the size of J&J's team currently selling the product. A price increase should also drive growth for this segment as Nucynta ER is currently \$12.80 per day, that compares to OxyContin CR at \$18.40 a day and Opana ER at \$20.40 a day. Furthermore, Depomed will be able to grow Nucynta in a segment that J&J did not address being the diabetic peripheral neuropathy segment. Approximately 20% of the adult population has diabetes, and up to 50% of these individuals will experience DPN at some point in their lifetime. A Nature review article in 2012 listed Gralise and Nucynta as two of the more interesting neuropathic pain products to hit the market, and predicted the latter will become the market leader by 2020. Below one can see current market share, which is expected to grow 5% annual from 2014-2014, for each version of the drug:

Short Acting Opioid Market	Long Acting Opioid Market
\$7.1B in 2014	\$5.5B in 2014
~230MM TRx in 2014	~20M TRx in 2014
NUCYNTA 0.3% market share	NUCYNTA ER 1.5% market share

Schoeneck feels the long-acting opioid market is not completely penetrated due to the disparity with Europe they enjoy prescription share of over 10% compared to 1.5% in the United States. The drug is 2-3 times less potent than Morphine and therefore leads to milder constipation, and doesn't cause withdrawal or potentially life-threatening respiratory depressions, which are all major disadvantages of other powerful opioids; in addition it has a low abuse and side effect profiles than alternatives. The firm has learned in the past how to acquire products, train its team to market them, and produce growing cash flows from these acquisitions. With Depomed leveraging the knowledge learned in the past half-decade regarding acquiring and relaunching, coupled with the fundamental medical potential of Nucynta, this acquisition will be no different.



## Financial overview

Current analyst expectations for Q1 revenues are \$33.6 million. In terms of how this compares to previous quarters, Q3 2014 had \$33.9 million in product sales alone. The market is underestimating Depomed's ability to market and grow its products. Keeping the other three drugs sales flat compared to the past two quarters (which they all actually grew, but for conservatism), and only forecasting growth in Lazanda which produced an annualized rate of \$20 million sales through only the first 6 weeks of this year. At a sales rate of \$20 million per year this gives \$5 million for the first quarter. Keeping each of the other product's sales flat and increasing Lazanda sales to \$4 million leads to product sales of \$35 million, exceeding Q1 estimates with earnings coming 5/11/15. Below is the capital structure of the firm:



As one can see DEPO enjoys a healthy capital structure, the firm posted a quick ratio of 10.3x in 2014 compared to 1.9x. The Altman Z Score rose to 4.06 last year from 1.14 the year before. The number of institutions holding has risen from 75% from 144 to 253 since a year ago, equating to a 25% increase in the percentage of shares held.

## Investment strategy

As stated above, earnings are coming 5/11/15, and \$33.9 million in revenues are expected. Over the past seven quarters, DEPO beat sales 7/7 times, and the price was higher one month after 6/7 times (Q1 2014 was down 0.40%). I expect DEPO to again beat conservative first quarter estimates. There is an upcoming catalyst his half year in the licensing department regarding IW-3718. Phase IIa trials began in March and results will be coming. I trust Mr. Rao and his expertise to choose a drug he thinks will make it to market and generate cash flows going forward. With moderate base sales growth forecasts and three quarters of tapentadol sales (\$200 m last year, sales team tripled at DEPO), I see no reason DEPO can't surpass \$330 million. With \$330 million which is a -15% revenue growths and conservative sales growth into the long term, as well as operating costs that are increasing towards peer medians, based on an ROIC model the firm is currently valued at \$33.3. Based on an ROE model the firm is valued at \$36.6. I see no reason why the stock has fallen from \$27 a few weeks ago other than that it's a repeating the fade into earnings it has shown in recent quarters. Lower bound one year targets are lower than the intrinsic value most likely due to the great parity between last year's revenue growth (+191%) and this years projected of -21%. But this does not reflect the true growth last year because of the one-time payment, so I am referring more to the intrinsic value. I felt using peer medians for current and long term betas were better because companies dealing with pain medications are more similar than pharmaceuticals in general. I am pitching a buy before earnings with a price target of \$36.6, but would carefully watch how Nucynta goes to market in June 2015 and reassess my position based on this.

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<b>DepoMed Inc.</b>	<b>DEPO</b>	<b>Analyst</b> Skyler Scavone	<b>Current Price</b> \$23.26	<b>Intrinsic Value</b> \$36.65	<b>Target Value</b> \$33.29	<b>Divident Yield</b> 0%	<b>Target Return</b> 1-y Return: 43.11%	<b>BULLISH</b>	
<b>General Info</b>		<b>Peers</b>		<b>Management</b>					
Sector	Healthcare	<b>Market Cap.</b>		<b>Professional</b>	<b>Title</b>	<b>Comp. FY2012</b>	<b>Comp. FY2013</b>	<b>Comp. FY2014</b>	
Industry	Pharmaceuticals	Impax Laboratories Inc.	\$3,254.06	Schooneck, James	Chief Executive Officer, President :	\$1,727,171	\$2,414,730	\$4,068,452	
Last Guidance	Feb-23-2015	Nektar Therapeutics	\$1,250.76	Moretti, August	Chief Financial Officer, Principal A	\$1,045,459	\$895,438	\$1,202,904	
Next earnings date	5/11/2015	Acorda Therapeutics, Inc.	\$1,280.23	Gosling, Matthew	Senior Vice President and General	\$807,040	\$947,125	\$1,428,861	
<b>Market Data</b>		#REFRESH		Vargas, Thadd	Senior Vice President of Business 1	\$724,267	\$849,099	\$1,248,714	
Enterprise value	\$1,059.30	Emergent BioSolutions, Inc.		Rao, Srinivas	Chief Medical Officer and Senior V	\$0	\$0	\$967,260	
Market Capitalization	\$2,032.29	WACC (based on market value weights)		Greco, Steve	Vice President of Sales	\$0	\$0	\$0	
Daily volume	0.25	<b>Current Capital Structure</b>		<b>Historical Median Performance</b>					
Shares outstanding	59.71	Total debt/market cap	16.55%			<b>DEPO</b>	<b>Peers</b>	<b>Industry</b>	<b>All U.S. firms</b>
Diluted shares outstanding	66.31	Cost of Borrowing	0.00%	Growth	60.9%	21.6%	10.9%	7.4%	
% shares held by institutions	99.58%	Interest Coverage	4.1x	ROE	6.9%	6.9%	7.0%	9.9%	
% shares held by insiders	0.84%	Altman Z	4.06	Net Profit Margin	33.4%	11.1%	5.5%	6.9%	
Short interest	17.98%	Debt Rating	AAA	Revenue/Common Equity	0.21	0.46	1.27	1.45	
Days to cover short interest	7.15	Levered Beta	0.66	Excess Cash/Rev.	139.3%	98.0%	13.5%	12.9%	
52 week high	\$28.16			Total Cash /Rev.	143.3%	98.5%	12.3%	15.2%	
52-week low	\$9.85			Unlevered Beta	1.38	0.61	0.91	0.95	
5y Beta	1.26			TEV/REV	2.5x	3.4x	4.0x	2.5x	
6-month volatility	46.72%			TEV/EBITA	5.1x	26.1x	12.1x	13.1x	
<b>Past Earning Surprises</b>		<b>Norm. EPS</b>		PE (normalized and diluted EPS)		11.5x	33.0x	24.3x	23.5x
Last Quarter	Revenue 350.0%	EBITDA 59.3%	200.0%	P/BV		0.6x	1.7x	1.9x	2.2x
Last Quarter-1	27.7%	0.0%	0.0%	<b>Non-GAAP Adjustments in estimates computations</b>					
Last Quarter -2	70.8%	0.0%	NM	Operating Leases Capitalization	100%	Straightline		10 years	
Last Quarter -3	70.2%	0.0%	NM	R&D Exp. Capitalization	100%	Straightline		10 years	
Last Quarter -4	102.5%	0.0%	NM	Expl./Drilling Exp. Capitalization	0%	N/A		N/A	
<b>Proforma Assumptions</b>				SG&A Capitalization	100%	Straightline		10 years	
				<b>Forecast</b>					
Money market rate as of today	0.54%	<b>Period</b>	<b>Rev. Growth</b>	<b>Adj. Op. Cost/Rev</b>	<b>Common Equity</b>	<b>Net Margin</b>	<b>ROE</b>	<b>Kc</b>	
Annual increase (decrease) in interest rates	0.1%	LTM	190.9%	33.0%	\$1,011.01	47%	18.3%	6.3%	
Yield Spread acceleration	1.2	NTM	-15.0%	38.2%	\$482.36	39%	12.7%	6.4%	
Marginal Tax Rate	37.5%	NTM+1	54.0%	43.4%	\$658.38	37%	39.0%	6.5%	
Risk-Free rate	2.6%	NTM+2	21.8%	48.6%	\$854.19	34%	32.2%	6.6%	
Tobin's Q	0.80	NTM+3	3.1%	53.8%	\$1,033.36	31%	23.1%	6.7%	
Op. Cash/Rev.	5%	NTM+4	5.0%	59.0%	\$1,199.83	27%	17.9%	6.8%	
Growth in PPE	NPPE Growth follows Revenue Growth	NTM+5	9.0%	64.2%	\$1,358.39	24%	14.9%	6.9%	
Long term Growth	4.0%	NTM+6	9.0%	69.4%	\$1,505.94	21%	12.5%	7.0%	
Base Year Unlevered Beta	is equal to 0.61	NTM+7	5.0%	74.6%	\$1,632.26	18%	9.9%	7.1%	
Long term Unlevered Beta	0.61	NTM+8	4.0%	79.8%	\$1,735.58	15%	7.8%	7.2%	
		Continuing Period	4.0%	85.0%	\$1,805.00	12%	10.0%	7.3%	
		<b>Valuation</b>					<b>Pricing Model</b>		
<b>Period</b>	<b>Common Equity x (ROE-Kc)</b>	<b>Total Debt</b>	<b>Other non-interest bearing claims</b>	<b>Shares Outstanding</b>	<b>DCF (Weight = 100%)</b>	<b>Relative (Weight = 0%)</b>	<b>Distress (Weight = 0%)</b>	<b>Weighted Average Price Per Share</b>	
LTM	\$0.00	\$229.89	\$74.71	59.71	\$37.61	\$32.49	\$6.93	\$37.61	
NTM	\$35.40	\$229.89	\$72.80	59.71	\$34.04	\$18.71	\$7.90	\$34.04	
NTM+1	\$138.98	\$229.89	\$74.25	59.71	\$37.50	\$27.23	\$10.46	\$37.50	
NTM+2	\$179.17	\$229.89	\$74.69	59.71	\$39.75	\$32.58	\$13.37	\$39.75	
NTM+3	\$163.79	\$229.89	\$73.80	59.71	\$41.31	\$34.00	\$16.04	\$41.31	
NTM+4	\$126.72	\$229.89	\$70.83	59.71	\$43.23	\$36.74	\$18.54	\$43.23	
NTM+5	\$99.12	\$229.89	\$55.30	59.71	\$45.44	\$42.02	\$20.78	\$45.44	
NTM+6	\$75.23	\$229.89	\$44.23	59.71	\$48.01	\$46.87	\$22.88	\$48.01	
NTM+7	\$43.73	\$229.89	\$19.52	59.71	\$50.73	\$51.27	\$25.67	\$50.73	
NTM+8	\$9.94	\$229.89	\$19.22	59.71	\$52.47	\$51.61	\$26.20	\$52.47	
Continuing Value	\$1,298.54								
<b>Monte Carlo Simulation Assumptions</b>					<b>Monte Carlo Simulation Results</b>				
	<b>Base</b>	<b>Stddev</b>	<b>Min</b>	<b>Max</b>	<b>Distribution</b>	<b>Intrinsic Value</b>		<b>1y-Target</b>	
Revenue Variation	0	10%	N/A	N/A	Normal	Mean est.	\$37.61	\$34.04	
Op. Costs Variation	0	10%	N/A	N/A	Normal	σ(e)	\$0.32	\$0.25	
Country Risk Premium	6%	N/A	5%	7%	Triangular	3 σ(e) adjusted price	\$36.65	\$33.29	
Long term Growth	4%	N/A	3%	61%	Triangular	Current Price	\$23.26		
							Analysts' median est.	\$28.92	