EDISON

PDL BioPharma

Q3 earnings

A transitional quarter

Pharma & biotech

PDL has reported earnings for Q316, the first quarter in which revenues ($14.3m) flowed in from its Noden Pharma investment. During Q3, Novartis continued to distribute the Noden products and transferred net profits after taking out the cost of manufacturing and a fee. Noden is now distributing the products itself as of Q4. PDL has also issued $150m in 2.75% convertible debt, due in 2021. The bulk of the proceeds went towards repurchasing $120m of principal of its 4% notes, due in 2018.

Year end	Revenue ($m)	PBT* ($m)	EPS* ($)	DPS ($)	P/E (x)	Yield (%)
12/14	581.2	501.3	2.04	0.61	1.0	29.3
12/15	590.4	530.1	2.04	0.60	1.0	28.8
12/16e	227.8	153.0	0.60	0.10	3.5	4.8
12/17e	190.1	70.8	0.31	0.00	6.7	N/A

Note: *PBT and EPS are normalized, excluding amortization of acquired intangibles, exceptional items and share-based payments.

Noden acquisition vehicle up and running

Through its 88% ownership position in Noden Pharma, which currently markets the Tekturna/Rasilez franchise, PDL now has a vehicle to take advantage of divestments from large pharmaceutical companies and build a successful, profitable specialty pharmaceutical franchise.

Auvi-Q to return to market in H117

Kaléo has announced that Auvi-Q, its proprietary product for the treatment of allergic reactions (and competitor to EpiPen), will be returning to the market in H117 due to the resolution of manufacturing problems. This reduces the risk that Kaléo will be unable to pay the principal and interest payments on its $144.8m note.

$150m convertible note offering

The company recently completed a $150m convertible debt offering with gross proceeds of $145.8m. The notes have a 2.75% coupon, are due in 2021 and have a conversion price of $3.81 per share (although with the associated capped call transaction, it will be non-dilutive under $4.88 per share for any amount owed above the principal amount). $121.5m of the proceeds will go towards repurchasing $120m in principal and $1.5m in accrued interest on its 4% 2018 notes with a $9.17 conversion price.

Valuation: $5.47 per share

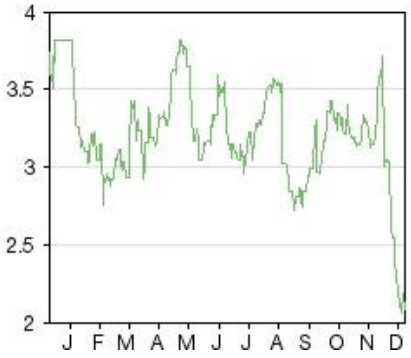
We have decreased our valuation from $1,133m or $6.84 per basic share to $906m or $5.47 per share, primarily due to the failure of Lilly's solanezumab (from which PDL would have received a 2% royalty), as well as cash flowing out to assets associated with Noden and Ariad and some adjustments to the portfolio. Our future valuation will depend on the profitability of Noden and additional deals. The company is currently well capitalized and we do not project a need for additional capital.

8 December 2016

Price	**US$2.08**
Market cap	**US$344m**

Net debt ($m) as at 30 September 2016	45.3
Shares in issue	165.5m
Free float	96%
Code	PDLI
Primary exchange	NASDAQ
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(35.0)	(35.8)	(42.4)
Rel (local)	(38.2)	(37.4)	(46.6)
52-week high/low		US$3.8	US$2.1

Business description

PDL BioPharma is reinventing itself as a healthcare-focused finance company through a three-pronged strategy: investing in royalty streams; providing high-yield financing to life science companies with near-term product launches; and purchasing approved drugs to be sold by Noden Pharma.

Next events

Solanezumab data	December 2016

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Edison profile page

Quarterly update

PDL recently reported results for Q3 and provided on update on numerous assets. Notably, the company reported $15.0m in royalty revenue from the Queen et al. royalty stream. This revenue is based on the sales of Tysabri over Q216. The royalty agreements for the other Queen et al. products have stopped, but the royalties for Tysabri are tied to product manufactured during 2014. Biogen continues to draw down this inventory, which will likely provide additional revenue. The Tysabri royalty for Q316 is similar to Q216, suggesting the same volume of product bearing the royalty was sold, and therefore this revenue stream will likely continue, at least to some degree, into Q4. We do not include this revenue in our forecasts and valuation due to lack of insight into these inventory levels.

Also, PDL announced that Janssen received FDA approval for Invokamet XR for Type 2 diabetes, from which PDL will receive royalties as it is part of the Depomed royalty right asset, triggering a $5m milestone payment. This follows the Jentadueto XR approval in Q216 from which PDL received a $6m milestone.

In accordance with its Iclusig royalty agreement with Ariad, PDL funded the second tranche of $50m. With this payment, PDL's royalty rate now increases to 5% through the end of 2018, after which it will receive 6.5% royalty.

In connection with its impaired Direct Flow asset, PDL funded an additional $3m in the form of a note in exchange for interest and an unspecified number of warrants with an exercise price of $0.01 per share. As Direct Flow is impaired and it is private with an undisclosed share price, we value the asset at the carrying value of the note, which is currently $60.1m. PDL is currently exploring its options for Direct Flow, including initiating foreclosure proceedings as Direct Flow has found it difficult to raise additional capital.

The Paradigm Spine agreement has successful concluded as Paradigm Spine paid PDL $57.5m in accrued interest and a prepayment fee on $54.7m in principal owed.

Finally, Kaléo has announced that Auvi-Q, its proprietary product for the treatment of allergic reactions (and competitor to EpiPen), will be returning to the market in H117 due to the resolution of manufacturing problems. This reduces the risk that Kaléo will be unable to pay the principal and interest payments on its $144.8m note.

Solanezumab failure

Lilly announced that solanezumab did not meet the primary endpoint in its EXPEDITION3 pivotal trial in people with mild dementia due to Alzheimer's disease. With a p-value of 0.095, there were trends favoring solanezumab, but the magnitude of the benefit was small and likely not clinically meaningful. Lilly has announced that it will not pursue regulatory submissions for the drug in this indication, although its future in other indications is unclear. PDL is entitled to a 2% royalty on the drug, so a successful trial could have been a lucrative and high-margin revenue stream.

Valuation

We have decreased our valuation from $1,133m or $6.84 per basic share to $906m or $5.47 per share, primarily due to the failure of Lilly's solanezumab (which accounted for approximately 15% of our valuation), as well as cash flowing out to assets associated with Noden and Ariad and some adjustments to the portfolio.

We increased the value of the Depomed royalties by $18.4m mainly due to Invokamet XR approval, which caused us to increase its probability of success from 70% to 100% and lower the discount rate from 12.5% to 10.0%. The value of the University of Michigan royalty on Cerdelga for Gaucher disease was reduced by $4.9m as Sanofi reported a lower trajectory of sales than we were expecting. Our peak sales estimate has been reduced from $770.7m to $642.9m. Our value for Direct Flow increased by $12m mainly due to the fact that PDL has provided additional financing to the company over the last couple of quarters and due to a change in valuation method as we no longer use NPV but use the carrying value of the amount owed that appears in PDL's regulatory filings.

Our future valuation will depend on the profitability of Noden and additional deals. The company is currently well capitalized and we do not project a need for additional capital.

Exhibit 1: PDL valuation

Royalty/note	Type	Expiration year	PDL balance sheet carrying value (m)	NPV (m)
Queen et al	Royalty	2015	N/A	N/A
Depomed	Royalty on Glumetza and other products	2024	$134.3	$230.1
VB	Royalty on Spine Implant	Undisclosed	$14.8	$24.5
University of Michigan	Royalty on Cerdelga	2022	$64.6	$24.8
DirectFlow	Note (Impaired)	2018	$60.1	$60.1
Wellstat	Note (Impaired)	Unknown	$50.2	$50.2
Hyperion	Note (Impaired)	Unknown	$1.2	$1.2
Avinger	Royalty	2018	$1.9	$2.2
Lensar	Note	2018	$43.9	$56.8
Kaleo	Note	2029	$146.7	$154.8
Acelrx	Royalty on Zalviso	2027	$74.1	$67.5
Ariad	Royalty on Iclusig	2033	$100.1	$87.1
Careview	Note	2022	$18.9	$20.7
Noden	Equity	N/A	N/A	$158.2
Kybella	Royalty	Unknown	$9.8	$12.7
Total				**$951**
Net debt (Q316 plus COD less Noden acq.), m				$45.3
Total firm value, m				$906
Total basic shares, m				165.5
Value per basic share				$5.47
Total options, m				0.2
Total number of shares, m				165.8
Diluted value per share				$5.46

Source: Edison Investment Research

Financials

PDL reported revenue of $53.6m for the quarter, up from $21.0m in Q2 due to higher royalties and interest revenue and the inclusion of Noden. R&D and SG&A spending totaled $12.3m, up from $7.0m last quarter, mainly due to an increased headcount related to Noden. The company ended the quarter with $106.6m in cash, $8.0m in short-term investments and $75m in a long-term certificate of deposit, which serves as collateral for the remaining portion of the Tekturna acquisition cost due to Novartis in July 2017. We do not expect PDL to need additional financing in the future, and we believe that it will not need to refinance its current outstanding debt of $233m in convertible notes (4% due 1 February 2018, $9.17 conversion price). We expect an aggregate $132m in additional debt to be issued to Noden to complete the Tekturna transaction based on PDL's guidance. However, should Noden fail to secure this financing, PDL is obligated to provide the cash itself.

Following the end of the quarter, the company completed a $150m convertible debt offering with gross proceeds of $145.8m. The notes have a 2.75% coupon, are due in 2021 and have a

conversion price of $3.81 per share. With the associated capped call transaction, no net additional shares will be issued for any amount owed above the principal amount unless the stock price is above $4.88. $121.5m of the proceeds will go to repurchasing $120m in principal and $1.5m in accrued interest on its 4% 2018 notes with a $9.17 conversion price. This lower conversion price increases the chance that the debt will be converted into shares rather than having to be paid back in cash.

Exhibit 2: Financial summary

	2014	2015	2016e	2017e
Year end 31 December	US GAAP	US GAAP	US GAAP	US GAAP
PROFIT & LOSS				
Revenue	581,225	590,448	227,784	190,071
Cost of Sales	0	0	(5,088)	(19,113)
Gross Profit	581,225	590,448	222,696	170,958
General & Administrative	(34,914)	(36,090)	(50,050)	(80,321)
EBITDA	546,311	550,379	170,713	88,704
Operating Profit (before GW and except.)	546,311	550,379	170,713	88,704
Intangible Amortisation	0	0	(6,014)	(15,886)
Other	0	(3,979)	0	0
Exceptionals	0	0	(2,629)	0
Operating Profit	546,311	550,379	162,070	72,818
Net Interest	(38,896)	(26,691)	(17,695)	(17,862)
Other	(6,143)	6,450	0	0
Profit Before Tax (norm)	501,272	530,138	153,018	70,842
Profit Before Tax (FRS 3)	501,272	530,138	144,375	54,956
Tax	(179,028)	(197,343)	(53,530)	(12,007)
Deferred tax	(0)	(0)	(0)	(0)
Profit After Tax (norm)	322,244	332,795	99,488	58,835
Profit After Tax (FRS 3)	322,244	332,795	90,845	42,949
Minority interest	0	0	(1,956)	(7,358)
Profit After Tax less Minority Interest (FRS 3)	322,244	332,795	88,889	35,590
Average Number of Shares Outstanding (m)	158.2	163.4	163.9	167.2
EPS - normalised (c)	203.66	203.69	59.51	30.80
EPS - FRS 3 (c)	203.66	203.69	54.24	21.29
Dividend per share (c)	61.1	60.2	10.0	0.0
Gross Margin (%)	100.0	100.0	97.8	89.9
EBITDA Margin (%)	94.0	93.2	74.9	46.7
Operating Margin (before GW and except.) (%)	94.0	93.2	74.9	46.7
BALANCE SHEET				
Fixed Assets	606,453	733,468	904,294	843,361
Intangible Assets	0	0	238,291	222,405
Tangible Assets	62	31	1,606	1,593
Royalty rights	259,244	399,204	391,927	354,240
Other	347,147	334,233	272,471	265,124
Current Assets	355,897	279,731	355,616	389,294
Stocks	0	0	0	0
Debtors	300	0	31,792	31,792
Cash	291,377	218,883	107,953	310,253
Other	64,220	60,848	215,872	47,249
Current Liabilities	(187,983)	(36,662)	(109,906)	(148,806)
Creditors	(318)	(394)	(7,134)	(7,134)
Short term borrowings	(175,496)	(24,966)	0	(126,400)
Other	(12,169)	(11,302)	(102,772)	(15,272)
Long Term Liabilities	(313,930)	(283,485)	(372,744)	(254,459)
Long term borrowings	(276,228)	(232,835)	(266,943)	(148,658)
Other long term liabilities	(37,702)	(50,650)	(105,801)	(105,801)
Net Assets	460,437	693,052	777,261	829,390
Minority Interests	0	0	0	(12,840)
Shareholder equity	460,437	693,052	777,261	816,550
CASH FLOW				
Operating Cash Flow	292,281	301,465	46,297	84,593
Net Interest	0	0	0	0
Tax	0	0	0	0
Capex	(49)	(9)	(109,938)	(6)
Acquisitions/disposals	21,360	(71,593)	3,071	75,374
Financing	0	0	0	0
Dividends	(96,557)	(98,307)	(16,433)	0
Other	(159,420)	(8,046)	(34,652)	42,340
Net Cash Flow	57,615	123,510	(111,655)	202,300
Opening net debt/(cash)	300,978	160,347	38,918	154,790
HP finance leases initiated	0	0	0	0
Exchange rate movements	0	0	0	0
Other	83,016	(2,081)	(4,217)	(8,115)
Closing net debt/(cash)	160,347	38,918	154,790	(39,395)

Source: Company accounts, Edison Investment Research

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