Horizon Pharma (NYSE: HZNP)

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We recommend an overweight position on Horizon Pharma's 6.625% 2023 senior unsecured notes. Based on management's proven track record for acquiring scalable drugs, we expect them to calculatedly spend cash on hand to invest in a profitable late stage or commercialized orphan drug by 1H19. HZNP's desire to build a robust development portfolio and the recent purchase of Stage II Teprotumumab signals a potential shift from acquiring more expensive, commercialized drugs. If this trend continues, management will be incentivized to use cash to deleverage. The recent focus on sales and commercialization for Krystexxa and Actimmune puts HZNP on track to reach untapped markets such as nephrology and osteoporosis. These markets will offset the past losses in primary care segments and increase FY18 sales to ~1.2 bn (~13% YoY growth). The negative sales trajectory of primary care drugs has little reason to continue and revenues in that segment should stabilize to $350mm. These collective cash flow and sales drivers will decrease leverage to ~4.2x by 1Q19 and net leverage to an industry leading ~2.2x. HZNP's low exposure to competitive pricing, strong portfolio of rapidly growing drugs, and a 5.9% YTW makes the company an attractive name in the sector.

Figure 1: Capitalization Table

Horizon Pharma Capitalization Table - November 13, 2018						
LTM EBITDA ($mm)	**406.3**					
Outstanding Debt Metrics & Leverage						
Type of Debt	**Rate%**	**Maturity**	**Debt Outstanding ($m)**	**xLTM Adj. EBITDA**	**Price**	**Yield**
First Lien Loan	US LIBOR +300.0	3/29/2024	818.0	**2.01x**	100.63	4.02%
Senior Unsecured Convertible Note	2.500%	3/15/2022	400.0		104.13	1.23%
Senior Unsecured Note	6.625%	5/1/2023	475.0		101.63	5.90%
Senior Unsecured Note	8.750%	11/1/2024	300.0		106.75	6.75%
Total Debt			**1,993.0**	**4.91x**		
Market Capitalization			3,681.1			
Less: Cash			813.4			
Enterprise Value			**4,860.7**	**11.96x**		

Source: Bloomberg, Company Filings, MFIF Analysis

Security Data

Bond Maturity: 05/01/23

Rating: B3/B-

Rank: Sr. Unsecured

Price: $101.629

YTW: 5.9%

Next Call: 12/03/2018 @ 104.97

Coupon: 6 5/8

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Expected Orphan Acquisition by Proven M&A Team

HZNP has expressed clear initiative in acquiring a rare disease drug in the near future. With cash on hand of ~$815mm, which we expect to grow to ~$960mm by the end of FY18, we do not expect any debt issuance. As Figures 2 & 3 show, HZNP has been successful in executing on drug purchases in the past with the 65% growth of Krystexxa in a year and ~70% growth of Ravicti in 1.5 years. Management has also expressed desire in building a robust development portfolio. In Jan. 2018, HZNP hired Shao-Lee Lin as EVP, Chief Scientific Officer, and Head of R&D. She has had extensive experience in the development stage of drugs at companies such as AbbVie, leading development programs for Humira and Mavyret. We foresee the possibility of management moving away from acquiring commercialized drugs and choosing to purchase cheaper, preclinical drugs such as Teprotumumab. If management shifts to buying these inexpensive preclinical drugs, they would have to consider using cash to deleverage.

Figure 2. Orphan/Rheumatology Acquisitions

Year	Drug	Drug Type	Spending Price (mm)	Following Year Sales (mm)	Price/Sales
2014	Actimmune	Orphan	$660	$107	6.1x
2015	Buphenyl Ravicti	Orphan Orphan	$1100	$168	6.5x
2016	Krystexxa, Migergot	Rheumatology Primary	$510	$162	3.1x
2016	Procysbi Quinsair	Orphan Orphan	$800	$141	5.7x
2017	Teprotumumab	Orphan	$145	NA	NA

Source: Company Filings, MFIF Analysis

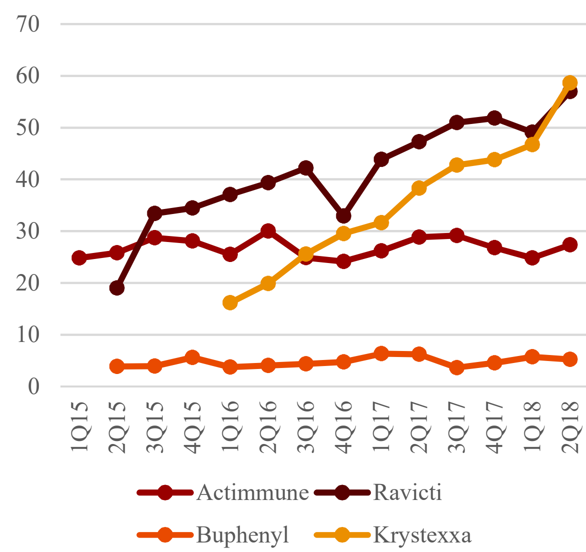
Untapped Markets to Counter Primary Care Damage

HZNP's Primary Care segment suffered in 2017 losing ~37% of sales. While this segment remains a cause of concern, Horizon is set to achieve extreme growth in its rare disease segment to overcompensate for this loss. Primary care is set to only make up ~25% of FY19 sales, with Rheumatology and Orphan Care (75% of FY19) set to grow at respective annualized rates of 14% and 47% to revive sales. Management has intensified its focus on finding untapped markets for these drugs and increased promotional efforts. HZNP just went through a "commercial expansion" in which it aggressively doubled its Krystexxa sales team to further penetrate the rheumatology segment but also reach out to the new nephrology segment. The nephrology segment doubled Krystexxa's addressable population from 50,000 to 100,000. Krystexxa's 65% sales growth guidance seemed ambitious to investors but the company is on track to beat this guidance. Actimmune's potential expansion in cancer and osteoporosis can effectively double its addressable population. These addressable patient expansions are an asset of the orphan drug model. To promote treatments for untreated diseases, independent investigator trials are being conducted for both Krystexxa and Actimmune to test potential untapped markets, effectively providing free third-party R&D for management. **Expect untapped markets to continue to deliver growth because of third-party trials, subsidized R&D expense, expedited approvals, and exclusivity.**

Risks

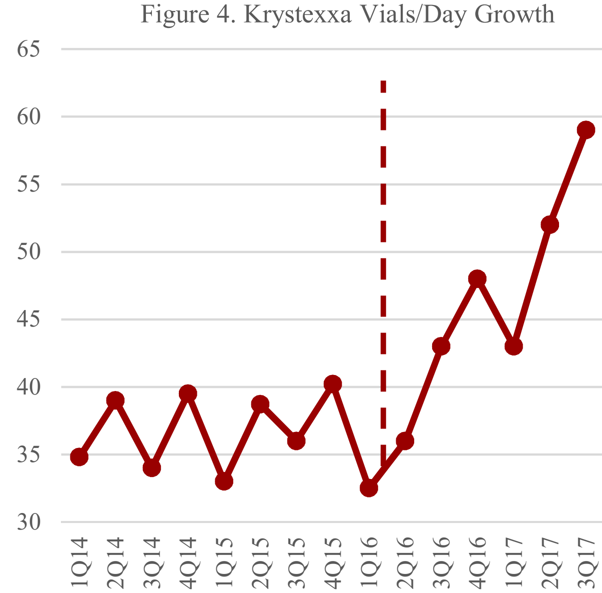
- HZNP Primary Care drugs priced significantly higher than alternatives
- 3 key drugs lose Orphan Status in 2020-2022
- Commercialization investment very aggressive for Krystexxa and Actimmune
- Potential lack of orphan M&A targets
- Management issued debt for acquisitions of Buphenyl, Ravicti, Procysbi, and Quinsair
- Development team still growing as reliance on acquisition remains

Figure 3. Sales of Acquired Rare Drugs



Source: Company Filings, MFIF Analysis

Figure 4. Krystexxa Vials/Day Growth

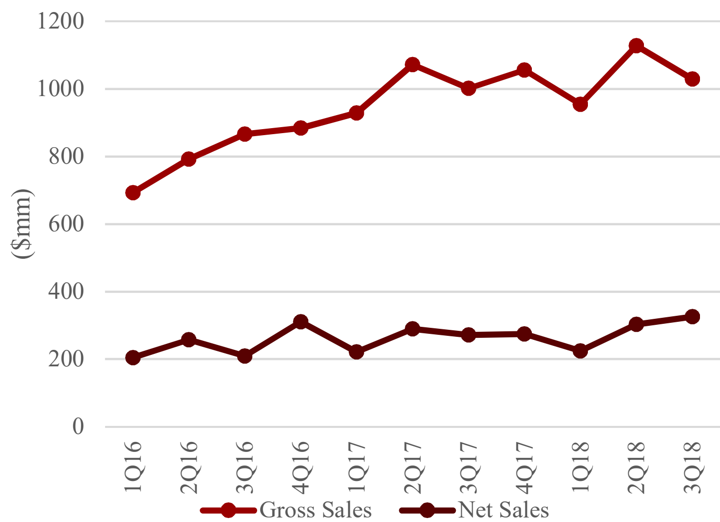


Source: Company Filings, MFIF Analysis

Primary Care Losses to Stabilize

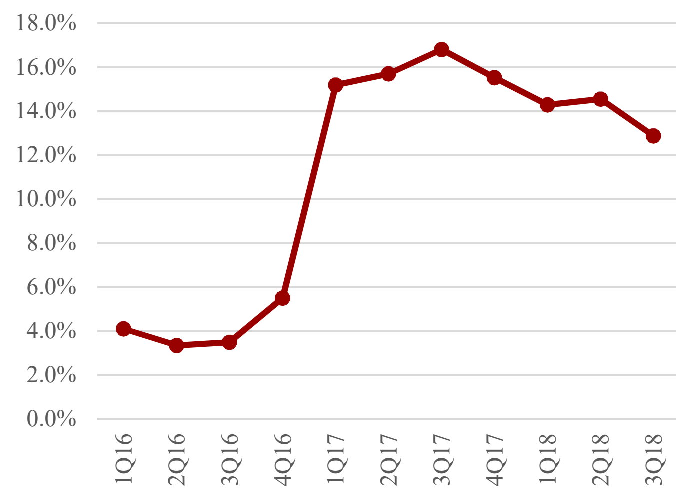
Investors have expressed concern over the negative trajectory of the Primary Care segment, but we expect these losses to stabilize. The decline in net sales was because of average net realized price (ANRP) levels from increased rebate levels that were agreed upon with PBMs. Net sales numbers are misleading investors to think that demand for these drugs is in a declining stage, when gross sales levels are actually flat. Sentiment against HZNP's Primary Care business came from negative publicity from threatened government pricing pressures, and from PBMs such as Express Scripts speaking out against Pennsaid, Duexis and Vimovo's prices. All three of these drugs have similar OTC drugs in Voltaren Gel, Ibuprofen and Famotidine, and Naproxen and Esomeprazole respectively. Big PBMs removed formulary status for these drugs and only reoffered them at the expense of higher rebates. Figure 6 shows that PBM rebates as a percentage of revenue have been flat since the newly negotiated contracting agreement, and there is no reason for a future increase. HZNP reacted by doing testing to show enhanced protection against side effects, but they have also gotten approval by the FDA to put certain messaging such as "*Do not substitute DUEXIS with the single-ingredient products of ibuprofen and famotidine*" on their labels. Many PBMs have given these drugs non-preferred status, requiring patients to try generic versions first. **With FDA support, a lack of approved alternatives, and continued sales despite PBM non-preferred status, we do not see PBMs disrupting HZNP's Primary Care segment further.**

Figure 5. Gross Sales vs. Net Sales



Source: Company Filings, MFIF Analysis

Figure 6. PBM Rebates as % of Gross Sales

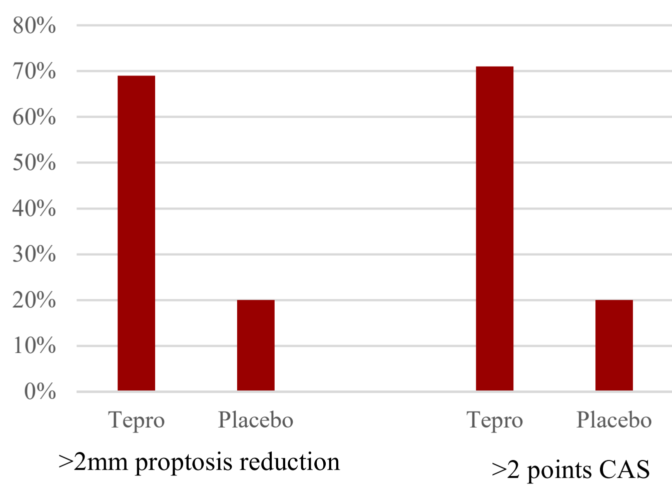


Source: Company Filings, MFIF Analysis

Teprotumumab in the Spotlight

In May 2017, Horizon acquired River Vision Development Corp. for its Thyroid Eye Disease Drug Teprotumumab in a $145 mm deal plus potential future payments based on regulatory milestones and sales. Long term data in Phase II trials has shown that responses to the Thyroid Eye Disease drugs have been maintained for patients, one year after treatment. Since eye bulging (proptosis) differentiates Teprotumumab from current therapies and seems to be a safer alternative, HZNP has the potential to tap into a 15,000 – 20,000 market. Phase III readout will happen in 2Q19. An encouraging Stage II and sooner than expected enrollment for Stage III has management encouraged going into 2019. Peak sales of $750 mm are reasonable given market size, assumed orphan drug designation, and lack of disease modifying therapies.

Figure 7. Teprotumumab Stage II Results after 24 Weeks



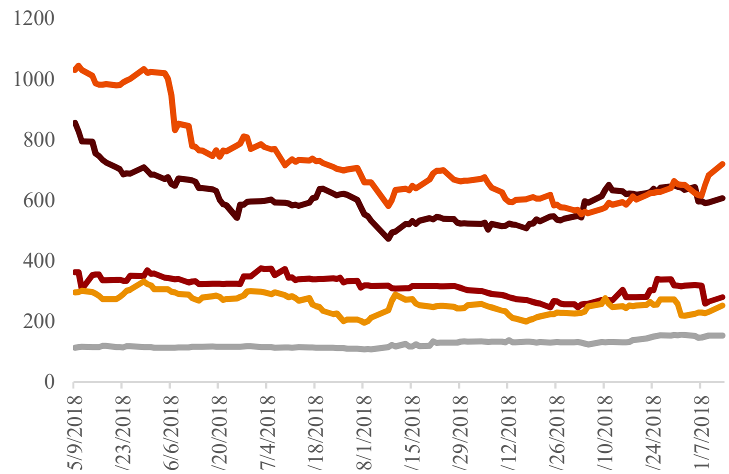
Source: Company Filings, MFIF Analysis

Relative Value
With HZNP's forecasted EBITDA uplifts, its credit metrics will match those of established pharmaceutical peers Teva and even Investment-Grade Mylan. HZNP leads its peers with a very impressive net leverage ratio of 2.9x and is only held back from a credit rating upgrade by the long-term sustainability of the small, private equity-like business model. However, these factors are a small risk to take on for a significantly superior yield.

Teva itself has faced issues related to its Primary Care segment with Express Scripts deciding to exclude formulary status for Ajovy, the company's primary growth driver. We see limited upside for Teva because of its lack of near-term product launches and no expectation of paying down debt. Given these challenges and an imploding generics business, we question whether Teva's scale and interest coverage itself merit a significantly better credit profile. With uncertainty over the company's primary revenue driver, we expect investors to seek a company with improving cash flow metrics, lack of competitive pressure and higher yield in HZNP.

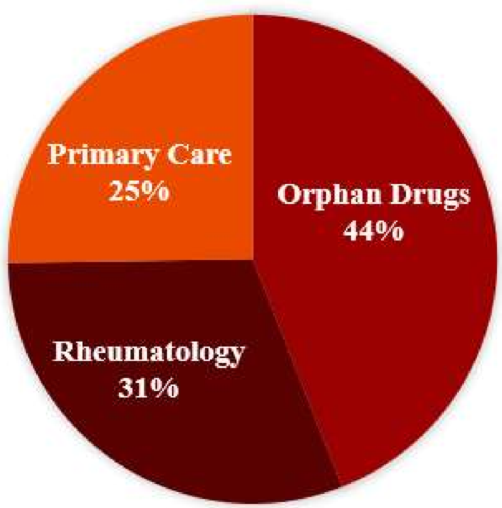
Investors are able to get a higher yield from HZNP without worrying about diversification and liquidity the way that MNK is. Uncertainty over Acthar remains as do drug reimbursement hurdles. Weighing these risks against HZNP's main risks in the primary care sector, a company with improving debt metrics and already diversified model is the better investment. While current spreads reflect some of this superiority, they do not reflect the untapped markets that HZNP will reach in 2018-19.

Figure 8. Z-Spread



Source: Bloomberg

Figure 9. 2019 Projected Sales



Source: MFIF Analysis

Figure 10. Competitor Comparison

($mm)	HZNP	MNK	ENDO	TEVA	MYL
Market Cap	$3,681	$2,219	$3,847	$24,110	$16,332
Enterprise Value	$4,861	$8,341	$11,013	$51,724	$30,721
LTM EBITDA	$406	$1,178	$1,454	$6,659	$3,710
EBITDA Margin	36.2%	42.2%	48.9%	33.7%	31.7%
Debt/EBITDA	4.91x	5.40x	5.69x	4.43x	3.97x
Net Debt/EBITDA	2.90x	4.33x	5.01x	4.28x	3.89x
EBITDA/Interest	3.30x	3.26x	2.86x	7.61x	7.47x
Rating	B-	B-	CCC+	BB	BBB-

Source: Bloomberg, Company Filings, MFIF Analysis

Figure 11. Summary Model

HZNP Summary Model | November 6, 2018	2016	2017	1Q18	2Q18	3Q18	4Q18E	2018E	2019E
Revenues								
Orphan Drug Sales	299.3	466.9	114.7	128.1	132.1	150.9	525.9	598.5
% Growth		56.0%	-24.0%	11.6%	3.1%	14.2%	12.6%	13.8%
Rheumatology Drug Sales	142.7	214.0	57.5	73.6	87.8	101.3	320.1	417.5
% Growth		50.0%	-6.4%	27.9%	19.3%	15.4%	49.6%	30.4%
Primary Care Drug Sales	604.1	375.3	51.6	101.1	100.2	103.5	361.7	342.9
% Growth		-37.9%	-46.4%	95.9%	-0.9%	3.3%	-3.6%	-5.2%
Net Revenue	981.1	1056.2	223.9	302.8	325.3	355.7	1207.7	1358.9
COGS	393.3	546.3	116.1	100.1	99.0	106.7	421.9	441.6
Gross Profit	587.8	510.0	107.8	202.8	226.3	249.0	785.8	917.2
Total Operating Expenses	735.0	902.3	235.1	200.9	172.1	182.8	790.8	784.8
Operating Income	(147.2)	(392.4)	(127.3)	1.8	54.2	66.2	(5.0)	132.4
Interest Expense	86.6	126.5	30.5	31.0	30.4	28.0	119.9	112.0
Other Non-Operating Expense	(5.7)	(5.6)	(0.1)	(0.3)	(0.5)	0.0	(0.9)	0.0
EBT	(228.1)	(513.3)	(157.7)	(28.9)	24.3	38.2	(124.0)	20.4
Taxes (Benefit)	(61.3)	(102.7)	(0.4)	4.0	(1.7)	0.0	(3.4)	0.0
Net Income	(166.8)	(410.5)	(157.3)	(32.8)	26.0	38.2	(120.7)	20.4
EBITDA Reconciliation								
Net Income	(166.8)	(410.5)	(157.3)	(32.8)	26.0	38.2	(120.7)	20.4
Interest Expense	86.6	126.5	30.5	31.0	30.4	28.0	119.9	112.0
Taxes	(61.3)	(102.7)	(0.4)	4.0	(1.7)	0.0	(3.4)	0.0
EBIT	(141.5)	(386.8)	(127.2)	2.2	54.7	66.2	(4.1)	132.4
D&A	221.8	283.4	68.9	68.5	69.2	70.0	276.7	282.2
EBITDA	80.4	(103.3)	(58.3)	70.7	124.0	136.2	272.6	414.7
Share Based Compensation	113.0	125.0	27.8	30.7	28.4	28.4	115.4	115.4
Other Adjustments	153.6	193.1	64.6	14.8	7.5	0.0	86.8	30.0
Adjusted EBITDA	347.0	214.7	34.1	116.2	159.9	164.7	474.8	560.1
EBITDA	347.0	214.7	34.1	116.2	159.9	164.7	474.8	560.1
Taxes	61.3	102.7	0.4	(4.0)	1.7	0.0	3.4	0.0
Interest	(86.6)	(126.5)	(30.5)	(31.0)	(30.4)	(28.0)	(119.9)	(112.0)
Changes in WC	(135.8)	(146.0)	57.7	23.7	50.5	8.7	140.5	136.7
CapEx	(15.7)	(4.3)	(0.7)	(0.1)	(0.1)	(1.4)	(2.3)	(4.0)
Free Cash Flow	170.2	40.7	61.0	104.7	181.6	143.9	496.5	580.8
Total Debt	2048.9	2021.0	2019.0	1993.0	1993.0	1991.0	1991.0	1983.0
Total Cash	509.1	751.4	680.7	715.2	813.4	964.1	964.1	1307.4
Debt/Adj. EBITDA	5.9x	9.4x	9.8x	5.5x	4.9x	4.2x	4.2x	3.5x
Net Debt/Adj. EBITDA	4.4x	5.9x	6.5x	3.5x	2.9x	2.2x	2.2x	1.2x
EBITDA/Interest	4.0x	1.7x	1.6x	2.9x	3.3x	4.0x	4.0x	5.0x
FCF/Debt	8.3%	2.0%	5.0%	12.4%	17.0%	24.9%	24.9%	29.3%