



23 August 2007

# CogState Limited (CGS)

Speculative Buy

Disappointing 4Q Sales Impact the FY Result

\$0.15

Thomas Duthy *PhD MBA*  
tduthy@taylorcollison.com.au  
+61 2 9232 1688

## FY07 Overview

CogState has reported a FY07 NPAT loss of \$1.65 million, well ahead of our expectations of \$1.1m.

EPS loss of 3.7c versus our estimate of 2.4c

Result primarily impacted by disappointing 4Q product sales, which were approximately 50% below our expectations.

FY07 product revenues of \$2.3m, up 13.2% pcp.

Salary and employee expenses (inc. options expense) down 6.7% pcp to \$2.6m, in line with our expectations.

Contracted future revenues in excess of \$1.5m, with an additional \$1.6m of in-process tenders for CNS clinical trials.

## Summary

Market Capitalisation (M)	\$6.7
Share Price	\$0.15
Valuation Per Share	\$0.30
Cash (M) as at 30/6/07	\$1.3
Pro-forma Cash (M) Post SPP*	\$2.3
Ave Monthly Volume (Yr Rolling)(M)	0.75
Year High	\$0.29
Year Low	\$0.13
Market Cap: Cash Ratio	5.2
Market Cap: Cash Ratio (Sector)	14.2

\* Assumes \$1.0m raised

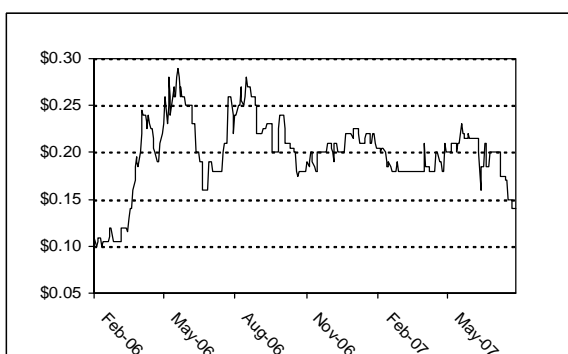
## Key Financials (A\$'000)

Year End	2006	2007	2008
	Actual	Actual	Est.
Revenue	2,433	2,605	4,100
Net Op. Rev	(1,642)	(1,768)	(333)
R&D Expenses	(237)	(107)	(112)
EBITDA	(2,023)	(1,980)	(520)
EBIT	(2,099)	(2,072)	(606)
NPAT pre Net R&D	(1,544)	(1,696)	(166)
Reported Profit	(1,603)	(1,653)	(278)
Reported EPS (c)	(4.1)	(3.7)	(0.5)
PE Ratio (x)	n/a	n/a	n/a
ROE (%)	-46.3%	-70.6%	-14.7%

## Our View

- CogState has delivered a FY result below expectations, primarily the result of a disappointing 4Q, which was flagged to the market in July. We believe the CogState business model of selling computerised cognition testing services to the global pharmaceutical clinical trials market fundamentally remains strong. The lumpiness of quarterly revenue recognition is a timing issue with contracts qoq. Since FY07, CogState signed three new clinical trial contracts with AstraZeneca, Merck and GSK, two of which are second contracts, adding weight to the argument that repeat business is growing. This is on top of agreements with Pfizer, Lundbeck and Abbott Labs. To date, CogState has a 100% success rate with clinical trial tenders, with in-process tenders in excess of A\$1.6m. In our view, as the Company grows its customer base, this will lead to contracts for later stage clinical trials (Phase 2, 3) and post-market approval (Phase 4) studies, which are more lucrative and longer dated. Such contracts are typically >US\$0.5m, with 60-80% of cash collected in first 3 months of contract. We see later stage trials as a means to smooth out revenues recognition qoq and are hopeful the company will sign additional contracts during the current Q.
- CogState's clinical trial focus was initiated in 1Q06. As a result of investment in IT systems such as DataPoint®, and establishment of the US sales office we have more confidence in stability of the cost base of approx \$4.3m (ex R&D) in FY08. Clearly, the building of further US/EU sales contracts for CNS clinical trials remains the key focus for FY08, and FY09 to drive profitability. We consider FY08 as a crucial year for CogState to prove its business model is a sustainable proposition, given the 2x poor quarters in FY07. We have revised our FY08 NPAT expectations from a small NPAT to a loss of \$0.28m, though have forecast a small NPAT in the 2H. We have also downgraded our DCF valuation by 23.1% to \$0.30 per share. With CogState scrip off 22.5% since July, the Company remains attractive given its \$6.9m market cap and discount to our revised valuation. We continue with our Speculative Buy recommendation.

## Share Price Graph (A\$)

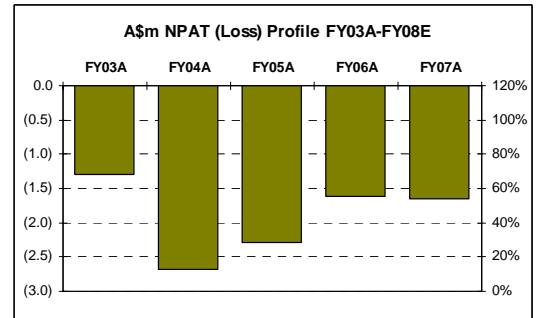


## FY07 Overview

*FY07 NPAT loss of \$1.65m, 21.1% improvement pcp.*

*Product revenues up 13.2% on pcp.*

CogState has reported an FY07 NPAT loss of \$1.65 million, well ahead of our expectations of \$1.1 million (see across). Product revenues were \$2.4 million, up 13.2% pcp though below our expectations (see below). The primary driver of revenue growth was once again increased access to the clinical trial testing market, where CogState continued to drive sales to key customers.



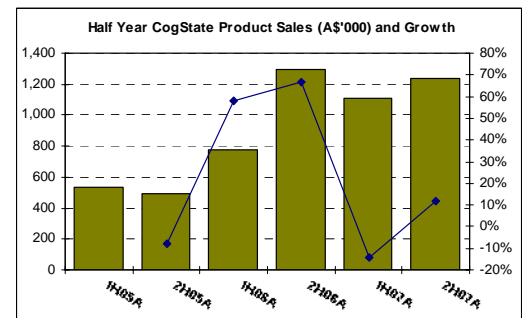
Source: Taylor Collison

The lumpiness of quarter on quarter revenue recognition and cash flows remains problematic, along with the US/European summer, which saw a decline in contracts during 1Q07. This, coupled with the disappointing 4Q07 resulted in total revenues that fell approximately \$0.5 million below our FY expectations.

*Gross margin improvement to 90%*

\$ million	FY06A	FY07A	Change
Product Sales	2.1	2.4	13.2%
COGS	(0.3)	(0.2)	-32.8%
<b>Gross Margin</b>	<b>83.4%</b>	<b>90.0%</b>	

While product revenues have grown substantially since CogState implemented its strategy of targeting global pharmaceutical companies for its battery of cognition tests, rather than individuals, growth from FY06 was less than our estimates, and arguably management expectations (see across).



Source: Taylor Collison

Datapoint® continues to meet or exceed management expectations. The main benefit for clients includes delivery of cognitive reports within hours of completion of the trial, as opposed to weeks.

*New Datapoint® system to drive future operating margin expansion.*

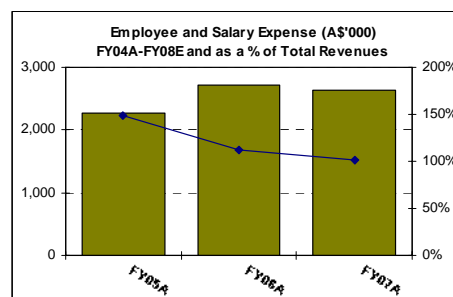
DataPoint® has been used successfully by major pharmaceutical companies, research institutions and sporting bodies from all over the world. In the clinical trials market, DataPoint® has been used in more than 30 clinical trials across all phases of clinical development.

Specific Companies who have used the system includes Pfizer, Abbott and GSK. Pharmaceutical clients are able to access, monitor and review data in real-time. As a result of investment into the system during FY06 and into FY07, the Company's R&D expenditure was reduced in FY07 to \$0.11 million, or 4.1% of total revenues (see below).

\$'000	FY06A	FY07A
R&D	237	107
<b>% of Revenues</b>	<b>9.7%</b>	<b>4.1%</b>

Salaries reduced by 3.1% on pcp, with revenue growth.

FY07 salaries expense was 3.1% less than pcp (see below), despite the Company establishing its US sales office in Connecticut with 6 full time personnel. We note that salaries as a percentage of total revenues continues to trend downwards, though as at FY07, was still in excess of 100%. As discussed (below) we do not envisage a significant expansion of personnel during FY08, as the Company has now built the necessary sales and management infrastructure to drive clinical trial contracts with pharmaceutical companies are therefore product revenue growth.



Source: Taylor Collison

Operating cash burn was reduced by 13.8% pcp to \$1.25 million in FY07 which was higher than our expectations, principally due to the disappointing 4Q07. Closing cash and cash equivalents was \$1.25 million. The Company recently announced a Share Purchase Plan (see important disclaimer at the end of this report) that seeks to raise up to \$1.8 million.

OCB down 13.8% pcp to \$1.25 million.

\$m	FY06A	FY07A	Change
OCB	(1.45)	(1.25)	-13.8%

## Evolution of the Business Model

Current quarter has seen 4 new contracts signed.

During the current quarter, CogState has signed an additional three clinical trial contracts with separate pharmaceutical companies (AstraZeneca, Merck, GSK). A major Phase 4 (post-market surveillance) contract was recently signed with Pfizer as well. With the exception of Pfizer, two of these contracts were second agreements, indicating that repeat business is growing and the Company is managing to diversify away its revenue base away from Pfizer, who has been traditionally CogState's biggest customer. On our estimates, dependence on Pfizer for revenues has shrunk from +80% in FY05 and 55% in FY06 to <50% in FY07.

DataPoint<sup>®</sup> remains a real competitive advantage for CogState.

Moreover, whereas during FY06 and FY07 CogState was effectively signing Phase 1 (safety) clinical trials with its customers, this is progressively moving to later stage (Phase 2 and Phase 3) style contracts. In our view, this is a reflection of the growing comfort factor of the customer with the ClinIT systems and more particularly DataPoint<sup>®</sup>. Such contracts are greater in quantum and run over a longer period, which we believe in the longer term will allow CogState to smooth out the qoq revenue volatility it currently incurs.

At hand contracts of A\$1.6m with A\$1.5m in bids, indicates FY08 likely to be strong.

We believe the project managers who supervise the clinical trials, can conservatively undertake 10x Phase 1 trials or a minimum of US\$1.0m worth of trials per annum, but the bigger the trial (and contract), the more efficient the role. CogState has outstanding contracted future revenues in excess of A\$1.5 million, with the Company bidding for a further A\$1.6 million in additional CNS clinical trial contracts. We note with interest the Company's 100% execution rate in pitching for such clinical trial contracts. Highlighting efficiency gains, CogState's gross margins expanded by an absolute 6.6% to 90% in FY07.

Significant operating leverage.

In our view, the primary advantages for CogState rely on the Company's high degree of operating leverage due to its high fixed cost base (employee salaries). Such expenses have historically run at >100% of total revenues, including during FY07. Into the future we believe labour savings via streamlined reporting should allow CogState to increase its contracts under management per person.

From a cash perspective, the business model remains attractive, with CogState collecting up to 60% of the contract's value within the first 8 weeks of the trial process (see below). With outstanding revenues held as a current liability and progressively brought to account throughout the remainder of the contract.

60% of cash collected within first 8 weeks of contracts.

**Payment schedule:**

20% on signing of contract/scope of work (upfront)  
 20% on delivery of software (4 weeks)  
 20% on delivery of all site materials (4 weeks)  
 20% on processing of first test (4 weeks)  
 20% on delivery of final report

Source: Company, TC estimates

Significant director stock purchases a sign the model remains strong.

Reinforcing our confidence in the long term business model, we also that during 4Q07, the Chairman acquired an additional \$250,000 worth of CogState scrip, taking his personal holding in the company to 13.6%. In the recently announced Share Purchase Plan the directors sub-underwrote \$0.25 million of the issue (please see important disclosures in Disclaimer). We view this as an excellent endorsement of the Company's future growth prospects in providing its cognition testing service to the pharmaceutical clinical trials testing market.

## Profiling the Client Base: CNS Pipelines in CY07

Current selected pharma pipelines worth up to US\$44m on our estimates.

We have examined the CY07 CNS pipelines of the major pharmaceutical companies (see below). We note that CogState has signed agreements with Pfizer, GSK, J&J, Abbott, Merck and Lundbeck. The analysis below has made certain Phase 1 assumptions for Phase 1 compounds from Eli Lilly and J&J who historically do not disclose pipelines earlier than Phase 2. At present, based on the current pipelines, exploitable cognition testing revenues is US\$44 million. At a maximum, assuming all compounds/drugs move to Phase 3 (which is improbable, but provides a ceiling to the estimates) the present pipelines have a 3-5 year value of US\$122.6 million.

Major Pharmaceutical Companies - CNS Drug Portfolios 2007 & Cognition Testing Potential

Company	Phase 1	US\$m	Phase 2	US\$m	Phase 3	US\$m	Total (US\$m)	Max Potential (US\$m)*
Pfizer	8	1.20	7	1.75	2	1.00	3.95	13.45
J&J	5	0.75	5	1.25	9	4.50	6.50	12.75
GSK	8	1.20	13	3.25	5	2.50	6.95	19.45
Novartis	5	0.75	3	0.75	3	1.50	3.00	8.25
Eli Lilly	5	0.75	2	0.50	1	0.50	1.75	6.50
Abbott	5	0.75	4	1.00	1	0.50	2.25	8.00
AstraZeneca	8	1.20	3	0.75	7	3.50	5.45	12.95
Sanofi Aventis	8	1.20	5	1.25	6	3.00	5.45	13.95
Wyeth	5	0.75	3	0.75	4	2.00	3.50	8.75
Roche	6	0.90	2	0.50	0	0.00	1.40	6.90
Lundbeck	3	0.45	1	0.25	3	1.50	2.20	4.95
Merck	6	0.90	1	0.25	1	0.50	1.65	6.65
<b>TOTAL</b>	<b>72</b>	<b>10.8</b>	<b>49</b>	<b>12.25</b>	<b>42</b>	<b>21</b>	<b>44.05</b>	<b>122.55</b>

\* Assumes all drugs move through clinical trials; TC est. av P1 contacts = US\$0.15m, P2 US\$0.25m, P3 US\$0.5m; Pipeline Source: Company

Reconciling these clinical studies with searches on the clinical trial database provided by the US government, suggests these 12 companies comprise 54%, 26% and 8% of US Phase 1, Phase 2 and Phase 3 studies being investigated in key CNS indications. At present, there is >100 schizophrenia Phase 3 trials being undertaken in the US and >50 Alzheimer's Disease studies. Cognition is a mandatory end point in these two indications, as an example.

In other words, CogState is able to diversify revenues streams away from these 12 companies to second and third tier pharma companies engaged in CNS research, along with academic institutions. However, we believe the Company's strategy will be to target those with the most breadth and depth to their pipelines. Following a "blue-chip" pharma strategy will potentially allow CogState to leverage off these contract wins to garner business from the lower tier pharma companies. In short, in our view CogState is still within the reputation building mode with its end customers for the ClinIT service.

## Outlook

We continue to remain bullish on CogState's business model targeting the clinical trial testing market. At present, the market is dominated by archaic "pencil and paper" testing batteries rather than computerised testing regimes. However, as CogState has demonstrated, the use of computerised testing batteries for cognition has growing acceptance within pharmaceutical circles, but more importantly with regulatory agencies such as the FDA or EMEA.

*Repeat business growing, bulk of FY08, FY09 estimates on clinical trial sales.*

Though the contracts CogState signs for clinical trials are non-recurring in nature, we note that repeat business is likely should the drug itself meet clinical trial endpoints and move through further clinical trials where cognition testing is mandated by the regulatory bodies. We continue to note the importance of cognition testing for indications such as schizophrenia, Alzheimer's disease, epilepsy and depression.

Interestingly, the repeat business CogState has generated during the current quarter is for new drugs with the same pharma company, rather than for the same drug developing through clinical trials. This may indicate CogState is winning market share from competitors including CANTAB and CDR. ClinIT continues to form the majority of our FY08 (89.7%) and FY09 (96.7%) product revenue estimates. From a cash flow perspective, the business remains attractive.

As a result of investment in IT systems such as DataPoint<sup>®</sup>, and establishment of the US sales office we have more confidence in stability of the cost base of approx \$4.3 million (ex R&D) in FY08. Clearly, the building of further US/EU sales contracts for CNS clinical trials remains the key focus for FY08, and FY09 to drive profitability. We consider FY08 as a crucial year for CogState to prove its business model is a sustainable proposition, given the 2x poor quarters in FY07.

We have revised our FY08 NPAT expectations from a small NPAT to a loss of \$0.28 million, though we forecast a small NPAT in the 2H. In short, our product sales growth expectations were on the high side, which we have revised downwards in line with contracted future revenue roll-off into FY08 and assumptions pertaining to the current \$1.6 million in bids.

We have also downgraded our DCF valuation by 23.1% to \$0.30 per share. With CogState scrip off 22.5% since July, the Company remains attractive given its \$6.9m market cap and discount to valuation. We continue with our Speculative Buy recommendation.

## CGS - Summary of Forecasts

CGS \$ 0.15

PROFIT & LOSS SUMMARY (A\$000s)				
Period	FY06A	FY07A	FY08E	FY09E
<b>Total Revenue</b>	<b>2,433</b>	<b>2,605</b>	<b>4,100</b>	<b>5,304</b>
<i>Growth (pcp)</i>	59.6%	7.1%	57.4%	29.4%
<b>Net Operating Revenue</b>	<b>(1,642)</b>	<b>(1,768)</b>	<b>(333)</b>	<b>794</b>
Direct R&D Expenses	(237)	(107)	(112)	(118)
<b>EBITDA</b>	<b>(2,023)</b>	<b>(1,980)</b>	<b>(520)</b>	<b>536</b>
Dep'n/Other Amort'n	(76)	(92)	(86)	(92)
<b>EBIT</b>	<b>(2,099)</b>	<b>(2,072)</b>	<b>(606)</b>	<b>444</b>
Net Interest	144	105	75	140
<b>Pre-Tax Profit</b>	<b>(1,955)</b>	<b>(1,967)</b>	<b>(531)</b>	<b>584</b>
Tax Expense	352	314	253	265
Minorities	0	0	0	0
<b>NPAT</b>	<b>(1,603)</b>	<b>(1,653)</b>	<b>(278)</b>	<b>850</b>
<i>Growth (pcp)</i>	29.6%	n/a	83.2%	n/a
Net Abnormals	0	0	0	0
<b>Reported Profit</b>	<b>(1,603)</b>	<b>(1,653)</b>	<b>(278)</b>	<b>850</b>
<b>NPAT pre Net R&amp;D</b>	<b>(1,544)</b>	<b>(1,696)</b>	<b>(166)</b>	<b>968</b>

PER SHARE DATA				
Period	FY06A	FY07A	FY08E	FY09E
<b>Reported EPS (c)</b>	<b>(4.1)</b>	<b>(3.7)</b>	<b>(0.5)</b>	<b>1.6</b>
<i>Growth (pcp)</i>	n/a	n/a	-85.2%	-398.1%
<b>EPS Pre-Net R&amp;D (c)</b>	<b>(3.9)</b>	<b>(3.8)</b>	<b>(0.3)</b>	<b>1.9</b>
<i>Growth (pcp)</i>	n/a	n/a	-91.4%	-669.4%
Dividend (c)	0.0	0.0	0.0	0.0
Franking	0%	0%	0%	0%
Gross CF per Share (c)	(3.6)	(3.0)	0.4	1.6
NTA per share (c)	6.9	2.7	3.6	6.5

KEY RATIOS				
Period	FY06A	FY07A	FY08E	FY09E
EBITD/Sales Margin %	-83.2%	-76.0%	-12.7%	10.1%
EBIT/Sales Margin %	-86.3%	-79.5%	-14.8%	8.4%
Current ratio (x)	4.7	2.3	2.1	2.8
Net Debt : Equity (%)	-85.9%	-78.9%	-105.9%	-102.6%
ROE (%)	-46.3%	-70.6%	-14.7%	28.4%
Dividend Payout Ratio (%)	0.0%	0.0%	0.0%	0.0%

VALUATION MULTIPLES				
Period	FY06A	FY07A	FY08E	FY09E
PE Ratio (x)	n/a	n/a	n/a	9.2
Dividend Yield (%)	0.0%	0.0%	0.0%	0.0%
EV/EBITD (x)	n/a	n/a	n/a	5.2
EV/EBIT (x)	n/a	n/a	n/a	6.3

CAPITAL RAISING ASSUMPTIONS				
Period	FY06A	FY07A	FY08E	FY09E
Shares Issued (m)	8.6	0.0	7.4	0.0
Issue Price (A\$)	0.10	0.00	0.135	0.00
Cash Raised (A\$m)	0.86	0.0	1.0	0.0

BALANCE SHEET SUMMARY				
Period	FY06A	FY07A	FY08E	FY09E
Cash	2,661	1,250	2,334	3,882
Receivables	434	204	362	775
Pre Paymenrs	22	25	25	25
Inventories	0	0	0	0
Investments	0	0	0	0
Other	77	215	215	215
<b>Total Current Assets</b>	<b>3,194</b>	<b>1,694</b>	<b>2,937</b>	<b>4,897</b>
Investments	0	0	0	0
Inventories	0	0	0	0
Property Plant & Equip	170	215	229	237
Intangibles	402	401	401	401
Deferred Tax Assets	46	47	47	47
Other	0	0	0	0
<b>Total Non-Current Assets</b>	<b>618</b>	<b>663</b>	<b>677</b>	<b>685</b>
<b>TOTAL ASSETS</b>	<b>3,812</b>	<b>2,357</b>	<b>3,614</b>	<b>5,582</b>
Accounts Payable	279	433	724	929
Revenue in Advance	302	159	402	516
Borrowings	0	0	0	0
Deferred Tax Liabilities	2	3	2	2
Provisions	93	139	241	310
<b>Total Current Liab</b>	<b>676</b>	<b>734</b>	<b>1,370</b>	<b>1,758</b>
Borrowings	0	0	0	7
Provisions	39	39	39	39
Other	0	0	0	0
<b>Total Non-Current Liab</b>	<b>39</b>	<b>39</b>	<b>39</b>	<b>46</b>
<b>TOTAL LIABILITIES</b>	<b>715</b>	<b>773</b>	<b>1,409</b>	<b>1,804</b>
<b>TOTAL EQUITY</b>	<b>3,096</b>	<b>1,584</b>	<b>2,204</b>	<b>3,779</b>

CASH FLOW SUMMARY				
Period	FY06A	FY07A	FY08E	FY09E
<b>EBIT (excl Abs/Extr)</b>	<b>(2,099)</b>	<b>(2,072)</b>	<b>(606)</b>	<b>444</b>
Add: Depreciation	76	92	86	92
Change in Pay.	(11)	154	291	205
Change in Rev. in Ad.	195	(143)	243	114
Less: Tax paid	352	314	253	265
Net Interest	144	105	75	140
Change in Rec.	(90)	230	(158)	(412)
Change in Inv.	0	0	0	0
<b>Gross Cashflows</b>	<b>(1,433)</b>	<b>(1,320)</b>	<b>184</b>	<b>848</b>
Capex	(108)	(137)	(100)	(100)
<b>Free Cashflows</b>	<b>(1,541)</b>	<b>(1,457)</b>	<b>84</b>	<b>748</b>
Dividends Paid	0	0	0	0
<b>Net Cash Flow</b>	<b>(1,541)</b>	<b>(1,457)</b>	<b>84</b>	<b>748</b>

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A.B.N. 53 008 172 450  
AFSL No. 247083

Participant of the Australian Stock Exchange Group

Level 2, 12 Pirie Street  
Adelaide, South Australia, 5000  
G.P.O. Box 2046, Adelaide, South Australia, 5001  
Telephone: 08 8217 3900 Facsimile: 08 8231 3506  
Email: [broker@taylorcollison.com.au](mailto:broker@taylorcollison.com.au)

Level 2, 55 Hunter Street  
Sydney, New South Wales, 2000  
G.P.O. Box 4261, Sydney, New South Wales, 2001  
Telephone: 02 9232 1688 Facsimile: 02 9232 1677  
Email: [sydney1@taylorcollison.com.au](mailto:sydney1@taylorcollison.com.au)

[www.taylorcollison.com.au](http://www.taylorcollison.com.au)

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