

23 January 2007

## All You Need Is Love

### Summary

- Following 2 years of being the most unloved sector in the Australian market, the biotechnology stocks are starting to show signs of life again.
- We believe the sector is ripe for a re-rating across the board due to:
  1. **Unfactored Progress:** in many cases the achievement of development milestones and/or value of acquisitions over the past 2 years have not been fully factored into prices
  2. **Strong Calendar of Events:** across the sector, we are expecting significant announcements with respect to major clinical trials and marketing approval for a number of products
  3. **Resources Downturn:** softening of the resources market has speculative investors looking towards the biotech sector for new investment opportunities
- The end of 2006 saw a number of companies undertaking capital raisings either through private placements or SPPs. In addition, several companies, including PGL, BLT, PXS, EGX, AVX, MSB, MBP and PTD experienced significant increases in share price over the past 3 months.
- Having reviewed the majority of listed companies, in this note, we look at 16 biotech stocks which we believe offer interesting opportunities for investors in the sector.
- Our **best buy** recommendations remain Acrux (**ACR**), ChemGenex (**CXS**) and Alchemia (**ACL**). These three companies have products in advanced stages of development (and consequently a lower risk of failure) which are close to market.
- We also identify companies who we believe should be close to establishing a licensing or partnership deal (**NEU, PXL, SPL**), near-term trading opportunities (**MBP, BTA, PTD**), low priced stocks with good prospects (**VSG, IMI**) and other stocks that have already experienced significant gains but are based on good technologies (**PXS, AVX, EGX, CYT, PYC**).
- We believe that if the current positive sentiment towards the biotech sector remains, these stocks should provide good exposure for speculative investors.

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## Summary

We have reviewed the listed biotechnology companies and categorised our recommendations into 5 groups as set out below:

**Best Buys:** these remain our best recommendations with well-developed products that are getting close to market which we believe still have significant upside

**On The Brink:** these stocks have had a lacklustre performance over the past 12-months but we believe the companies are well-positioned to put in place commercial arrangements in the near future which could trigger a significant re-rating

**Trading Ideas:** while these companies are trading to what we estimate is a reasonable valuation, there are near term events that we believe could trigger further interest from the market

**Penny Darlings:** these are smaller companies with low-priced shares but are about to show good revenue growth that could significantly lift their price from its current low level

**Ones To Watch:** these are high quality companies in the sector that have compelling technologies and products under development. While the market has already put a premium on these stocks (relative to the rest of the sector), they remain good stocks to be in for longer term positions.

**Figure 1: Summary of Biotech Investment Recommendations**

	Price (\$)	Market Cap (\$m)	Rationale
<b><u>Best Buys</u></b>			
ACR	\$0.78	\$106.5	Evamist and deal opportunities around multi-product portfolio
CXS	\$0.65	\$98.6	Clinical data and completion of Ceflatonin registration trials
ACL	\$0.88	\$118.5	New partner for synthetic heparin and FDA approvals for additional indications for Arixtra
<b><u>On The Brink</u></b>			
NEU	\$0.52	\$68.2	Commence Phase-3 for Glypromate and licensing deals around rest of portfolio
PXL	\$0.31	\$47.0	Prototypes of two diagnostic tests near completion and licensing of Eukaryon compounds
SPL	\$0.47	\$78.0	Deals around DNT portfolio particularly for siRNA transfection agent
<b><u>Trading Ideas</u></b>			
MBP	\$1.06	\$318.1	Further market support in anticipation of Phase-2b data for obesity drug in March
BTA	\$1.59	\$286.1	Strong cashflow from Relenza royalty expected over the next 12 months
PTD	\$1.55	\$254.3	Currently trading at cash/royalty with reasonable early stage pipeline
<b><u>Penny Darlings</u></b>			
VSG	\$0.013	\$7.9	Revenues from Breath-A-Way and sales of Funhaler expected
IMI	\$0.022	\$21.0	Strong growth in sales of Intelliheart monitors with attached annuity stream
<b><u>Others To Watch</u></b>			
PXS	\$2.99	\$530.3	Progress in clinical development of Bronchitol and commencement of Aridol sales
EGX	\$0.75	\$104.3	Potential takeover target with fee-for-service revenues and internal products
AVX	\$0.46	\$112.4	Data from Phase-2b for HIV drug in 1Q with Phase-3 at end of year
CYT	\$0.69	\$50.4	Phase-1 trial for CYT997 in progress, stock is yet to gain market support
PYC	\$0.50	\$60.8	Validation of Phylomer technology platform will result in significant re-rating

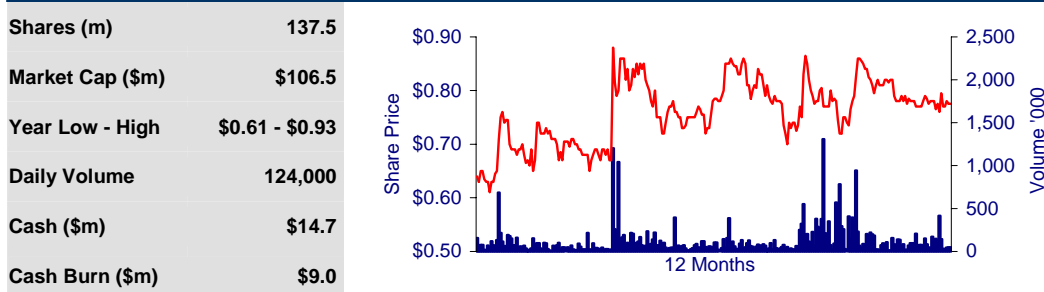
Source: Patersons Analysis

## Best Buys

### ACRUX (ACR)

**(\$0.78)**

**Figure 2: Acrux – Company Performance & Summary**



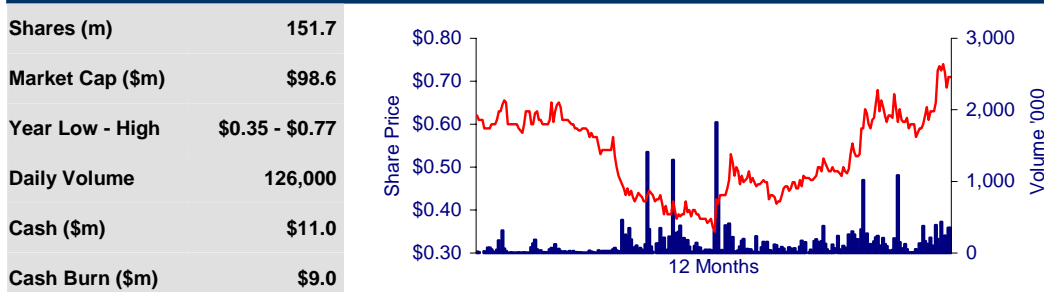
Source: IRESS

- We believe ACR is set to have a very positive year with its most advanced product, Evamist, set to receive marketing approval from the FDA in 2H CY07 and a robust pipeline of products that offer multiple opportunities to establish new commercial partnerships.
- The granting of marketing approval will trigger a US\$3.0m payment from its current licensee VIVUS. However, this partnership is currently under review and may be renegotiated if VIVUS is unable to deliver on the expected commercial outcomes from the product.
- ACR also has several products under development that are ripe for licensing deals including Fentanyl (pain relief), testosterone (male and female applications), contraception, RoW rights for Evamist and development of animal health applications through Elanco (USA).

### ChemGenex (CXS)

**(\$0.65)**

**Figure 3: ChemGenex – Company Performance & Summary**



Source: IRESS

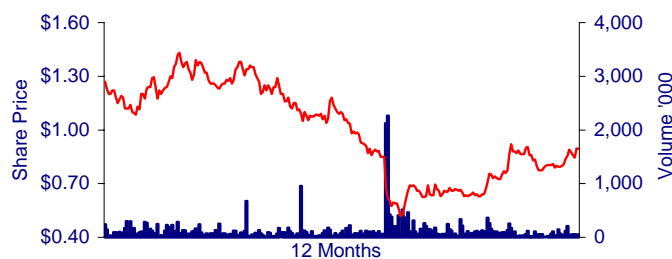
- CXS's lead anticancer product, Ceflatonin, will be completing clinical testing for the treatment of CML patients who have developed resistance to the current mainline treatment Gleevec as a result of the T315I mutation.
- The clinical data for Ceflatonin so far has been outstanding with several patients showing a complete hematologic or cytogenic response. CXS has several, open-label trials for Ceflatonin in progress that will provide ongoing clinical results throughout the year.
- CXS is expected to complete filing approval for the T315I-resistance with the FDA under the recently granted Fast Track program by the end of CY07. However, the clinical data to date strongly supports several additional clinical applications for Ceflatonin

## Alchemia (ACL)

(\$0.88)

Figure 4: Alchemia – Company Performance & Summary

Shares (m)	135.4
Market Cap (\$m)	\$118.5
Year Low - High	\$0.51 - \$1.54
Daily Volume	236,000
Cash (\$m)	\$16.0
Cash Burn (\$m)	\$16.0



Source: IRESS

- ACL's share price has shown some recovery since the announcement in August 2006 that its partnership with Abraxis was likely to be terminated but still remains lower than its historical trading levels.
- While the termination of the Abraxis partnership has introduced a 1 year delay to filing the ANDA, the fundamentals of ACL's synthetic heparin product and the commercial opportunity it provides remain unchanged. We believe the company will be able to secure a new commercial partnership during the year and, with further clinical data expected this year from Arixtra trials, the potential clinical applications may well be expanded.
- In addition to synthetic heparin, ACL is expected to be reporting clinical trial data for HyCAMP, which it acquired as part of Meditech, during 1Q CY07 which could provide further support for the stock.

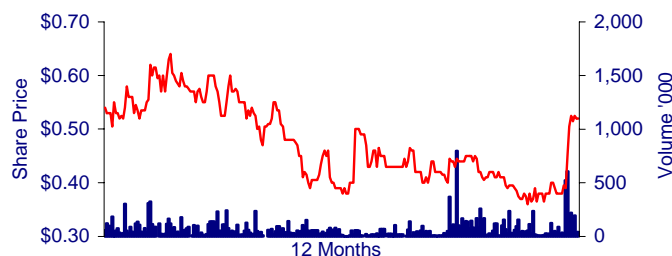
## On The Brink

### Neuren (NEU)

(\$0.52)

Figure 5: Neuren – Company Performance & Summary

Shares (m)	131.1
Market Cap (\$m)	\$68.2
Year Low - High	\$0.36 - \$0.65
Daily Volume	76,000
Cash (\$m)	\$9.2
Cash Burn (\$m)	\$8.5



Source: IRESS

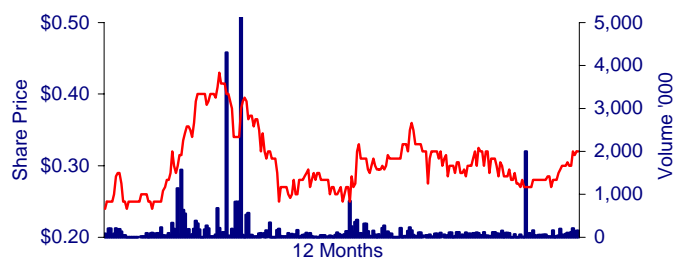
- NEU is well-positioned to deliver strong news-flow on both its clinical development programs and on commercialisation of non-core elements of its intellectual property portfolio. While the stock has experienced limited support over the past 12-months, if the company achieves the anticipated news-flow, we believe interest in NEU will be renewed.
- NEU has filed its IND application for Glypromate with the FDA and a 520 patient Phase-3 trial for neurological protection during CABG is expected to commence in mid-1H CY07. In addition, Phase-2 trials for the follow-on drug, NNZ2566 are expected to start during CY07.
- NEU has engaged Burrill & Company (USA) to assist with identifying out-licensing opportunities for four of its programs.

## Proteome Systems (PXL)

(\$0.31)

**Figure 6: Proteome Systems – Company Performance & Summary**

Shares (m)	154.2
Market Cap (\$m)	\$47.0
Year Low - High	\$0.24 - \$0.45
Daily Volume	177,000
Cash (\$m)	\$3.5
Cash Burn (\$m)	\$8.0



Source: IRESS

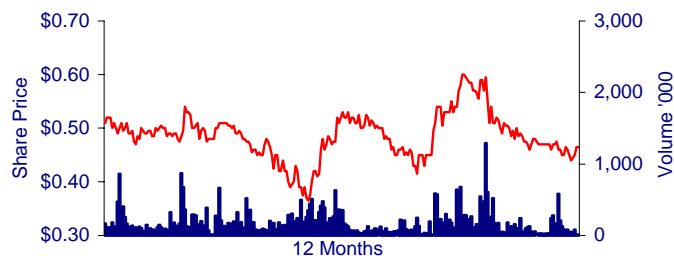
- PXL is expected to complete the development of its prototype test for diagnosis of active tuberculosis and for prostate cancer in 1H CY07. This will allow the rapid validation of these tests on large numbers of clinical samples prior to development of the final test format.
- At the prototype-test stage, either of these technologies may attract the interest of potential licensees to take the validation and clinical development forward.
- In addition, PXL has a number of drug candidates in development for protection from radiation and neurological damage from the Eukaryon acquisition in 2005 which provide further opportunities for near-term licensing deals that should provide more support for PXL.

## Starpharma (SPL)

(\$0.47)

**Figure 7: Starpharma – Company Performance & Summary**

Shares (m)	167.8
Market Cap (\$m)	\$78.0
Year Low - High	\$0.35 - \$0.64
Daily Volume	172,000
Cash (\$m)	\$12.3
Cash Burn (\$m)	\$8.5



Source: IRESS

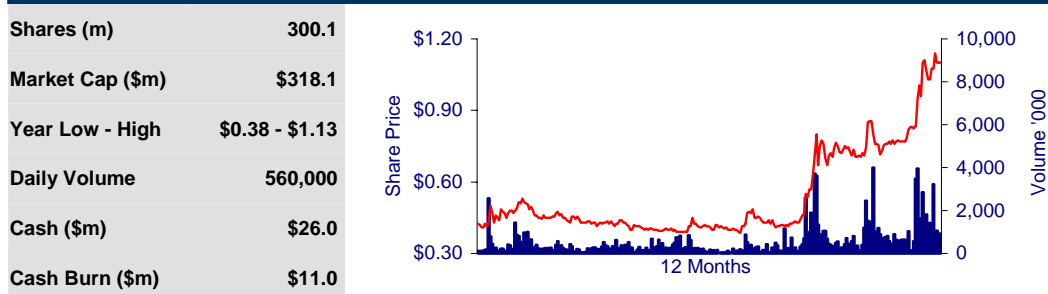
- Since completing the acquisition of the US nanotechnology company DNT in October last year, SPL's price has been under pressure which we believe is primarily due to the announcement regarding delays on the clinical development of VivaGel for HIV.
- We remain positive on the commercial opportunity that DNT may provide and believe this was a valuable acquisition for SPL that was achieved at an attractive price. However, the market has historically appeared to place little value on SPL's holding in DNT and been unable to quantify the commercial value of its intellectual property portfolio.
- In view of this, we believe the key, near term trigger for SPL will be the establishment of a commercial arrangement based on DNT's portfolio. We are anticipating that such an arrangement may come from DNT's siRNA transfection agent PrioFect that potentially could enter the market in 1H CY07.

## Trading Ideas

### Metabolic (MBP)

**(\$1.06)**

**Figure 8: Metabolic – Company Performance & Summary**



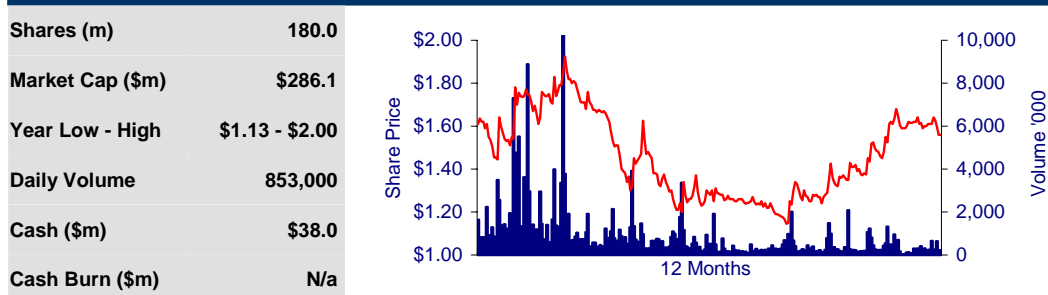
Source: IRESS

- While MBP has expanded its pipeline through the acquisition of a candidate anti-pain drug, extension of application for AOD9064 to osteoporosis and several earlier stage projects, much of the perceived value comes from the weight reduction properties of AOD9064.
- Data from the second Phase-2b trial should be announced in March. This trial has a 3x greater number of subjects than the previous trial (which did not have sufficient statistical power to confirm an effect) and, given the previous data also, used lower doses of the drug.
- There is little doubt that the outcome of this trial will have a significant impact on MBP's price (either positive or negative). However, in the interim, we believe the shareprice will continue to get support in the lead up to the results announcement providing investors with a good trading opportunity. MBP reached \$2.19 in the lead up to Phase-2 results in 2004.

### Biota (BTA)

**(\$1.59)**

**Figure 9: Biota – Company Performance & Summary**



Source: IRESS

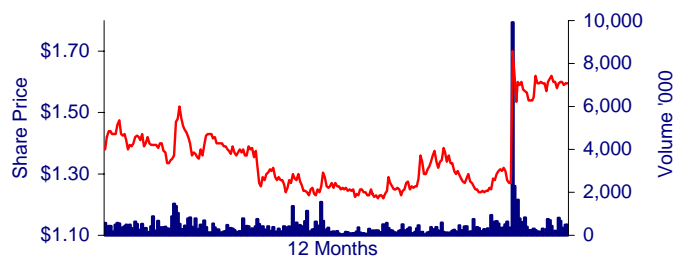
- With GSK's expanding its capacity for the production of Relenza and government stockpile orders starting to be fulfilled, we are expecting BTA to provide a strong cash result this year that is likely to result in profitability.
- BTA reported sales of Relenza in 1Q FY07 entitle the company to approximately \$5.3m in royalty payments. Based on the current stockpiling orders, we expect that the Relenza royalty revenue for each of the remaining quarters are likely to equal or exceed this figure.
- The company will also receive further payments under its licensing arrangements with MedImmune and Boehringer Ingelheim. We expect that strong revenue growth will lead to further support for BTA particularly if the sector continues to gain the attention of speculative investors.

## Peptech (PTD)

(\$1.55)

Figure 10: Peptech – Company Performance & Summary

Shares (m)	164.1
Market Cap (\$m)	\$254.3
Year Low - High	\$1.21 - \$1.85
Daily Volume	395,000
Cash (\$m)	\$200.0
Cash Burn (\$m)	N/a



Source: IRESS

- PTD experienced a significant re-rating in December 2006 with the announcement that GSK purchased their 33% stake in Domantis (UK) for A\$178m. With the proceeds from this transaction, a royalty stream from its TNF patents worth \$60m-\$80m and a pre-transaction cash balance of close to \$40m, we believe PTD is currently trading at below cash value.
- PTD's product pipeline is still relatively early however its anti-TNF domain antibody PN0621 is expected to enter clinical development in 2Q CY07 and the anti-C5a receptor drug PMX53 from the Promics acquisition is expected to enter Phase-2 for AMD.
- In addition to these and other R&D projects, PTD has an Animal Health division with two products in market which is likely to be divested at some stage. We believe that this or progress with its R&D portfolio should bring PTD above its current cash-backed price.

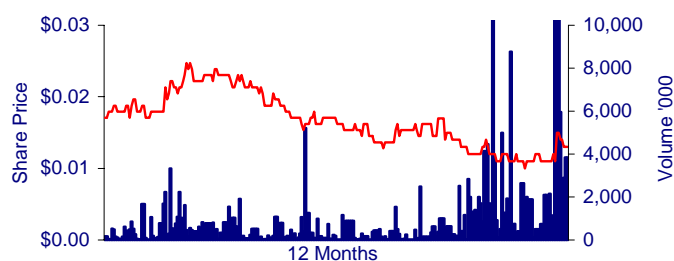
## Penny Darlings

### Visiomed (VSG)

(\$0.013)

Figure 11: Visiomed – Company Performance & Summary

Shares (m)	605.4
Market Cap (\$m)	\$7.9
Year Low - High	\$0.010 - \$0.026
Daily Volume	895,000
Cash (\$m)	\$1.6
Cash Burn (\$m)	\$1.0



Source: IRESS

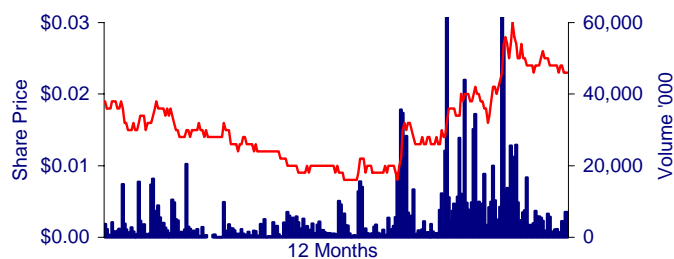
- With the re-tooling for manufacture of the paediatric asthma Funhaler spacer completed and the acquisition of Breath-A-Way in November, VSG is set to generate good earnings in the next 12 months.
- The new manufacturing of the Funhaler spacer has significantly reduced production costs and times and will enable the company to achieve gross margins of around 70%. The initial run of spacers sold rapidly and the company has distribution arrangements in place in Australia and access to the worldwide market through a licensing deal with Respironics.
- Breath-A-Way is expected to contribute over \$1.6m in revenue from sales and royalty payments in CY07. We anticipate that the company may report a profit in the next 12-months that would warrant a significant lift in valuation.

## IM Medical (IMI)

(\$0.022)

Figure 12: IM Medical – Company Performance & Summary

Shares (m)	955.1
Market Cap (\$m)	\$21.0
Year Low - High	\$0.007 - \$0.031
Daily Volume	5,800,000
Cash (\$m)	\$3.0
Cash Burn (\$m)	\$2.0



Source: IRESS

- IMI is in the rollout stage for its Intelliheart devices that provide non-invasive diagnostic information on cardiovascular function. The rollout appears to be exceeding initial forecasts with 60 devices in place at the end of December 2006 and, with interstate rollout commencing in 1Q CY07, a further 60 expected by the end of CY07.
- IMI provides its machines under two arrangements, either a straight sale (with maintenance contract) or sells the services and reports generated from the machines. Thus the install base establishes an annuity stream for IMI from the machines.
- With a large potential market and good uptake to date, we expect IMI to garner greater support from the market as its product rollout progresses.

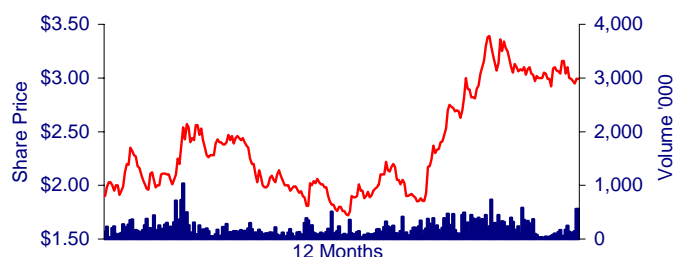
## Ones To Watch

### Pharmaxis (PXS)

(\$2.99)

Figure 13: Pharmaxis – Company Performance & Summary

Shares (m)	177.3
Market Cap (\$m)	\$530.3
Year Low - High	\$1.68 - \$3.45
Daily Volume	224,000
Cash (\$m)	\$85.0
Cash Burn (\$m)	\$20.0



Source: IRESS

- With a market cap of over \$500m, it cannot be said that the market has failed to recognise the potential for Pharmaxis. The company's asthma management product, Aridol, has marketing approval in Australia and Europe with US approval expected by the end of the year. Bronchitol is currently in multiple clinical trials for cystic fibrosis and bronchiectasis.
- In addition to sales of Aridol, during CY07 the company will be reporting data from its European Phase-3 trial for bronchiectasis and commencement of Phase-3 trials for bronchiectasis in the US and for cystic fibrosis.
- With a strong management team, excellent products and a good cash position, PXS is one of the highest quality company's in the sector. We believe it will continue to do well and investors should consider accumulating the stock, particularly on any share price weakness.

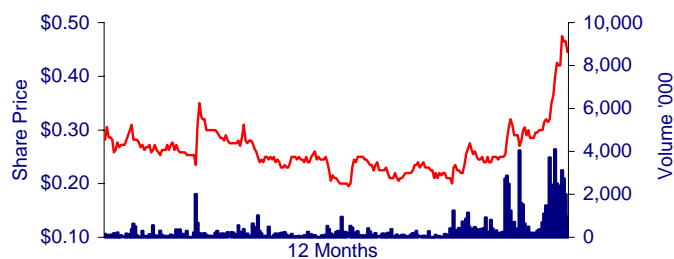


## Avexa (AVX)

(\$0.46)

Figure 14: Avexa – Company Performance & Summary

Shares (m)	247.0
Market Cap (\$m)	\$112.4
Year Low - High	\$0.20 - \$0.45
Daily Volume	330,000
Cash (\$m)	\$21.0
Cash Burn (\$m)	\$16.0



Source: IRESS

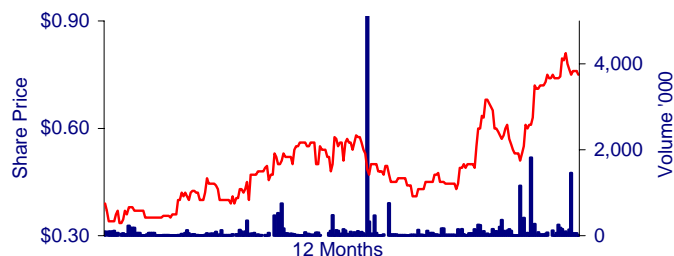
- Phase-2b data for AVX's lead product, apricitabine (previously called AVX754), is expected to be announced in 1Q CY07. Assuming these data are positive, the company is aiming to commence a Phase-3 clinical trial by the end of the year.
- Apricitabine was licensed from Shire in 2005 and is a modified version of an existing nucleoside reverse transcriptase inhibitor (NRTi) called 3TC and is active against resistant strains of the HIV retrovirus. To date, the drug has shown good safety data and, given it is the 2nd generation of an existing drug, the development risks are considerably reduced.
- AVX has had a positive start to the year and is likely to get further support on positive results from the Phase-2b trial. However, we would expect the company to raise additional funds to support the Phase-3 trial.

## Evogenix (EGX)

(\$0.75)

Figure 15: Evogenix – Company Performance & Summary

Shares (m)	139.1
Market Cap (\$m)	\$104.3
Year Low - High	\$0.32 - \$0.82
Daily Volume	99,000
Cash (\$m)	\$8.5
Cash Burn (\$m)	\$4.0



Source: IRESS

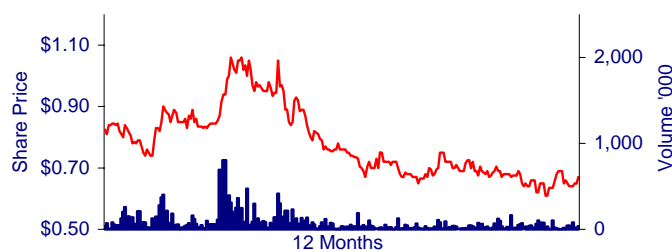
- With a technology platform that focuses on the optimisation and humanisation of antibodies, EGX is well positioned to capitalise on the current global interest in therapeutic antibodies. While the company is developing its own therapeutics as well as undertaking fee-for-service research project, we believe the company is likely to represent an attractive takeover target which could provide near term capital gains for shareholders.
- In both Europe and US, there have been several acquisitions of antibody platform companies by big pharma that have been done at high premiums (Domantis, Abmaxis, Cambridge Antibody Technologies).
- While EGX has had a significant share price growth over the past 3 months, we believe there may still be additional upside if it becomes subject to a takeover bid.

## Cytopia (CYT)

(\$0.69)

**Figure 16: Cytopia – Company Performance & Summary**

Shares (m)	73.6
Market Cap (\$m)	\$50.4
Year Low - High	\$0.60 - \$1.08
Daily Volume	72,000
Cash (\$m)	\$16.0
Cash Burn (\$m)	\$5.5



Source: IRESS

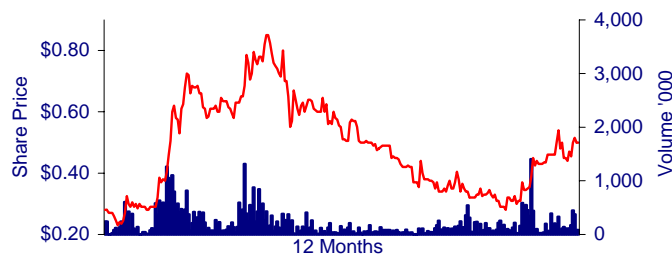
- CYT gained the market's attention in mid-CY07 with the announcement of a significant license and research agreement with Novartis based on the company's JAK3 intellectual property. In the lead up to the announcement, CYT's price reached \$1.08 but has since declined steadily despite the company making good progress.
- The company's oral anti-cancer drug, CYT997, commenced a Phase-1 clinical trial which is expected to be complete in 3Q CY07. CYT also has further programs targeting JAK2 and a preclinical compound that will enter the clinic in late '07 or early '08.
- While CYT's pipeline is still early, the company has a number of high potential programs in progress and has yet to benefit from the renewed interest in the biotech sector. As CYT will remain a pooled development fund until 30 June 2007, investors may be able to gain some tax benefits on capital gains from CYT up until that time.

## Phylogica (PYC)

(\$0.50)

**Figure 17: Phylogica – Company Performance & Summary**

Shares (m)	121.6
Market Cap (\$m)	\$60.8
Year Low - High	\$0.23 - \$0.86
Daily Volume	188,000
Cash (\$m)	\$5.0
Cash Burn (\$m)	\$4.0



Source: IRESS

- Phylogica has a technology platform that utilises non-mammalian peptide fragments (nicknamed "phylomers") as potential therapeutic agents. While there is a sound rationale for why this may be a particularly interesting approach for identifying novel drug candidates, at this stage a phylomer drug lead candidate has yet to enter advanced preclinical development.
- PYC has been very active in establishing partnerships (Opsana, Johnson&Johnson, Baker Institute, University of Melbourne, McComb Foundation) as well as undertaking its own screening programs in order to maximise the exposure of its libraries to as many therapeutic targets as possible.
- We believe the identification of a therapeutically active phylomer by either PYC or one of its partners would provide real validation of the company's intellectual property and be a significant inflection point with respect to valuation.

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