

9 October 2006

Starpharma Gets Bigger by Going Smaller

Summary

- SPL has announced it is acquiring the remaining 67% of the US-based private company Dendritic Nanotechnologies Inc. (DNT) it does not currently own through a scrip-based offer. We view this as a very positive move for the company and maintain our **SPECULATIVE BUY** recommendation for SPL with a price target of \$0.79.
- SPL is issuing DNT shareholders with SPL shares valued at A\$9.4m (US\$7.0m) based on the 5-day VWAP of \$0.47. In our view, this is a very attractive acquisition price for SPL shareholders and provides them with significant upside from the DNT portfolio.
- In our initiation of coverage report for SPL ("Big Opportunities For Small Things", 29 September 2005), we highlighted our view that SPL's shareholding in DNT was a significant strategic asset for the company.
- The acquisition of the remaining 67% of DNT is, in our view, a company transforming event giving SPL:
 - a leading IP in position in dendrimer nanomolecular structures
 - an expanded product pipeline which will include industrial and medical applications of dendrimers
 - diversification beyond higher risk pharmaceutical applications
 - higher profile in the US through both greater US presence and shareholding by The Dow Chemical Company
- We believe that these factors make SPL a more attractive investment opportunity through both the reduction of risk and the greater number of near term commercial opportunities that will be available.

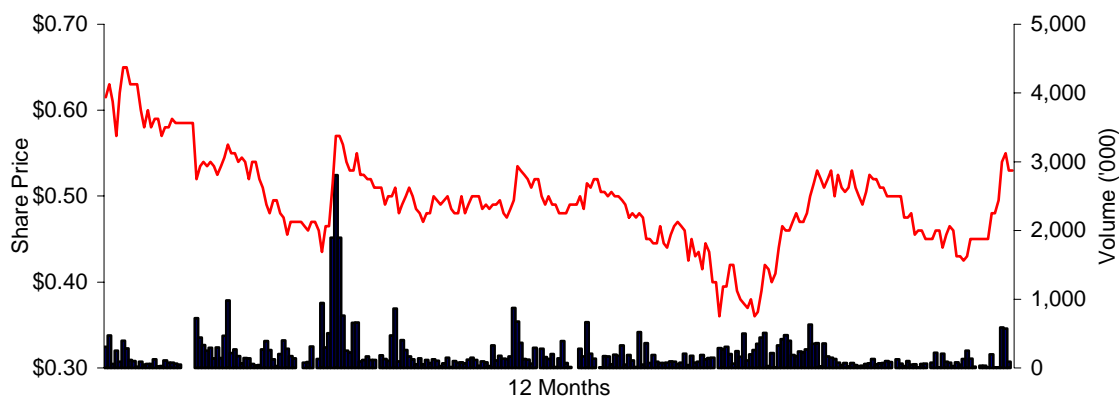
Company	
Stock code:	SPL
Share price:	\$0.53
Recommendation:	Speculative Buy

S&P/ASX 300 = 5218

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Company Statistics & Performance

Shares on Issue	147.7m	Av. Daily Vol.	203,000
Market Cap.	\$78.3m	52 Week Range	\$0.35 - \$0.67
Cash (30 June 2006)	\$14.3m	Annual Cash Burn	\$7.9m



DNT Dominates Dendrimer-Based Technology

DNT was established in 2002 as a joint venture between Dr Tomalia (an ex-employee of The Dow Chemical Company and the inventor of dendrimers) and SPL to develop products using dendrimer nanotechnology. Dendrimers are a special form of polymeric molecules that have highly ordered and regular structures.

Under the terms of the joint venture, SPL had access to all of DNT's dendrimer intellectual property (IP) for therapeutic applications while DNT would focus on other applications.

In January 2005, The Dow Chemical Company (NYSE:DOW, MCap US\$37.2 billion) assigned all of its dendrimer IP to DNT in exchange for a 30% equity stake. As a result, DNT owns the most comprehensive dendrimer IP portfolio that comprises over 200 patents in 41 different patent families.

DNT has established commercial deals with a number of leading companies including Pfizer Inc., Sigma Aldrich, General Dynamics and Lumera. DNT has already licensed two products that are currently generating approximately A\$1.25m in sales and royalty revenue:

- Cardiac diagnostic marker licensed to Dade Behring
- Gene transfection technology licensed to Qiagen.

DNT has also developed transfection technology for the delivery of siRNA molecules into cells which has a number of advantages over cationic lipids which are currently used and could provide near term access to a current market of \$120m that is growing at 15%.

In May 2005, DNT announced the development of a synthetic methodology for generating dendrimers called Priostar. This methodology has significant advantages including lower time and cost of production, scalability and produces dendrimers with greater thermal stability and a larger number of surface groups. As a consequence, Priostar makes a number of industrial applications economically viable including resins, lubricants, adhesives, filtering and electronics.

DNT's comprehensive dendrimer IP portfolio will provide SPL with several near-term commercial opportunities and expands on the position it has established for the use of dendrimers in pharmaceutical applications with the development of its VivaGel microbicide.

Strategic Benefits for SPL

The acquisition of DNT will provide strategic benefits for SPL in two key areas:

- risk reduction through diversification
- greater US profile and access

Risk Reduction through Diversification

DNT will provide SPL with a large number of non-pharmaceutical commercialisation opportunities. In addition to tapping into new markets, these opportunities are typically lower risk than pharmaceutical products which have high development costs and significant attrition rates.

With current royalty revenues of A\$1.25m, we believe and a large number of commercialisation opportunities under discussion, we believe that DNT is close to becoming cash flow positive and thus should only have a minimal impact on SPL's cash burn and reserves.

Greater us Profile

DNT has already established a strong profile in the US nanotechnology space due to its dominance of dendrimer technology. We believe that this is one of the factors that has contributed to the relatively high level of trading of SPL's ADRs in the US market. The acquisition of the remainder of DNT will enable SPL to further leverage the profile of DNT in the US market.

As part of the transaction, Dow will become a significant shareholder of SPL and, in addition to taking a board position, there are escrow arrangements and incentives for Dow to retain its position. Dow is a very significant industrial company in the US market and this association is sure to positively impact on the profile of SPL with the US capital markets.

We believe that these factors will put SPL in a strong position to tap into the US capital markets. Furthermore, in our view, the US market is likely to have a greater appreciation of the value of both VivaGel and the DNT's products and IP portfolio which could result in a significant re-rating for SPL in the near future.

The Deal Looks Good

SPL's pre-acquisition shareholding of 33% was the result of establishing the joint venture and maintaining its equity position through the investment of A\$5.2m.

SPL will be issuing approximately 20.1m new SPL shares to existing DNT shareholders in exchange for their 67% holding. Once the allocation of SPL shares are adjusted for the different classes of DNT shares, Dow will hold 8.6% of SPLs post-acquisition issued capital while the remaining DNT shareholders (mainly founders and staff) will have approximately 3.4%.

As the new issue is below 15% of SPL's current capital (147.7m shares), the company is not required to seek shareholder approval. While the transaction does require the approval from the majority of holders of each DNT share class, Dow and SPL (who own the majorities) have already indicated that they will vote in favour of the transaction.

There are a number of specific provisions for Dow that are covered in the transaction including:

- a period of royalty payments on IP that Dow assigned to DNT,
- escrow periods and incentives for Dow to retain its equity position in SPL
- a right for Dow to maintain its equity position through participation in future funding rounds
- representation on SPL's board

We view these as confirming Dow's commitment to the combined entity which and we believe that this commitment will engender the support of the investment community both here and overseas.

In our view, the acquisition was done at a price that is very favourable for SPL's shareholders. The valuation of DNT that is implied by the transaction is A\$14.1m. However, given that the transaction appears to primarily driven by the majority shareholders (Dow and SPL), we do not consider it to represent an independent valuation event for DNT but rather a reallocation of assets by the majority shareholders to better realise their potential.

In our view, the acquisition has generated a true platform technology company that will be utilising the platform in a number of different industry sectors and should, thus, provide a very attractive investment opportunity.

What is DNT Worth?

DNT has never been subject of an independent valuation through an arms-length investment by external investors. In our initiation of coverage report on SPL, we suggested that DNT could be worth up to US\$90m based on an analysis of comparable nanotechnology companies listed on NASDAQ in the US.

We maintain our view that the comprehensive IP portfolio that DNT has secured covering the use of dendrimers and the extensive commercial opportunities that this portfolio will provide supports a valuation significantly greater than the A\$14m (US\$10.5m) implied by SPL's acquisition.

We have reviewed the NASDAQ listed nanotechnology companies in more detail in order to derive a potential valuation for DNT. In our view, the two most similar companies are Altair Nanotechnologies (NASDAQ:ALTI) and Nanophase (NASDAQ:NANX). Both of these companies have technologies for generating nanocrystalline materials based on various metal oxides. While these materials differ from the regular, structured polymers that DNT focuses on, they have applications to a wide range of both industrial and medical applications including medical imaging, coatings, filtration and drug delivery.

Figure 1: Financial & Market Data for ALTI and NANX

	6 Oct 2006	12 Months to 30 June 2006 (US\$m)			
	MCap (US\$m)	Cash	Technology Value	Revenue	Operating Cashflow
Altair Nanotechnologies	222.8	14.4	208.4	2.9	-11.6
Nanophase	111.5	6.2	105.3	7.5	-3.0

Source: NASDAQ

Given that the revenues from both of these companies for the past 12 months are still relatively modest, the US market is placing significant value on the blue-sky potential and commercial opportunities that these companies offer.

The sales and licensing revenues for DNT in 2005 were approximately A\$1.3m (US\$0.9m). In our view, there are a number of clear commercial opportunities for DNT that could significantly raise this number in the near future.

Based on these comparables, we believe a conservative estimate of a potential market valuation for DNT in two years time is US\$75m, at which point we would anticipate that additional revenue streams will have been secured. Discounting this at 15% implies a present value of US\$56.7m or A\$0.45 per share.

A conservative DCF estimate of potential cash flow from DNT would support a valuation of A\$96m or \$0.57 per share. On both of these estimates, we believe there is significant opportunity to exceed our projections and provide further upside for SPL shareholders.

In summary, we retain our view that there is significant value in DNT over and above the value that has been implied by the terms of acquisition by SPL. We believe that this value will be realised in SPL's share price as some of the commercial opportunities become crystallised. The bottom line is, however, the targets required to exceed our conservative estimate should be readily achievable and are likely to be exceeded providing significant potential upside to SPL's shareholders.

We also believe that US investors are likely to appreciate DNT's potential and that this is likely to result in strong support in the US market.

Valuation

Our updated valuation of SPL is \$0.79. This valuation takes into account the current funding by the NIH of VivaGel for both HIV and HSV. We still have ~\$25m in clinical development costs for VivaGel clinical trials in our model however we believe that the company may be able to get further funding support for these trial from external sources such as the Gates Foundation.

We have also used our lower estimate of DNT's value (ie: US\$75m in 2008) which is a number that could rapidly be exceeded. Finally, we have not included any value for other IP within SPL including the potential application of SPL7013 as a condom coating, SPL's stakeholding in Dimerix, and other projects that are in progress. Thus our breakdown valuation for SPL of \$0.79 provides scope for significant upward re-rating.

Figure 2: Breakdown Valuation of SPL (Post DNT Acquisition)

Asset	\$m	Per Share
VivaGel	\$62.2	\$0.37
DNT	\$76.0	\$0.45
Cash	\$14.3	\$0.09
Operational Expenditure	-\$20.2	-\$0.12
TOTAL	\$132.3	\$0.79

Source: Paterson Estimate

NOTE: Assumes 20.1m shares issued for 67% equity of DNT resulting in total of 167.8m SPL share on issue

Risks with DNT Acquisition

As we have indicated, we believe that SPL has acquired DNT under favourable terms. As DNT generated A\$1.3m in revenue in 2005, we estimate that the DNT will only increase SPL's cash burn by less than A\$2m.pa. This increase in cash burn could be rapidly offset by a number of potential deals that are currently under consideration.

While we believe the financial risk to SPL on the acquisition is minimal, there are a number of areas of risk that SPL will need to manage to ensure the value from DNT is realised:

- SPL's R&D and business development expertise to date has primarily been in the area of therapeutics. The company will need to ensure that it is able access the appropriate expertise to develop and realise the commercial opportunities in industrial and material markets.
- With DNT's operations located in the US, SPL's management will need to ensure that appropriate management and reporting structures are established to manage DNT to ensure projects are focused on commercial outcomes
- As the transaction essentially only required the approval of the majority shareholders in DNT (SPL and Dow) it is possible that some key staff in DNT may not view that transaction favourably which could impact on their near term performance or retention.

Disclaimer: Patersons Securities Limited acted as Lead Manager to a Share Placement that raised \$12m at \$0.51, and as Underwriter to a Share Purchase Plan that raise \$3m at \$0.51 per share for Starpharma Holdings Limited in November 2005. Patersons Securities Limited acted provided Corporate Advisory Services in relation to the acquisition of Dendritic Nanotechnologies Incorporated by Starpharma Holdings Limited. It received fees for all of these services.

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