



3 March 2008

CogState Limited (CGS)

Speculative Buy

1H NPAT Loss of \$0.6m; Very Significant Demand Continues

\$0.13

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1H08 Key Points

CogState has reported a 1H08 NPAT loss of \$0.6m, a 36.2% improvement on pcp and higher than expectations.

Variation in estimates principally result of lower than expected product revenues of \$1.6m (up 34.1% on pcp) versus our estimate of \$2.0m.

Salary Expense (ex options) of \$1.45m up 21.9% on pcp, representing opening of European sales office.

Total operating expenditure of \$2.2m was up 6.1% on pcp and in line with estimates.

To date in FY08, Company has issued 33 quotes worth A\$5.8m, up 280% on pcp with historically high conversion ratios.

Summary

Market Capitalisation (M)	\$6.7
Share Price	\$0.13
Cash (M) as at 31/12/07	\$0.86
Cash Burn Per Quarter (M) (est.)	\$0.3
Market Cap.: Cash	7.8
Valuation Per Share & Price Target	\$0.32
52 week low	\$0.11
52 week high	\$0.23
Ave Monthly Vol (year rolling)(M)	0.77

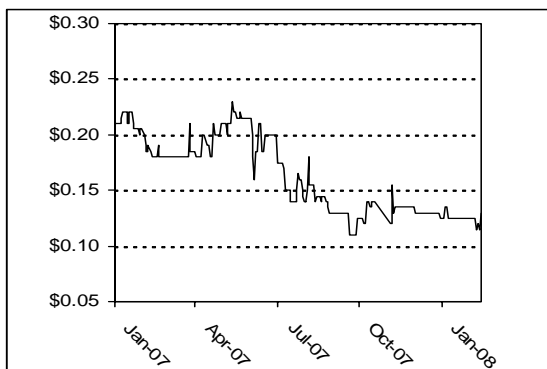
Key Financials (A\$'000)

Year End	2007	1H08	2008
	Actual	Actual	Est.
Revenue	2,605	1,670	3,980
Net Op. Rev	(1,769)	(558)	(453)
R&D Expenses	(106)	0	(111)
EBITDA	(1,980)	(589)	(639)
EBIT	(2,072)	(628)	(725)
NPAT pre Net R&D	(1,697)	(604)	(288)
Reported Profit	(1,653)	(604)	(400)
Reported EPS (c)	(3.7)	(1.3)	(0.8)
PE Ratio (x)	n/a	n/a	n/a
ROE (%)	-70.6%	-28.7%	-32.0%

Our View

- Though CogState delivered a 1H08 NPAT loss higher than our estimates, we remain confident in the business outlook. The Company continues to add depth (new pharma companies) and breadth (later stage and higher value clinical trials, viz Phase 2 and Phase 3) to its product offering. The ClinIT computerised cognitive testing system is used in pharmaceutical clinical trials, principally to test new drugs targeting central nervous system (CNS) disorders/diseases. There is a significant trend towards computerised cognition testing versus traditional pencil/paper tests in clinical trials, driven by speed, efficiency, sensitivity and accuracy advantages. However, most importantly, the testing regimes are now far more widely used in multiple drug approval studies providing a degree of standardisation for regulatory agencies, such as the US FDA or European EMEA.
- We have made no significant adjustments to our 2H08 estimates after our conference call with management. We note the revenue impact of quoted contracts cited during February (10 contracts worth A\$2.7m) are not expected to produce any significant impact on the 2H, where we expect CogState to report a maiden NPAT of \$0.2 million, but rather roll off into FY09 and FY10. We have downgraded our FY08 NPAT loss by 42.8% to \$0.4 million, principally due to the softer than anticipated product revenues in the 1H. We note the substantial increase in business activity during FY08 and potential for 2H profitability could provide further near term upside from current levels. We continue with our Speculative Buy recommendation and 12 month price target of \$0.32.

Share Price Graph (A\$)

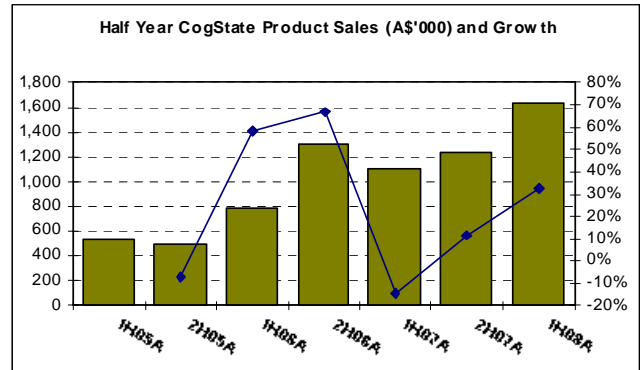


1H08 Overview

1H NPAT loss of \$0.6m, 36.2% improvement on pcp.

Increased sales to global pharmaceutical clinical trials.

CogState has reported a 1H08 NPAT loss of \$0.6 million, a 36.2% improvement on pcp but significantly below our expectations, principally due to product revenues of \$1.6 million (up 34.1% on pcp) were below our estimates of \$2.0 million (see across and below). Given the service nature of the clinical trial contracts, gross margins continue to remain in excess of 90%, with an absolute improvement of 6.3% on pcp. 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. Since 1H05, CogState has steadily grown its product revenues into the global pharmaceutical clinical trials market. Business conditions remain buoyant for its clinical trials testing business, with “unprecedented” demand since the 1H08 (more below).

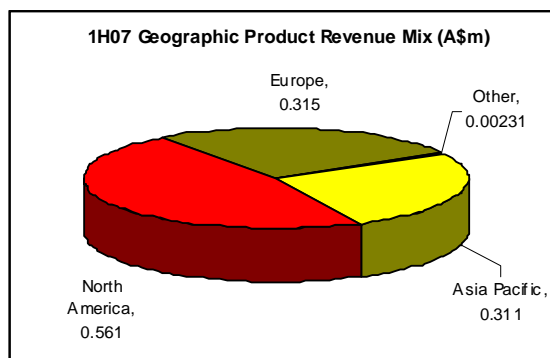


Source: Company

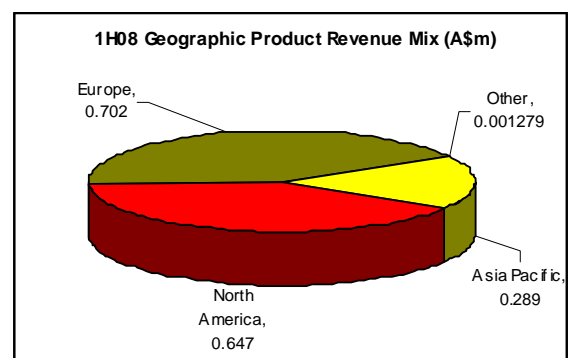
\$ million	1H07A	1H08A	Change
Product Sales	1.1	1.6	47.5%
COGS	(0.11)	(0.06)	-45.0%
Gross Margin	90.0%	96.3%	

European sales of A\$0.7m up 122.9% on pcp.

The Company has experienced a significant surge in clinical trial revenues out of Europe, which in our view has justified its expenditure in opening a European sales office, with a specialist recruitment during 1H08 (see below). The Company recorded a 7.15% decline in Asia Pacific sales, offset by a 15.3% increase in North American sales and a 122.9% surge in European clinical trial sales versus pcp.



Source: CogState



Source: CogState

Datapoint® continues to perform for end customers.

During the 1H, CogState has seen significant benefits from Datapoint®, a real-time cognitive data monitoring system. The main benefit for clients includes delivery of cognitive reports within hours of completion of the trial, as opposed to weeks. Secondly, pharmaceutical clients are able to access, monitor and review data in real-time. CogState is benefiting from efficiency gains attributable to Datapoint®. We have seen no net increase in personnel since FY07 (though costs have increased), yet quoted work for pharma trials increased 120%.

1H08 salaries expense up 25.7% on pcp.

1H08 salaries expense (ex options) was 25.7% up on pcp (see below), largely the result of the Company expanding its operations to include a UK sales office headed by a respected clinician with extensive CNS testing experience. We note that salaries as a percentage of total revenues continues to trend downwards. Increased salary expense was offset through a significant reduction in R&D expense and legal/travel expense.

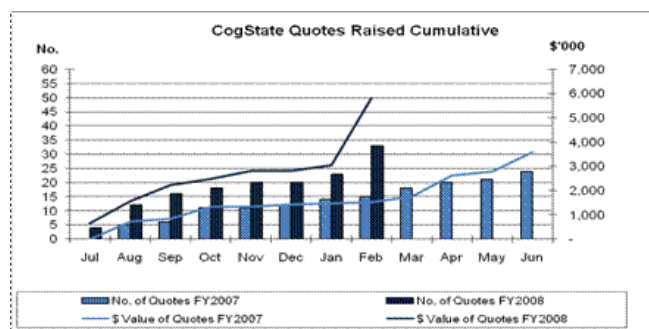
\$ million	1H07A	1H08A	Change
Employee benefits	(1.19)	(1.45)	21.9%
% of Total Revenues	95.3%	86.6%	

Operating cash burn was up 25.7% on pcp with \$0.86 million cash at balance date. The Company had a large receivable of \$1.1 million at the 1H, of which approximately \$1.0 million was collected since commencement of 2H08.

Recent Developments – Substantial Uplift in Business Prospects

In 8 months to date, Company has issued 33 quotes with value of A\$5.8 million, up 280% on pcp. In February alone, the Company indicated 10 quotes were issued with a combined value of A\$2.7 million (see across). We view very favourably the Company has now been asked to tender for much larger clinical trials, Phase 2 and Phase 3, which are longer dated and of much higher contract value (US\$0.3-US\$0.5 million on TC base estimates) than earlier stage clinical trials (i.e. Phase 1).

In Feb, CogState issued 10 quotes worth A\$2.7m.



Source: Company

We understand the Company is also diversifying its customer base, and winning repeat business from end customers – which is a reasonable indication the product offering (ClinIT) is generating traction. While the Company did not indicate its historic conversion rate success, we note management's comments that pharmaceutical companies tend only to request quotes from 1-2 clinical trial suppliers. Given the oligopolistic market structure of computerised cognition testing businesses, likely alternatives remain CDR (UK) and Cambridge Cognition (UK). We understand that historically CogState has won >85% of contracts tendered for, which provides us with some confidence in execution.

High historic conversion of quotes to contracts, >85%.

Outlook

We continue to remain impressed with management's ability to grow its clinical trial testing market. This market represents a unique opportunity for vendors like CogState. We note that 12 of the Top pharmaceutical companies with central nervous system (CNS) drugs in development applicable for CogState's ClinIT testing programs could provide a maximum of US\$119 million in cognition testing business to vendors.

Given the uplift in CogState's clinical trial revenues and our observation on pharma/biotech CNS clinical trials generally over the last 12 months, we believe the archaic, but well validated "pencil and paper" testing batteries are progressively being superseded by computerised cognition testing regimes.

While the prospects remain strong based on historic conversion rates, we note the revenue impact of any such contract wins quoted for in Jan/Feb are not expected to produce any significant impact on the 2H (TC est. maiden NPAT of \$0.2 million), but rather roll off in FY09 and FY10. We have downgraded our FY08 NPAT loss by 42.8% to \$0.4 million, principally due to the softer than anticipated product revenues in the 1H. We have made no significant adjustments to our 2H08 estimates after our conference call with management. We continue our Speculative Buy recommendation, and 12 month price target of \$0.32.

Downgraded FY NPAT Loss to \$0.4m

CGS - Summary of Forecasts

CGS \$ 0.13

PROFIT & LOSS SUMMARY (A\$000s)						
Period	FY06A	1H07A	FY07A	1H08A	FY08E	FY09E
Total Revenue	2,433	1,245	2,605	1,670	3,980	5,220
Growth (pcp)	59.6%	26.4%	7.1%	34.1%	52.8%	31.2%
Net Operating Revenue	(1,642)	(802)	(1,769)	(558)	(453)	710
Direct R&D Expenses	(237)	(106)	(106)	0	(111)	(117)
EBITDA	(2,023)	(965)	(1,980)	(589)	(639)	537
Dep'n/Other Amort'n	(76)	(37)	(92)	(39)	(86)	(132)
EBIT	(2,099)	(1,002)	(2,072)	(628)	(725)	405
Net Interest	144	57	105	31	75	56
Pre-Tax Profit	(1,955)	(945)	(1,967)	(597)	(650)	461
Tax Expense	352	(3)	314	(7)	250	263
Minorities	0	0	0	0	0	0
NPAT	(1,603)	(948)	(1,653)	(604)	(400)	724
Growth (pcp)	29.6%	24.3%	n/a	36.3%	75.8%	n/a
Net Abnormals	0	0	0	0	0	0
Reported Profit	(1,603)	(948)	(1,653)	(604)	(400)	724
NPAT pre Net R&D	(1,544)	(842)	(1,697)	(604)	(288)	841

PER SHARE DATA						
Period	FY06A	1H07A	FY07A	1H08A	FY08E	FY09E
Reported EPS (c)	(4.1)	(2.2)	(3.7)	(1.3)	(0.8)	1.4
Growth (pcp)	n/a	143.5%	n/a	-21.4%	-78.8%	-276.9%
EPS Pre-Net R&D (c)	(3.9)	(0.0)	(3.8)	(0.0)	(0.6)	1.6
Growth (pcp)	n/a	-38.9%	n/a	-35.3%	-85.1%	-384.8%
Dividend (c)	0.0	0.0	0.0	0.0	0.0	0.0
Franking	0%	0%	0%	0%	0%	0%
Gross CF per Share (c)	(3.6)	(2.1)	(3.0)	(3.6)	(0.2)	1.5
NTA per share (c)	6.9	4.1	2.7	3.3	1.0	2.2

KEY RATIOS						
Period	FY06A	1H07A	FY07A	1H08A	FY08E	FY09E
EBITD/Sales Margin %	-83.2%	-77.5%	-76.0%	-35.3%	-16.1%	10.3%
EBIT/Sales Margin %	-86.3%	-80.5%	-79.5%	-37.6%	-18.2%	7.8%
Current ratio (x)	4.7	2.6	2.3	2.7	1.2	1.5
Net Debt : Equity (%)	-85.9%	-74.8%	-78.9%	-42.7%	-102.4%	-103.8%
ROE (%)	-46.3%	-36.1%	-70.6%	-28.7%	-32.0%	58.7%
Dividend Payout Ratio (%)	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

VALUATION MULTIPLES						
Period	FY06A	1H07A	FY07A	1H08A	FY08E	FY09E
PE Ratio (x)	n/a	n/a	n/a	n/a	n/a	9.3
Dividend Yield (%)	n/a	n/a	n/a	n/a	n/a	0.0%
EV/EBITD (x)	n/a	n/a	n/a	n/a	n/a	7.8
EV/EBIT (x)	n/a	n/a	n/a	n/a	n/a	10.3

CAPITAL RAISING ASSUMPTIONS						
Period	FY06A	1H07A	FY07A	1H08A	FY08E	FY09E
Shares Issued (m)	8.6	0.0	0.0	7.4	7.4	0.0
Issue Price (A\$)	0.10	0.00	0.00	0.135	0.135	0.00
Cash Raised (A\$m)	0.86	0.0	0.0	1.0	1.0	0.0

BALANCE SHEET SUMMARY							
Period	FY06A	1H07A	FY07A	1H08A	FY08E	FY09E	
Cash	2,661	1,646	1,250	857	934	1,621	
Receivables	434	737	204	1,124	351	775	
Pre Payments	22	65	25	72	25	25	
Inventories	0	0	0	0	0	0	
Investments	0	0	0	0	0	0	
Other	77	99	215	46	46	46	
Total Current Assets	3,194	2,547	1,694	2,099	1,357	2,466	
Investments	0	0	0	0	0	0	
Inventories	0	0	0	0	0	0	
Property Plant & Equip	170	235	215	303	329	297	
Intangibles	402	402	401	402	402	402	
Deferred Tax Assets	46	47	47	46	47	47	
Other	0	0	0	0	0	0	
Total Non-Current Assets	618	684	663	751	778	746	
TOTAL ASSETS	3,812	3,231	2,357	2,850	2,135	3,213	
Accounts Payable	279	378	433	413	664	929	
Revenue in Advance	302	506	159	251	273	361	
Borrowings	0	0	0	0	0	0	
Deferred Tax Liabilities	2	5	3	4	2	2	
Provisions	93	104	139	124	234	310	
Total Current Liab	676	993	734	792	1,173	1,603	
Borrowings	0	0	0	0	0	7	
Provisions	39	37	39	49	49	49	
Other	0	0	0	0	0	0	
Total Non-Current Liab	39	37	39	49	49	56	
TOTAL LIABILITIES	715	1,030	773	841	1,222	1,659	
TOTAL EQUITY	3,096	2,201	1,584	2,009	912	1,554	

CASH FLOW SUMMARY						
Period	FY06A	1H07A	FY07A	1H08A	FY08E	FY09E
EBIT (excl Abs/Extr)	(2,099)	(1,002)	(2,072)	(628)	(725)	405
Add: Depreciation	76	37	92	39	86	132
Change in Pay.	(11)	99	154	(20)	231	266
Change in Rev. in Ad.	195	204	(143)	(255)	114	88
Less: Tax paid	352	(3)	314	(7)	250	263
Net Interest	144	57	105	31	75	56
Change in Rec.	(90)	(303)	230	(920)	(147)	(423)
Change in Inv.	0	0	0	0	0	0
Gross Cashflows	(1,433)	(911)	(1,320)	(1,760)	(116)	787
Capex	(108)	(97)	(137)	(121)	(200)	(100)
Free Cashflows	(1,541)	(1,008)	(1,457)	(1,881)	(316)	687
Dividends Paid	0	0	0	0	0	0
Net Cash Flow	(1,541)	(1,008)	(1,457)	(1,881)	(316)	687

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