Zacks Small-Cap Research

July 30, 2015
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Depomed, Inc. (DEPO-NASDAQ)

DEPO: Better than expected initial NUCYNTA sales convince us the billion dollar potential of NUCYNTA---Outperform

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	08/09/2011
Current Price (07/29/15)	$31.87
Target Price	**$36.00**

UPDATE

On July 29, DepoMed reported its financials for the second quarter ended June 30, 2015. Total sales for 2Q15 reached $94.3 million, an increase of 233.8%. Omitting NUCYNTA sales, the company still achieved 33.3% revenue growth in 2Q15.

We are especially impressive with the initial NUCYNTA sales of $56.7 million in 2Q, which blew away our estimate of $45 million. This further convinces us the blockbuster potential of NUCYNTA for DepoMed.

We continue to remain optimistic regarding the Depomed story, especially as it pertains to the NUCYNTA® franchise, as we strongly believe the transaction will be transformational for the company.

SUMMARY DATA

52-Week High	**$33.28**
52-Week Low	**$9.95**
One-Year Return (%)	**207.67**
Beta	**1.02**
Average Daily Volume (sh)	**2,958,736**
Shares Outstanding (mil)	**60**
Market Capitalization ($mil)	**$1,972**
Short Interest Ratio (days)	**6.48**
Institutional Ownership (%)	**88**
Insider Ownership (%)	**3**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**7.9**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**N/M**
P/E using 2015 Estimate	**53.1**
P/E using 2016 Estimate	**21.4**

Risk Level	**Average,**
Type of Stock	**Small-Blend**
Industry	**Med-Drugs**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2014	76.5 A	67.7 A	51.5 A	194.6 A	390.4 A
2015	32.2 A	94.5 A	106.1 E	119.2 E	352.1 E
2016					497.5 E
2017					620.0 E

Earnings per Share
(Adjusted EPS)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2014	-$0.01 A	$0.01 A	$0.03 A	$0.21 A	$0.26 A
2015	-$0.13 A	$0.27 A	$0.30 E	$0.39 E	$1.00 E
2016					$1.49 E
2017					$2.27 E

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WHAT'S NEW

DepoMed Reports Better Than Expected Product Sales

On July 29, DepoMed released its second quarter financials ended June 30, 2015.

Total product sales for 2Q15 reached $94.3 million, compared to $28.3 million for 2Q14, an increase of 233.8%, and an increase of 198% compared to $31.7 million for first quarter of 2015. Second quarter of 2015 product sales also handily beat our estimate of $81.7 million.

The increase was mainly due to the initial strong sales of $56.7 million from the NUCYNTA products (including NUCYNTA immediate release and NUCYNTA ER). As a reminder, DepoMed acquired NUCYNTA franchise from JNJ in April and initiated the marketing and promotion since then. The initial sales of NUCYNTA products were much better than our estimate of $45 million.

Even without NUCYNTA sales, sales of 2Q15 still booked 33.3% increase year over year and 18.7% increase sequentially.

Other products also contributed to the strong 2Q15 product sales growth.

Gralise sales for 2Q15 increased to $20.93 million from $15.11 million, an increase of 38.1%. Record total prescriptions of Gralise (83k) for 2Q15 were recorded, up 18% compared to 2Q14.

Cambia sales for 2Q15 were $6.85 million, compared to $4.96 million for 2Q14, an increase of 38.1%. Total prescriptions were 35k for 2Q15, up 35% compared to 2Q14.

Lazanda sales for 2Q15 increased to $3.85 million from $1.35 million for 2Q14, an increase of 184.6%. Record Lazanda total sprays of 148k in 2Q15 were up 156% compared to second quarter 2014.

Only Zipsor sales in 2Q15 slightly declined to $6.01 million from $6.82 million in 2Q14, a decrease of 11.8%.

DepoMed's commercial strategy also resulted in gains in market share in 2Q15:

- Gralise market share was 3.2% in 2Q15, up from 2.8% in second quarter 2014
- Cambia market share was 7.5% in 2Q15, up from 5.2% in second quarter 2014
- Lazanda market share was 4.2% in 2Q15, nearly doubled from second quarter 2014

Three Months Ended June 30 (in $millions)			
	2015	**2014**	**Increase (%)**
NUCYNTA products	$56.65	N/A	**N/A**
Gralise	$20.93	$15.11	38.5%
Cambia	$6.85	$4.96	38.1%
Lazanda	$3.85	$1.35	184.6%
Zipsor	$6.01	$6.82	-11.8%
Total	$94.30	$28.25	233.8%

GAAP net loss was $21.7 million ($0.36 per share). Non-GAAP adjusted net income was $20 million ($0.27 per share).

Guidance Raised for 2015

As a result of the strong financial performance in 2Q15, especially the strong performance of newly acquired NUCYNTA franchise, DepoMed is raising its 2015 financial guidance for total product sales, adjusted earnings and adjusted EBITDA.

	Updated Guidance	Prior Guidance
Total Product Sales	$320 to $340 million	$310 to 335 million
Total SG&A and R&D Expense*	$195 to $210 million	$195 to 210 million
Non-GAAP Adjusted Earnings	$40 to $50 million	$16 to 28 million
Non-GAAP Adjusted EBITDA	$95 to $110 million	$85 to 100 million

Initial Strong Sales Convinces us that NUCYNTA Franchise Has Blockbuster Potential

Background of NUCYNTA

NUCYNTA® is indicated for the management of moderate to severe acute pain in adults, while **NUCYNTA® ER** is indicated for the management of: 1) pain severe enough to require daily, around-the-clock, long-term opioid treatment and for which alternative treatment options are inadequate, and/or 2) neuropathic pain associated with diabetic peripheral neuropathy (DPN) in adults severe enough to require daily, around-the-clock, long-term opioid treatment and for which alternative treatment options are inadequate. We would like to point out that the drug is the only Schedule II new chemical entity (NCE) opioid approved in the U.S. in the last 30 years.

Tapentadol is a centrally-acting synthetic analgesic with a believed dual mechanism of action. Pre-clinical animal studies have shown that tapentadol is a μ -opioid receptor (MOR) agonist and norepinephrine reuptake inhibitor (NRI). Clinical data suggests a statistically significant improvement in pain with tapentadol use in as little as 48 hours after starting treatment. Because of the dual mechanism, the drug has utility in both nociceptive and neuropathic pain. It has a low abuse profile and mild side effect rate when compared to other opioid products.

NUCYNTA® was approved in November 2008. The extended-release version, which was formulated by Depomed, was approved in August 2011. Depomed was previously receiving a low single-digit royalty on sales of NUCYNTA® ER at J&J. Trailing twelve-month sales ending December 31, 2014 (unaudited) totaled $172 million, with approximately $44 million of that in the fourth quarter 2014. Management notes that the ER formulation has around one-third of the overall franchise. We suspect that overall prescription growth is flat due to minimal promotional effort being put forth by J&J in 2014. Despite this modest effort, there were still over 800,000 prescriptions written for the drug last year. NUCYNTA® has less than 1% market share in the short-acting opioid market. The ER formulation fairs slightly better, with around 1.5% market share of the long-active opioid market based on 2014 data. Based on the 44% price increase Depomed instituted in early April 2015, NUCYNTA® ER at $18.44 per day is now priced comparable to OxyContin® CR at $18.40 per day and Opana® ER at $20.40 per day.

Why NUCYNTA® Makes Sense for Depomed

The NUCYNTA® franchise acquisition meets all of the company's criteria for a deal, and includes:

Scale & Size: Depomed has said that any acquisition needs to increase the scale and accelerate growth of the overall company. With $172 million in 2014 revenue, NUCYNTA® / ER is expected to increase Depomed's annual product revenue by 2.5x.

Synergies: Depomed has been squarely focused on the pain and neurology market since the launch of Gralise® (gabapentin extended release) in late 2011. The acquisitions of Zipsor® (diclofenac potassium liquid capsules) in the pain market and Cambia® (diclofenac potassium oral solution) in the neurology market have added nicely to the synergistic co-promotion of Depomed's brands. According to management, the prescriber overlap in pain,

neurology, and primary care is roughly 70% with NUCYNTA® / ER and Gralise®, Cambia®, and Zipsor®. The NUCYNTA® market was being promoted by approximately 80-90 contract representatives at J&J. Depomed expanded that to >270 reps today. This is three-times the size of J&J's effort that delivered $172 million in revenues in 2014. We suspect that this increased promotion will have a meaningful impact on NUCYNTA® / ER prescriptions by the end of 2015.

To pain specialists, Depomed's new 275 sales reps will have an attractive bag of products including NUCYNTA®, Gralise®, and Zipsor®. Although Zipsor® moves to the third position, it still remains handsomely cash flow positive for the company at roughly $28-30 million in annualized revenue. To neurologists, Depomed can now promote two powerful and differentiated neuropathic pain products with NUCYNTA® ER and Gralise®, along with Cambia® to headache specialists. Gralise® is indicated for post-herpetic neuralgia (PHN) and used off-label for diabetic peripheral neuropathy (DPN) and fibromyalgia. With NUCYNTA® ER, Depomed can actively promote the DPN label – something J&J had yet to embark upon – giving neurologists a full suite of neuropathic pain options for their patients. DPN is an enormous opportunity. Approximately 20% of the adult population has diabetes, and up to 50% of these individuals will experience DPN at some point in their lifetime (Tesfaye, S. et. al, 2012). A Nature Review article from 2012 lists both Gralise® and NUCYNTA® ER as two of the more interesting neuropathic pain products to hit the market, predicting that NUCYNTA® ER will become the market leader by 2020. From a synergistic standpoint, the deal is a perfect fit for Depomed.

Protection: The tapentadol composition of matter patent goes until August 2022, with potential pediatric extension taking exclusivity into 2023. Depomed plans to explore filing additional patents that could extend exclusivity of the product.

Blockbuster Potential of NUCYNTA Franchise

NUCYNTA acquisition completed earlier than expected on April 2, enabling Depomed to record full second quarter NUCYNTA net sales of $56.7 million. Product franchise was officially re-launched in mid-June with expanded sales force of 275 plus full marketing and medical support. The sales force of 275 reps more than tripled compared to sales force of 80-90 reps for JNJ.

We believe the effect of the re-launch strategy and the tripled sales force is expected to impact NUCYNTA prescription growth beginning later this year.

Per management, product positioning will be focused on NUCYNTA's dual mechanism of action designed to target both nociceptive and neuropathic pain. The company plans to capture market share in large and growing markets including chronic pain and chronic lower back pain (CLBP). Over 100 million US patients suffer from chronic pain, while 31 million US patients suffer from chronic lower back pain. DepoMed will specifically targeting the CLBP patient population. The company also launched NUCYNTA for moderate to severe painful diabetic peripheral neuropathy (DPN), which affects another 1-2 million patients.

All these commercial strategies mentioned above combined with strong initial sales make us believe that NUCYNTA has blockbuster potential and will become the company's flagship brand.

Current Valuation Still Attractive

We continue remain positive on the Depomed story, especially as it pertains to the NUCYNTA® franchise, as we believe the transaction to acquire NUCYNTA® / ER is transformational for the company. The strategic fit is excellent and past execution has been outstanding. There is clearly a lot of future execution that still must take place for this to benefit shareholders but the plan is in place, and in our opinion, looks solid. We view the name as a good core-holding in the specialty pharmaceutical industry with significant upside should the NUCYNTA® / ER product take off.

Current share price is at about $32, valuing the company at $1.9 billion in terms of market cap. We think current valuation is still attractive.

Based on our long term financial model, revenue will reach $350 million in 2015 with non-GAAP earnings per share (EPS) of $1.00. We continue to expect that the NUCYNTA® / ER deal will be strongly accretive, and that Depomed will generate over $100 million in positive free cash flow in 2016. Non-GAAP EPS will grow from $1.00 in 2015 to $2.27 in 2017 based on total revenue of $620 million.

We think DepoMed shares should be valued using a 25x P/E multiples, which is close to the biotech industry's average P/E ratio of 22.6. Using this P/E ratio, multiplied by our estimated EPS of $2.27 for 2017, discounted at 25% for two years, we come up with our fair value of DepoMed at $36 per share.

PROJECTED INCOME STATEMENT

DEPOMED, INC.	Q1A	Q2A	Q3A	Q4A	2014 A	Q1A	Q2A	Q3E	Q4E	2015 E	2016 E	2017 E
Gralise	$10.9	$15.1	$16.3	$18.1	$60.4	$17.3	$20.9	$21.5	$22.5	$82.2	$100.0	$115.0
YOY Growth	*78.4%*	*76.7%*	*66.4%*	*54.4%*	*66.9%*	*59.1%*	*38.5%*	*31.7%*	*24.2%*	*36.1%*	*21.7%*	*15.0%*
Zipsor	$5.3	$6.8	$6.1	$6.8	$25.2	$5.8	$6.0	$6.5	$7.0	$25.4	$28.0	$30.0
YOY Growth	*75.8%*	*22.9%*	*2.1%*	*19.5%*	*23.7%*	*9.4%*	*-11.8%*	*5.7%*	*2.3%*	*0.8%*	*10.4%*	*7.1%*
Lazanda	$0.7	$1.4	$2.3	$2.7	$7.0	$3.2	$3.9	$4.5	$5.2	$16.7	$23.0	$30.0
YOY Growth	-	-	-	-	*472.4%*	*368.5%*	*184.6%*	*98.0%*	*95.1%*	*140.1%*	*37.4%*	*30.4%*
CAMBIA	$4.6	$5.0	$5.8	$6.3	$21.7	$5.4	$6.8	$8.2	$9.0	$29.4	$36.0	$40.0
YOY Growth	-	-	-		-	*16.1%*	*38.1%*	*40.6%*	*43.6%*	*35.7%*	*22.4%*	*11.1%*
Nucynta / ER	-	-	-	*$44*	*$172*	$0	$56.7	$65.0	$75.0	$196.7	$305.0	$396.50
YOY Growth	-	-	-	-	-	-	-	-	-	-	*55.1%*	*30.0%*
Total Product Sales	**$21.5**	**$28.2**	**$30.6**	**$33.9**	**$114.2**	**$31.7**	**$94.3**	**$105.7**	**$118.7**	**$350.4**	**$492.0**	**$611.5**
YOY Growth	*135.6%*	*100.2%*	*87.9%*	*80.3%*	*95.9%*	*47.3%*	*233.8%*	*245.6%*	*250.3%*	*206.7%*	*40.4%*	*24.3%*
Total Royalties	**$43.3**	**$33.7**	**$20.1**	**$13.8**	**$110.9**	**$0.5**	**$0.2**	**$0.4**	**$0.5**	**$1.7**	**$3.0**	**$6.0**
YOY Growth	*207.4%*	*123.4%*	*30.6%*	*-25.6%*	*146.4%*	*-98.8%*	*-99.4%*	*-98.0%*	*-96.4%*	-	-	-
Total Licenses Revenues	**$11.8**	**$5.8**	**$0.8**	**$147.0**	**$165.2**	**$0**	**$0**	**$0**	**$0**	**$0**	**$2.5**	**$2.5**
YOY Growth	*296.8%*	*657.9%*	*-86.8%*	*4337.1%*	*828.5%*	-	-	-	-	-	-	-
Total Revenues	**$76.5**	**$67.7**	**$51.5**	**$194.6**	**$390.4**	**$32.2**	**$94.5**	**$106.1**	**$119.2**	**$352.1**	**$497.5**	**$620.0**
YOY Growth	*192.4%*	*126.1%*	*37.4%*	*379.2%*	*190.9%*	*-57.9%*	*39.5%*	*106.1%*	*-38.7%*	*-9.8%*	*41.3%*	*24.6%*
Cost of Goods Sold	$3.7	$4.7	$3.5	$3.2	$15.1	$3.1	$22.9	$25.5	$28.5	$80.0	$93.5	$110.1
Product Gross Margin	*82.8%*	*83.4%*	*88.5%*	*90.4%*	*86.7%*	*90.2%*	*75.8%*	*75.9%*	*76.0%*	*77.2%*	*81.0%*	*82.0%*
SG&A	$32.5	$32.6	$27.1	$29.0	$121.1	$34.5	$57.4	$45.0	$46.5	$183.5	$180.0	$190.0
% SG&A	*42.5%*	*48.1%*	*52.6%*	*14.9%*	*31.0%*	*107.3%*	*60.7%*	*42.4%*	*39.0%*	*52.1%*	*36.2%*	*30.6%*
R&D	$2.0	$1.4	$1.6	$2.0	$7.1	$1.9	$4.7	$2.6	$2.7	$11.9	$10.0	$10.0
% R&D	*2.7%*	*2.1%*	*3.2%*	*1.0%*	*1.8%*	*5.8%*	*5.0%*	*2.5%*	*2.3%*	*3.4%*	*2.0%*	*1.6%*
Amortization	$2.5	$2.5	$2.5	$2.5	$10.2	$2.5	$26.7	$28.5	$28.5	$86.3	$115.0	$115.0
Operating Income	$35.7	$26.5	$16.7	$157.8	$236.8	($9.8)	($17.2)	$4.5	$13.0	($9.5)	$99.0	$194.9
Operating Margin	-	-	-	-	*60.7%*	-	-	-	-	*-2.7%*	*19.9%*	*31.4%*
Non-Cash PDL Int. Exp.	($5.4)	($4.9)	($4.4)	($57.2)	($71.9)	$0	$0	$0	$0	$0	$0	$0
Other Income (Net)	($0.6)	($0.6)	($5.9)	($2.6)	($9.6)	($6.0)	($4.4)	($2.0)	($2.0)	($14.4)	($15.0)	($15.0)
Pre-Tax Income	$29.8	$21.0	$6.5	$98.0	$155.3	($15.8)	($21.7)	$2.5	$11.0	($23.9)	$84.0	$179.9
Taxes	$11.8	$8.3	$0.0	$0.0	$20.1	($4.2)	$0.0	$0.7	$2.9	($6.2)	$21.8	$46.8
Tax Rate	*40%*	*39%*	*40%*	*0%*	*13%*	*26%*	*0%*	*26%*	*26%*	*26%*	*26%*	*26%*
GAAP Net Income	$17.9	$12.7	$6.5	$98.0	$136.0	($11.6)	($21.7)	$1.9	$8.1	($17.7)	$62.2	$133.1
Net Margin	-	-	-	-	*34.8%*	-	-	-	-	*-5.0%*	*12.5%*	*21.5%*
GAAP EPS	**$0.30**	**$0.21**	**$0.11**	**$1.23**	**$2.05**	**($0.20)**	**($0.36)**	**$0.03**	**$0.13**	**($0.29)**	**$0.76**	**$1.57**
YOY Growth	-	-	-	-	*172.4%*	-	-	-	-	*-114.0%*	*-364.5%*	*106.6%*
Adjustments to GAAP	($18.7)	($12.4)	($4.3)	($83.7)	($119.2)	$3.6	$17.0	$17.0	$17.0	$54.6	$60.0	$60.0
Non-GAAP Net Income	($0.8)	$0.3	$2.1	$14.4	$16.0	($8.0)	($4.7)	$18.9	$25.1	$37.0	$122.2	$193.1
Adjusted (Non-GAAP) EPS	**($0.01)**	**$0.01**	**$0.03**	**$0.21**	**$0.26**	**($0.13)**	**($0.08)**	**$0.30**	**$0.39**	**$0.60**	**$1.49**	**$2.27**
Diluted Wt. Ave Shares Out	59.9	60.4	60.9	79.4	66.3	59.6	60.0	62.0	65.0	61.6	82.0	85.0

Source: Company filing and Zacks Investment Research Estimates

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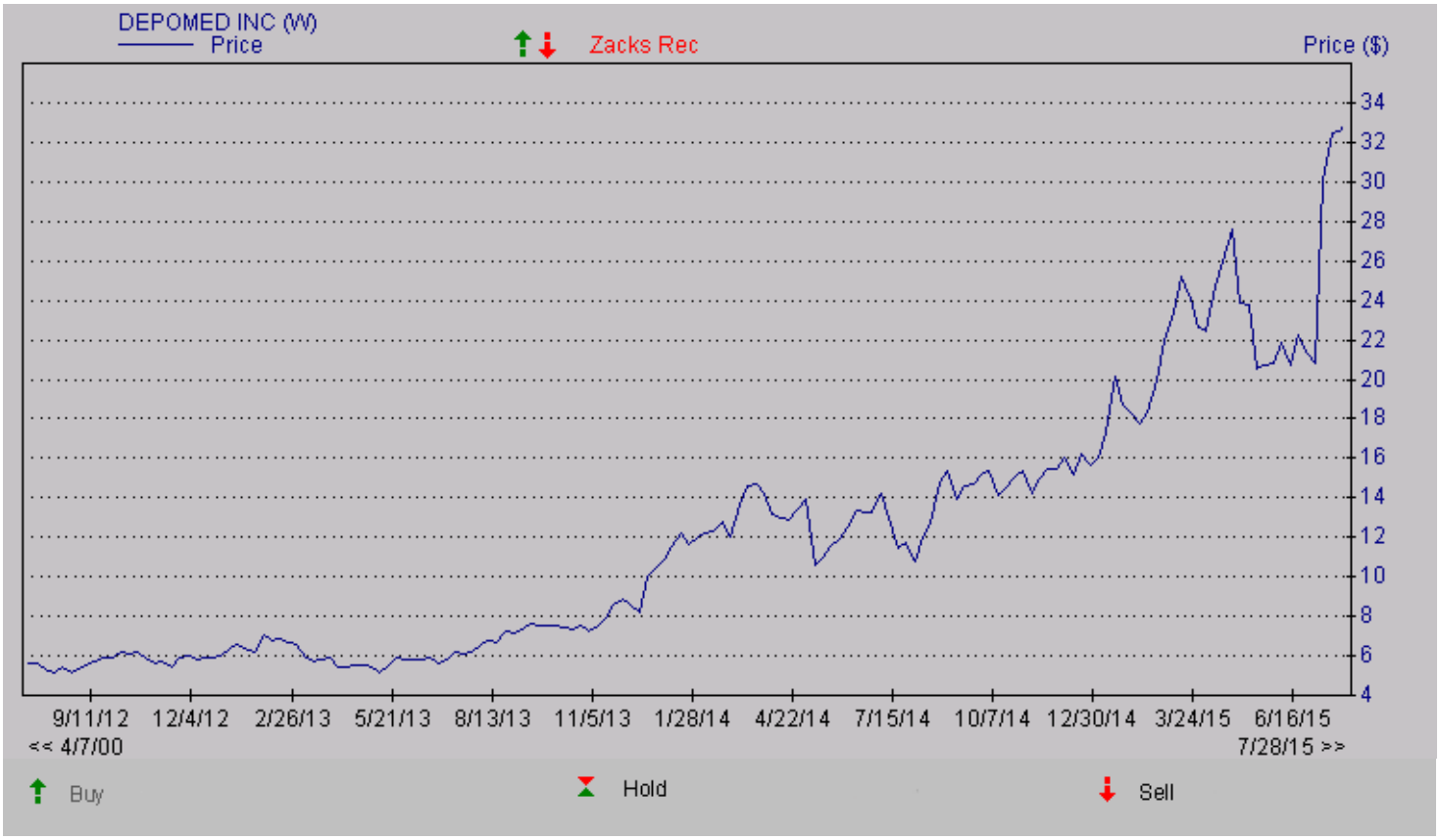

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