Zacks Small-Cap Research

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# Cipher Pharmaceuticals Inc. (CPHR-NASDAQ)

***CPHR: Strong second quarter financials….***

## UPDATE

The Cipher Pharmaceutical (CPHR) story continues to become more interesting as the management executes on its plan to become a leading dermatology-focused specialty pharmaceutical company. Since the onset of 2015, Cipher has completed six transactions.

The company reported strong second quarter financial results despite all the M&A activity, showing that management can execute on both the existing operations and business development. Below we highlight some of the key points to Cipher's most recent transactions, and offer to investors our current thoughts on the company's strategy and current valuation.

| | |
|---|---|
| **Current Recommendation** | **Buy** |
| Prior Recommendation | N/A |
| Date of Last Change | 01/18/2015 |
| Current Price (08/20/15) | $6.40 |
| **Target Price** | **$17.00** |

## SUMMARY DATA

| | |
|---|---|
| **52-Week High** | **$16.33** |
| **52-Week Low** | **$7.23** |
| **One-Year Return (%)** | **N/A** |
| **Beta** | **N/A** |
| **Average Daily Volume (sh)** | **7,364** |
| **Shares Outstanding (mil)** | **26** |
| **Market Capitalization ($mil)** | **$188** |
| **Short Interest Ratio (days)** | **3.94** |
| **Institutional Ownership (%)** | **28** |
| **Insider Ownership (%)** | **6** |
| **Annual Cash Dividend** | **$0.00** |
| **Dividend Yield (%)** | **0.00** |
| **5-Yr. Historical Growth Rates** | |
| **Sales (%)** | **N/A** |
| **Earnings Per Share (%)** | **N/A** |
| **Dividend (%)** | **N/A** |
| **P/E using TTM EPS** | **N/A** |
| **P/E using 2015 Estimate** | **20.8** |
| **P/E using 2016 Estimate** | **10.6** |

| | |
|---|---|
| **Risk Level** | **High,** |
| **Type of Stock** | **Small-Growth** |
| **Industry** | **Med-Drugs** |

## ZACKS ESTIMATES

**Revenue**
(in millions of $)

| | Q1 (Mar) | Q2 (Jun) | Q3 (Sep) | Q4 (Dec) | Year (Dec) |
|---|---|---|---|---|---|
| 2014 | 7.1 A | 8.0 A | 6.6 A | 7.5 A | 29.2 A |
| 2015 | 9.2 A | 8.8 A | 12.5 E | 16.0 E | 44.7 E |
| 2016 | | | | | 66.5 E |
| 2017 | | | | | 120.3 E |

**Earnings per Share**
(EPS is operating earnings before non recurring items)

| | Q1 (Mar) | Q2 (Jun) | Q3 (Sep) | Q4 (Dec) | Year (Dec) |
|---|---|---|---|---|---|
| 2014 | $0.14 A | $0.16 A | $0.31 A | $0.13 A | $0.74 A |
| 2015 | $0.10 A | -$0.01 A | $0.07 E | $0.14 E | $0.31 E |
| 2016 | | | | | $0.61 E |
| 2017 | | | | | $1.34 E |

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## WHAT'S NEW

***Product Sales Picked Up Steam in Second Quarter of 2015***

On Aug 14, 2015, Cipher Pharmaceuticals (CPHR) reported strong financial results for the fiscal second quarter of 2015 ending March 31, 2015. This is the first quarter the company reported its financials in the US dollar. All numbers in previous quarters (in Canadian dollar) were converted into US dollar.

Total revenue for the second quarter of 2015 was $8.8 million, compared to $8.0 million for the second quarter of 2014, an increase of 10%. Total revenue for 2Q15 also increased 19.4% from $7.4 million for the first quarter of 2015.

Revenue growth in second quarter of 2015 was mainly driven by strong growth in product sales, which was up 451% compared to that for second quarter of 2014. The high growth in product sales was offset by decline in licensing revenue in the second quarter of 2015, which was down 16%.

**For the three months ended June 30 ($'000)**

| | 2015 | 2014 | $ change in 2015 | % change in 2015 |
|---|---|---|---|---|
| Licensing revenue | 6,318 | 7,553 | (1,235) | (16) |
| Product revenue | 2,517 | 457 | 2,060 | 451 |
| Total revenue | 8,835 | 8,010 | 825 | 10 |

Product revenue growth was primarily a result of the acquisition of **Innocutis** completed in April 2015, which added 7 commercial products marketed in the US. Innocutis products contributed $1.8 million, composed primarily of Sitavig® at $0.5 million, Nuvail® at $0.5 million and Bionect® at $0.4 million.

Canadian product sales of Epuris and Vaniqa also contributed $0.7 million to the total product revenue growth. Prescription market share of Epuris® increased to 19% in June 2015 from 17.6% at the end of March 2015.

| Products Marketed by Cipher ($mm) | | | | | | |
|---|---|---|---|---|---|---|
| **US** | 2Q15 | 2Q14 | **Canada** | 2Q15 | 2Q14 | **Total ($mm)** |
| **Sitavig** | $0.5 | | **Epuris+Vaniqa** | $0.7 | $0.5 | |
| **Nuvail** | $0.5 | | | | | |
| **Bionect** | $0.4 | | | | | |
| **Other** | $0.4 | | | | | |
| **Total** | **$1.8** | | | **$0.7** | | **$2.5** |

At the front of licensing/royalty revenue stream, total licensing revenue decreased 16% to $6.3 million from $7.6 million in Q2 2014, largely due to the decreased revenue from Lipofen, which dropped to $0.9 million in 2Q15 from $1.8 million in 2Q14, a decline of 50%. In the company's quarterly report, management explained that an authorized generic version of Lipofen was launched by Cipher's US marketing partner in 2Q14, which resulted in the increase in 2Q14 related to launch quantities being shipped to distributors. The product continues to perform well despite the fact that Cipher's partner, Kowa, has reduced their marketing efforts.

Absorica® revenue was $5.1 million in 2Q15, compared with $5.3 million in Q2 2014, a slight decline of 3.8%. This slight decline was primarily driven by a jump in the company's 30 mg strength due to a competitor's stock out in 2Q14. Market share of Absorica continues to hold in the 19% to 20% range in the last three quarters, as compared to 20.3% for 2Q14 according to IMS Health. We continue to believe Absorica will perform well and will be the largest licensing revenue contributor in the coming quarters.

We see Absorica revenues growing to $25.6 million in 2015, providing strong positive cash flow to Cipher that is allowing management to branch-out and fund all the recent acquisitions, as well as take on debt at favorable terms. Sunpharma has made it clear that dermatology is a core focus for the new Sun-Ranbaxy combined company, and Absorica is the flagship brand. Sales of Absorica in 2014 were around $240 million. We believe peak sales are $300 million, still leaving good room for growth in royalties to Cipher.

ConZip®/Durela® revenue in 2Q15 was $0.3 million compared with $0.5 million in Q2 2014.

| Licensing/Royalty ($mm) | | | |
|---|---|---|---|
| | **2Q15** | **2Q14** | **Change** |
| **Absorica** | $5.1 | $5.3 | -3.8% |
| **Lipofen** | $0.9 | $1.8 | -50.0% |
| **ConZip/Durela** | $0.3 | $0.5 | -40.0% |
| **Total** | **$6.3** | **$7.6** | **-16.4%** |

R&D expenses in 2Q15 were $0.5 million, compared to $0.3 million in 2Q14. R&D expenses relate to the company's drug development activities.

SG&A expenses in 2Q15 were $5.9 million, compared to $2.1 million in 2Q14. The increase of SG&A expenses in 2Q15 was primarily driven by the Innocutis acquisition.

GAAP net loss was $0.6 million ($0.02 per share) for 2Q15, compared to GAAP income of $4.1 million ($0.16 per share). Non-GAAP net loss was $0.2 million ($0.01 per share), compared to non-GAAP net income of $4.1 million ($0.16 per share).

Cipher reported adjusted EBITDA of $2.1 million in 2Q15, compared to adjusted EBITDA of $5.9 million in 2Q14. The decrease of $3.8 million was primarily due to the negative EBITDA in 2Q15 from Innocutis of $1.8 million as well as transaction costs and expenses related to the Innocutis acquisition. The adjusted EBITDA number adds back non-cash items to the net income, including $1.2 million in depreciation and amortization expense.

*For the three month periods ended June 30,*

| | 2015 | 2014 | $ change in 2015 | % change in 2015 |
|---|---|---|---|---|
| ADJUSTED EBITDA | 2,132 | 5,915 | (3,783) | (64) |

*For the three month periods ended June 30,*

| | 2015 | 2014 |
|---|---|---|
| Net income (loss) for the period | (558) | 4,131 |
| Add back | | |
| Depreciation and amortization | 1,231 | 178 |
| Interest expense | 968 | - |
| Deferred tax | 358 | 1,311 |
| EBITDA | 1,999 | 5,620 |
| Change in fair value of derivative | (392) | - |
| Share-based compensation | 525 | 295 |
| Adjusted EBITDA | 2,132 | 5,915 |

***Strong Balance Sheet***

Cipher exited the second quarter 2015 with $29.7 million in cash.

In April, 2015, Cipher closed on a private offering of $100 million in aggregate principal amount of Senior Secured Notes due 2020, provided by investment funds managed by Athyrium Capital Management. Cipher received an initial drawdown of $40 million, which was used to fund the majority of the upfront purchase of INNOCUTIS. The remaining balance of the Senior Secured Notes will be made available to finance future acquisitions and is subject to certain conditions. The five year fixed rate 10.25% Notes are payable on the last day of each quarter. The Notes are interest-only and are secured by assets of Cipher and its subsidiaries, subject to certain exceptions.

***Acquisition, an Integral Part of Growth Strategy***

Cipher achieves sustainable growth by both organic growth and acquisition. Management is committed to make Cipher to become a leading dermatology-focused specialty pharmaceutical company. Since the onset of 2015, Cipher has completed the following six transactions:

- Cipher began the year with the acquisition of the Canadian licensing rights to Ozenoxacin, a topical antibiotic for the treatment of adult and pediatric impetigo, from privately-held Ferrer of Spain. Second Phase 3 trial was completed in July 2015. We expect Cipher to file NDA in Canada in 1Q16.
- Later in January 2015, Cipher completed the acquisition of Melanovus Oncology Inc., with access to seven pre-clinical assets for melanoma and other cancers for only $0.5 million.
- In February 2015, Cipher completed the acquisition of Astion Pharma, which provided two late-stage inflammatory products and a mid-stage candidate for lupus.
- In March 2015, Cipher licensed the Canadian rights to Can-Fite's CF101 for moderate to severe plaque psoriasis.
- On April 13, 2015, Cipher completed the acquisition of INNOCUTIS with seven marketed dermatology products including a potential breakthrough treatment for herpes labialis (cold sores).
- Finally, on May 6, 2015, Cipher acquired the Canadian rights to Vaniqa and Actikerall from Spanish pharmaceutical company, Almirall S.A.

We will discuss the Innocutis acquisition in more detail. We believe this is the most important one which establishes the company's US presence, the largest healthcare market in the world.

***Acquisition of INNOCUTIS***

On April 13, 2015, Cipher announced it had acquired INNOCUTIS Holdings LLC, a privately held specialty dermatology company, for US $45.5 million in cash. With the acquisition, Cipher enters the U.S. dermatology market, specifically with infrastructure to launch products with the current 31 full-time sales representatives covering approximately 3,500 dermatologists across 28 states in the U.S. The products consist of established revenue-generating branded prescriptions that provide physicians with alternate solutions for the management of challenges experienced in daily dermatological practice. INNOCUTIS has seven marketed products and we highlight several of these products below.

- Sitavig® (acyclovir) 50 mg employs the proprietary Lauriad® Muco-Adhesive Buccal technology where a single dose tablet is placed in the gum, delivering a high concentration of acyclovir directly to the site of the cold sore infection. INNOCUTIS claims this is the only treatment proven to reduce the occurrence of future outbreaks of herpes labialis (cold sores) and represents a breakthrough for the treatment of herpes, which is composed of over 20 million prescriptions and approximately $4 billion in annual sales in the U.S. alone. In a recent study, over 1/3 of patients were cold sore free after 10 months of treatment with Sitavig® (Bieber *et al.,* 2014).

The product was launched in the U.S. during the third quarter of 2014, and we expect that Cipher will file for Canadian approval at some point in 2016. We also think there may be an opportunity down the road for Cipher to sell (partner or sublicense) Sitavig® to other specialty markets including primary care, geriatric medicine and women's health, as studies have shown that a greater percentage of women suffer from herpes labialis than men, with increased susceptibility in the elderly population. Sitavig® currently has three active patents with expiration dates in 2027 and 2030.

Cold sores or fever blisters are small, contagious blisters that can appear on the face, lips and inside of the mouth and are caused by the herpes simplex virus, commonly referred to as HSV-1 or HSV-2 (*below*). Cold sores are

contagious during an outbreak but also during a process known as “viral shedding” which can occur even when no blister is physically present. The virus is most commonly spread through kissing or sharing food and/or drink with an infected person. The blisters can itch and burn, and can be extremely painful when they break open.



Source: www.sitavig.com

Herpes labialis is a widespread condition and according to the World Health Organization (WHO), an estimated 400 million people worldwide are currently infected with HSV-2. By the age of 50, up to 80% of Americans will have been exposed to HSV with approximately 25-35% of adults suffering from recurrent cold sores. With approximately 100 million cold sore outbreaks occurring in the U.S. alone, this represents a significant market potential of hundreds of millions of dollars. It is speculated that by 2017, the herpes simplex treatment market could reach $4.8 billion. We believe that this represents a great market opportunity for Cipher’s newly acquired Sitavig® as it could be change the treatment care for cold sores. We think that the drug will gain more popularity with prescribers as Cipher expands on its potential and we look forward to seeing how Cipher does with this drug in North America pending Canadian approval. Sales of Sitavig in the U.S., launched only in the middle of 2014, totaled $2.1 million. Based on our analysis of the data and the market opportunity, we believe Sitavig as peak U.S. sales of $200 million, with another $10-15 million potential in Canada.

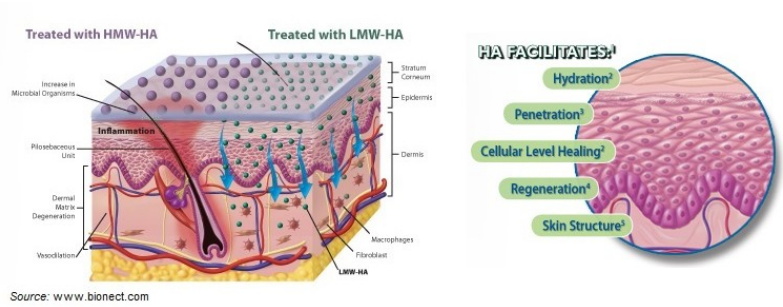
- Nuvail™ (poly-ureaurethane 16%) nail solution is a patented biocompatible polymer that is FDA approved for managing the signs and symptoms of nail dystrophy, such as nail splitting and nail fragility. The product helps prevent nail brittleness and dries quickly, with an invisible matte finish and can be used in both men and women. Nuvail™ improves overall nail appearance by penetrating the intracellular spaces and nail surface ridges, creating a stable, yet flexible molecular structure and providing mechanical support (*below*). It does not wash off because it is comprised of hydrophobic (non-water soluble) molecules and continues to work following first application with continual protection of nails to environmental factors. We believe that the ease of application will appeal to both men and women who suffer from nail dystrophy.




Source: www.nuvail-rx.com

U.S. Nuvail sales in 2014 totaled $3.5 million. We see peak U.S. sales in the $25-30 million range, with another $2-3 million potential in Canada.

- Bionect® (hyaluronic acid sodium salt, 0.2%) is a non-sensitizing, water based, non-steroidal, topical low molecular weight hyaluronic acid (LMW-HA) formulation that can be used for the dressing and management of partial to full thickness dermal ulcers (pressure sores, venous stasis ulcers, arterial ulcers, diabetic ulcers), wounds including cuts, abrasions, donor sites, and post-operative incisions, irritations of the skin, and first and second degree burns. LMW-HA, which is found in Bionect® is a substance that is naturally found in the skin and other parts of the body and attracts and holds up to 1,000 times its weight in water. This key feature allows for the transport of oxygen, protein and nutrients through the skin and also helps to maintain an intact dermal matrix structure (*below*). According to studies, LMW-HA also plays a crucial role in the processes of tissue repair and inflammation (Weindl *et al*., 2004).



Source: www.bionect.com

Bionect® is available in cream, gel and aqueous-based spray formulations and also promotes skin healing and is intended to cover a wound or burn and in turn, protects against abrasion, friction and desiccation. U.S. sales of Bionect in 2014 totaled only $2.1 million. We believe peak U.S. sales are around $5 million.

- Inova® 4% & 8% and Inova® ACT 4/1 & 8/2 include benzoyl peroxide preparations for mild to moderate symptoms associated with acne vulgaris. Although the exact mechanism of action of benzoyl peroxide is not known, it is an oxidizing agent that has antibacterial properties against Propionibacterium acnes and patients that have been treated with benzoyl peroxide show a reduction in free fatty acids, lipids and mild desquamation (drying and peeling activity) with concurrent reduction in comedones and acne lesions. Inova® 4% & 8% have either 4% or 8% benzoyl peroxide while Inova® Acne Control Therapy (ACT) 4/1 & 8/2 incorporates benzoyl peroxide 4% and salicylic acid 1% and benzoyl peroxide 8% and salicylic acid 2%, respectively. Both are individually wrapped pads and employ the Easy Pad® Delivery System. These pads also have Tocopherol 5% Topical Antioxidant, which is a pure formulation from natural sources, and include sunflower oil as well as a silicone delivery vehicle.

We believe these products will be popular with the adolescent and teenage populations due to their convenience and ease of application and use. We believe Cipher can plug both Inova® products (as well as Dermadexin) into the company's existing product portfolio in Canada with Epuris for acne and eventually Ozenoxacin for impetigo. Inova U.S. sales in 2014 were $1.5 million. We believe peak sales are roughly $3-4 million.



Source: INNOCUTIS

- CNL8™ (ciclopirox topical solution, 8%) nail kit provides up to six months of nail therapy and includes 15ml (3-5ml bottles) of ciclopirox 8%, 25 SwabPlus® nail lacquer remover swabs, and 1 emery board for treatment of mild to moderate onychomycosis (nail fungus) due to Trichophyton rubrum. The management program also includes removal of the unattached, infected nails by a physician as frequent as once a month. Ciclopirox is a synthetic antifungal and one in vitro study suggests that it works via chelation of polyvalent cations (Fe+3 or Al+3) resulting in the inhibition of the metal-dependent enzymes that are responsible for the degradation of peroxides within the fungal cell.

INNOCUTIS recorded approximately $9.6 million in net product revenue for all of 2014, driven largely by Nuvail at $3.5 million, Sitavig at $2.1 million, and Bionect at $2.1 million. We see Sitavig as having the largest upside potential, with peak North American sales approaching $250 million. We also believe that Nuvail has peak North American sales at around $30 million. Cipher expects that within two years, the INNOCUTIS acquisition to be accretive to earnings per share. The acquisition of INNOCUTIS will bring in 31 sales representatives to Cipher to target some 3,500 U.S. dermatologists and high-prescribing primary-care physicians for things like psoriasis, pruritis, and cold sores. We expect that Cipher will expand to approximately 60 representatives, similar to the size of the sales force that Sunpharma is using to promote Absorica, in the U.S. in 2016. This should allow the company to double its target prescriber base.

The agreement consists of $45.5 million in cash to be paid by Cipher on closing of the deal and additional INNOCUTIS management incentive payments of up to $3.0 million in cash over a three-year period based on the achievement of certain financial milestones. So all-in-all, at a price-to-trialing-twelve-month sales ratio of less than 5x seems very reasonable to us, especially considering we believe Cipher can get Sitavig and Nuvail to over $250 million sales at peak.

***Acquisitions Fit Nicely In With Existing Derm Products***

All of the deal-making at Cipher over the past several months has been orchestrated to build a premier independent special pharmaceutical company with a laser-focus on the North American **dermatology market**. As a reminder, Cipher has two existing dermatology products, an improved formulation of isotretinoin, sold in the U.S. as Absorica® by Ranbaxy US and Epuris® in Canada by Cipher, and Beteflam Patch, currently under regulatory review by Health Canada.

- ***Beteflam Patch***

On February 12, 2015, Cipher announced that Health Canada has accepted for review the new drug submission (NDS) for Beteflam Patch (previously referred to as Betesil Patch). The actual application was filed on December 15, 2014. As a reminder, Cipher licensed the Canadian rights to the Beteflam Patch in 2012 from Swiss-based Institut Biochimique SA ("IBSA"). IBSA owns the U.S. rights to the product. Acceptance for review by Health Canada resulted in a CDN$150,000 milestone payment from Cipher to IBSA.

Beteflam Patch is a novel, patent-protected, self-adhesive medicated plaster containing 0.1% betamethasone valerate, for the treatment of inflammatory skin conditions such as chronic plaque psoriasis (CPP). The efficacy and safety of the product has been established in two successful Phase 3 trials and one successful Phase 4 trial conducted by IBSA. IBSA recently published positive results from a large non-inferiority study, which compared the product to Dovobet (betamethasone plus calcipotriol), a commonly prescribed combination product containing a corticosteroid and a vitamin D analogue.

The Beteflam Patch is applied once-daily to the affected region and may be cut to fit the particular size and shape of the psoriatic lesion thereby reducing potential contact of the steroid with healthy areas of skin. The occlusive format of the Beteflam Patch is designed to provide a consistent distribution, delivery and absorption of the active ingredient and enhances the potency of the corticosteroid. The patch also helps to moisturize the skin, which accelerates healing and provides a protective barrier that reduces local trauma to the lesion due to scratching and prevents transfer of fluids from the lesion onto clothing. Beteflam patch will be the first topical betamethasone patch on the market in Canada once approved.

If approved in late 2015, we think the Beteflam Patch is an excellent complement dermatology product for Cipher's contract sales force to co-promote along with Epuris and newly acquired products like Dermadexin and Pruridexin, or even CF101. We expect a decision from Health Canada in the fourth quarter 2015.

We think Cipher can achieve breakeven Canadian operations based on the launch of Epuris alone by the end of 2015. This would be sales in the area of $3 million. Adding several more dermatology products to the portfolio, like Beteflam Patch, Dermadexin, Pruridexin, Sitavig, and CF101 will help improve the overall efficiency and profitability of Cipher's Canadian operations. We think the Canadian operations can generate sales in the $50 million range in time. The prescriber overlap for these newly acquired products and Epuris looks fantastic, likely over 70%.

***Executing on its Growth Strategy***

As a summary, Cipher has completed five transactions since the start of 2015 that execute on its 3-point growth strategy:

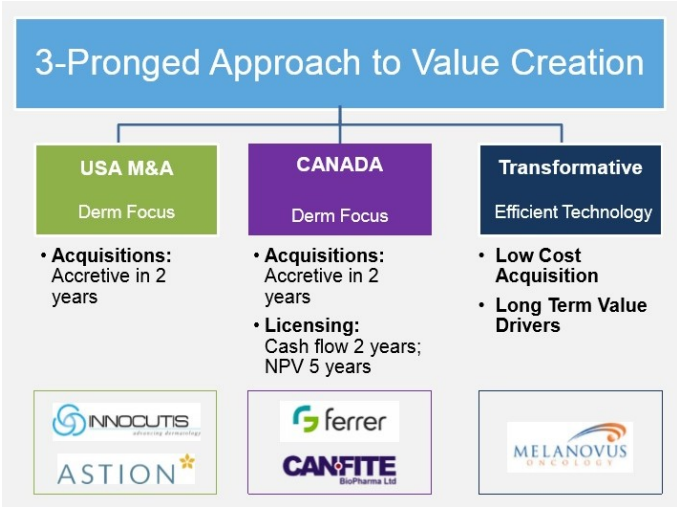
*I. Acquire dermatology companies and/or products in the U.S. and establish commercial infrastructure*
- ✓ Acquired INNOCUTIS, establishing Cipher's commercial presence in the U.S. dermatology market.
- ✓ Acquired worldwide rights to three products focused on inflammatory dermatological diseases (Dermadexin, Pruridexin, and ASF-1096) from Astion Pharma. Cipher's commercialization efforts will focus on the U.S. initially.

*II. Expand Canadian dermatology franchise*
- ✓ Licensed the Canadian rights to Ozenoxacin, a topical treatment for adult and pediatric impetigo.

- ✓ Announced that Beteflam Patch has been accepted for review by Health Canada.
- ✓ Licensed the Canadian distribution rights to CF-101, a novel chemical entity being developed by Can-Fite Biopharma for moderate to severe plaque psoriasis and rheumatoid arthritis.
- ✓ Acquired Canadian rights to Vaniqa and Actikerall, two approved dermatology products each with $1 to $2 million sales potential.

III. Acquire potentially transformative technology that can be commercialized efficiently

- ✓ Acquired seven pre-clinical compounds for the treatment of melanoma, skin cancer and other cancers from Melanovus Oncology Inc.




***Conclusion***

Cipher has kept itself extremely busy over the past 8 months, expanding its pipeline through several key advancements, including six acquisitions and licensing deals all designed to turn Cipher into a fully-integrated dermatology-focused specialty pharmaceutical company by 2020. Cipher's newly expanded product portfolio includes products focused on acne, psoriasis, dermatitis, pruritis, lupus, impetigo, melanoma, hyperkeratotic actinic keratosis, ulcers, nail dystrophy, herpes, onychomycosis, hyperpigmentation, un-wanted facial hair, and rheumatoid arthritis. Through these acquisitions, Cipher is on its way to building an integrated North American sales force comprised of 31 U.S. (serving over 3,500 dermatologists in 28 states in the U.S alone) and 7 Canadian sales reps. We expect that both numbers are going higher in the next several quarters.

We believe the opportunity to leverage the existing sales force to cover multiple products. If approved later this year, we believe that the Beteflam Patch will be an excellent complement dermatology product for Cipher's contract sales force to co-promote with Epuris, Dermadexin, Pruridexin, and potentially CF101. Similarly, we also see considerable overlap between the acne products, Inova and Epuris, with Dermadexin and possibly Ozenoxacin. We believe that Cipher's new combined sales force and combined customer base, will offer considerable cross selling opportunities as they continue to expand their offerings in dermatology in the U.S. and Canada and will keep profit margins well above industry average.

If management continues to capitalize on selective acquisitions, continues to develop their deep and growing pipeline of dermatology products, we believe the shares continue to offer significant upside potential. With the recent acquisitions, we believe Cipher is on its way to building a leading pure play dermatology based specialty pharmaceutical company with a focus on growing its North American presence. And what is even more impressive is that execution remains excellent. As such, we continue to have faith in management's vision, growth strategies and strategic priorities, and expect another solid performance for 2015 and beyond.

***Valuation and Recommendation***

We continue to rate Cipher shares a Buy and raise our price target to $17 from previous $16 per share.

Our model is consistent with management's guidance that the INNOCUTIS deal will become accretive in two years. We model product revenue will reach $18.7 million in 2015, and grow to $135 million in 2018, an impressive compound annual growth rate (CAGR) of 93%, driven by both existing products and new approvals.

With respect to the valuation, we believe Cipher shares are undervalued at current market price. Currently, Cipher shares are traded at about $6.30 per share, which values the company at about $160 million in terms of market cap. This is deeply discounted compared to its peers. We believe Cipher shares are fair-valued at $16 per share. The specialty pharmaceutical industry trades at an average P/E ratio of 15x. According to our financial model, Cipher's EPS will grow from $0.31 in 2015 to $1.94 in 2018, another impressive CAGR of 85%. Applying the 15 x P/E multiple and the $1.94 EPS in 2018, discounted at 20% for three years, we come up with the fair value of $17 per share.

We think if Cipher can demonstrate that they can execute and drive meaningful revenue and earnings growth over the next several quarters, the stock will be an excellent buy at this level. Finally, we see the end-game for Cipher shareholders as an acquisition, and inversion, by a larger U.S. pharmaceutical player.

## *INCOME STATEMENT*

| CPHR ($mm) | Q1 A | Q2 A | Q3 A | Q4 A | 2014 A | Q1 A | Q2 A | Q3 E | Q4 E | 2015 E | 2016 E | 2017 E | 2018 E |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Royalites & Licensing** | **$6.8** | **$7.6** | **$6.2** | **$6.8** | **$27.4** | **$6.7** | **$6.3** | **$6.5** | **$6.5** | **$26.1** | **$30.0** | **$35.3** | **$38.5** |
| YOY Growth | 109.2% | 41.6% | 14.3% | -41.3% | 6.9% | -1.3% | -16.4% | 5.7% | -4.7% | -4.7% | 344.8% | 458.7% | 492.3% |
| **Product Sales** | **$0.3** | **$0.5** | **$0.5** | **$0.6** | **$1.9** | **$0.7** | **$2.5** | **$6.0** | **$9.5** | **$18.7** | **$36.5** | **$85.0** | **$135.0** |
| YOY Growth | - | 431.4% | 1019.0% | 134.4% | 369.3% | 112.7% | 450.8% | 1176.6% | 1400.8% | 899.6% | 95.5% | 132.9% | 58.8% |
| **Total Revenues** | **$7.1** | **$8.0** | **$6.6** | **$7.5** | **$29.2** | **$7.4** | **$8.8** | **$12.5** | **$16.0** | **$44.7** | **$66.5** | **$120.3** | **$173.5** |
| YOY Growth | 118.6% | 47.8% | 22.0% | -37.3% | 12.4% | 3.6% | 10.3% | 88.8% | 114.7% | 53.1% | 48.7% | 80.9% | 44.2% |
| Cost of Goods Sold | $0.1 | $0.1 | $0.1 | $0.2 | $0.5 | $0.2 | $0.9 | $2.1 | $3.3 | $6.5 | $12.8 | $29.8 | $47.3 |
| **Gross Profit** | **$7.1** | **$7.9** | **$6.5** | **$7.3** | **$28.7** | **$7.2** | **$7.9** | **$10.4** | **$12.7** | **$38.2** | **$53.7** | **$90.6** | **$126.3** |
| Product Gross Margin | 70.5% | 70.0% | 73.6% | 75.0% | 72.7% | 71.3% | 62.9% | 65.0% | 65.0% | 65.0% | 65.0% | 65.0% | 65.0% |
| Selling, Marking, General & Admin | $2.1 | $2.1 | $1.9 | $2.9 | $9.0 | $3.3 | $5.9 | $6.5 | $5.8 | $21.5 | $25.0 | $30.0 | $35.0 |
| Research & Development | $0.3 | $0.3 | $0.2 | $0.3 | $1.1 | $0.4 | $0.5 | $0.5 | $1.3 | $2.7 | $4.0 | $7.5 | $10.0 |
| Amortization Expense | $0.2 | $0.2 | $0.2 | $0.2 | $0.7 | $0.1 | $1.2 | $1.2 | $1.2 | $3.8 | $5.0 | $5.0 | $5.0 |
| **Operating Income** | **$4.5** | **$5.3** | **$4.1** | **$4.0** | **$17.9** | **$3.4** | **$0.3** | **$2.2** | **$4.4** | **$10.3** | **$19.7** | **$48.1** | **$76.3** |
| other net | 0.09 | 0.11 | 0.13 | 0.15 | 0.49 | 0.14 | (0.48) | 0.20 | 0.50 | 0.36 | 2.00 | 2.50 | 2.50 |
| **Net Income before tax** | **$4.6** | **$5.4** | **$4.3** | **$4.2** | **$18.4** | **$3.6** | **($0.2)** | **$2.4** | **$4.9** | **$10.7** | **$21.7** | **$50.6** | **$78.8** |
| Taxes / Other | $1.1 | $1.3 | ($3.7) | $1.0 | ($0.4) | $1.1 | $0.4 | $0.6 | $1.1 | $3.1 | $5.3 | $13.0 | $20.6 |
| Tax Rate | 23.6% | 24.6% | -89.1% | 24.0% | -2.0% | 31.2% | 127.9% | 26.0% | 26.0% | 30.5% | 27.0% | 27.0% | 27.0% |
| **GAAP Net Income** | **$3.5** | **$4.1** | **$7.9** | **$3.2** | **$18.8** | **$2.5** | **($0.6)** | **$1.8** | **$3.7** | **$7.5** | **$16.4** | **$37.6** | **$58.2** |
| YOY Growth | 135.3% | 38.1% | 145.6% | -80.3% | -21.4% | -28.6% | -113.5% | -77.0% | 17.2% | -59.9% | -12.6% | 129.1% | 54.8% |
| **Reported EPS** | **$0.14** | **$0.16** | **$0.31** | **$0.13** | **$0.74** | **$0.10** | **($0.02)** | **$0.07** | **$0.14** | **$0.29** | **$0.61** | **$1.34** | **$1.94** |
| YOY Growth | 129.0% | 34.0% | 135.6% | -80.8% | -23.8% | -29.6% | -113.1% | -77.2% | 14.4% | -60.7% | 108.6% | 121.0% | 44.5% |
| One time charge | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.4 | 0.0 | 0.0 | 0.4 | 0.0 | 0.0 | 0.0 |
| **Non-GAAP net income** | **3.5** | **4.1** | **7.9** | **3.2** | **18.8** | **2.5** | **(0.2)** | **1.8** | **3.7** | **7.9** | **16.4** | **37.6** | **58.2** |
| **Non-GAAP EPS** | **$0.14** | **$0.16** | **$0.31** | **$0.13** | **$0.74** | **$0.10** | **($0.01)** | **$0.07** | **$0.14** | **$0.31** | **$0.61** | **$1.34** | **$1.94** |
| Shares Outstanding | 25.1 | 25.2 | 25.6 | 25.4 | 25.3 | 25.5 | 25.9 | 25.9 | 26.0 | 25.8 | 27.0 | 28.0 | 30.0 |

*Source: Company filings and Zacks estimates*

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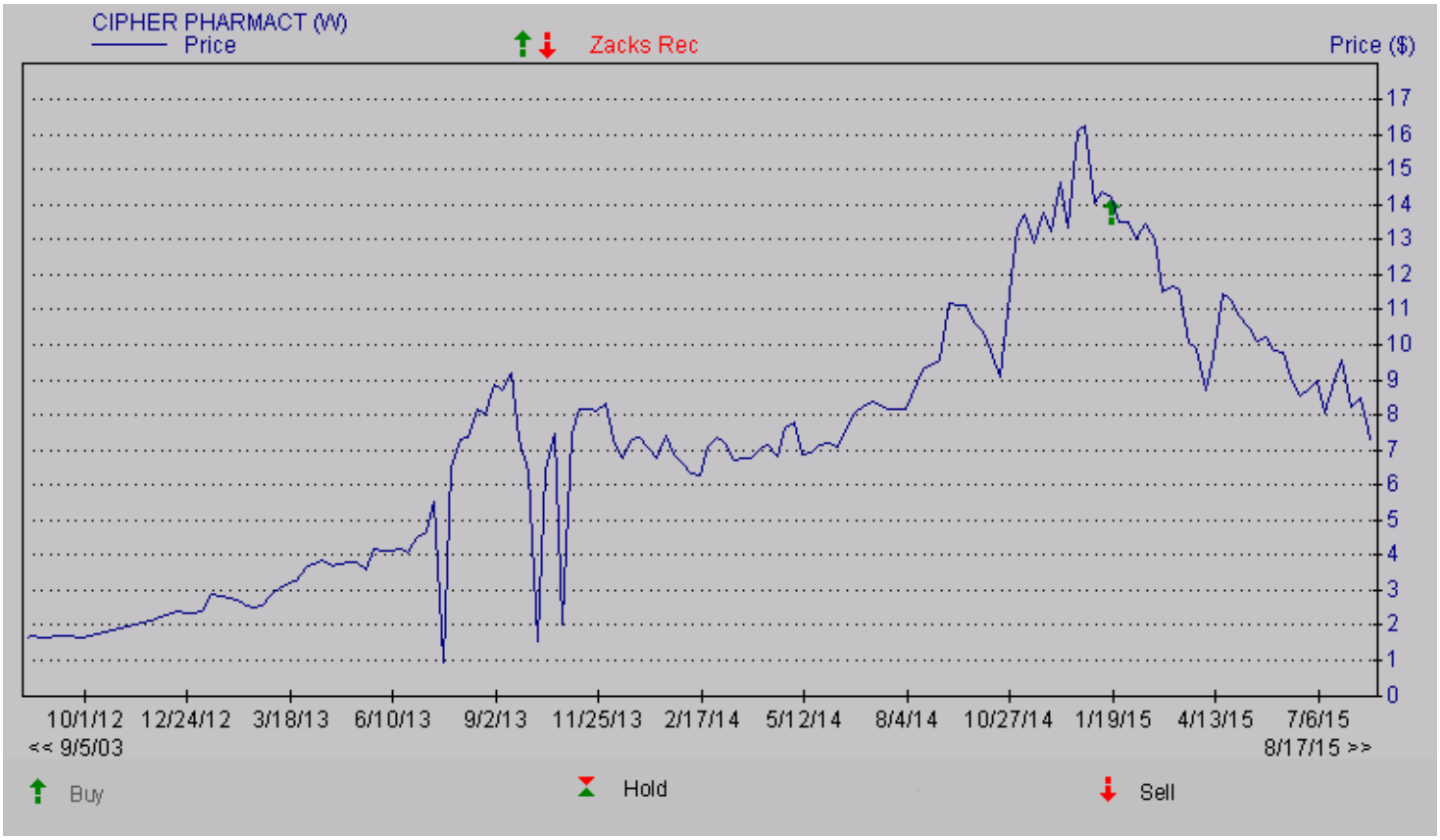


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