



26 February 2009

CogState Limited (CGS)

Speculative Buy

1H09 NPAT of \$1.3m within Guidance; Pharma Hungry for More

\$0.22

Thomas Duthy *PhD MBA*
tduthy@taylorcollison.com.au
+61 2 9377 1500

1H09 Key Points

CogState has recorded a 1H09 NPAT of \$1.3m, in line with expectations and previous management guidance.

Underlying NPAT of \$0.65m ex FX gain of \$0.65m on US\$ denominated cash and receivables.

Product revenues of \$3.9m were up 134.8% on pcp, with a strong contribution from the USA via pharmaceutical clinical trials.

Unrecognised revenue from contracted order book of \$3.4m, \$2.0m to be recognised in 2H09.

FY09 NPAT guidance of \$1.50m-\$1.75m issued.

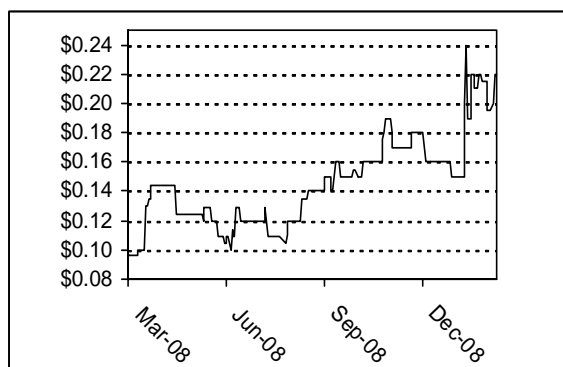
Summary

Market Capitalisation (M)	\$14.4
Shares on Issue (M)	65.6
Share Price	\$0.22
Cash (M) as at 31/12/08	\$2.8
Cash Burn Per Quarter (M) (est.)	n/a
Valuation Per Share & Price Target	\$0.45
52 week low	\$0.06
52 week high	\$0.24
Ave Monthly Vol (year rolling)(M)	0.61

Key Financials (A\$'000)

Year End	1H09	2009	2010
	Actual	Est.	Est.
Revenue	4,568	8,195	9,100
Net Op. Rev	1,471	2,007	2,460
R&D Expenses	0	0	0
EBITDA	1,415	1,882	2,272
EBIT	1,316	1,691	1,913
NPAT pre Net R&D	1,291	1,735	2,098
Reported Profit	1,291	1,735	2,098
Reported EPS (c)	2.1	2.7	3.2
PE Ratio (x)	n/a	8.2	6.9
ROE (%)	n/a	49.3%	34.7%

Share Price Graph (A\$)



Our View

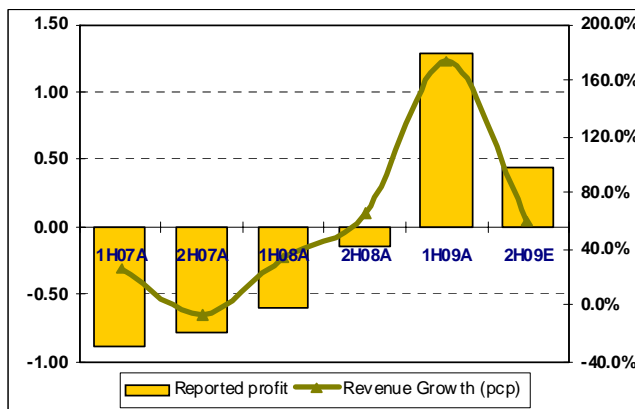
- We admire the defensive characteristics of CogState's revenue streams, despite global conditions, as evidenced by 1H09 and guidance provided on FY09 NPAT. The continued growth opportunities in servicing the pharmaceutical clinical trials market can be highlighted by the business models of both CogState and AtCor Medical (ASX: ACG; TC: Speculative Buy: \$0.30 PT). Both companies recorded very strong revenue growth servicing this market, and both reported a profitable 1H09, aided by FX gains from US\$ revenues and A\$ costs. Historically, the strong A\$ provided a significant headwind for Australian based clinical trial vendors operating globally. CogState appears resolute in its focus on servicing this market, which we believe is worth up to US\$100m from analysis of global pharmaceutical pipelines applicable for the CogState ClinIT platform.
- CogState also continues to demonstrate the benefit of operating in effectively an oligopolistic market; viz computerised cognition testing services to the global pharmaceutical clinical trials market. While some impact on Phase 1 contracts is expected (typically US\$0.1-\$0.3m contracted value) from the global slowdown, the Company continues to benefit from new sales opportunities in larger value/duration Phase 2/3 trials. We are forecasting an FY09 NPAT of \$1.74m, at the top end of guidance, which we believe is conservative given the order book/outlook and the fact it represents a maiden earnings forecast by management. Though our FY09 earnings estimates remain largely unchanged, we have upgraded our FY10, FY11 EPS estimates by 0.8c and 0.5c, respectively. CogState remains debt free, and currently trades on a forecast 8.2x FY09 EPS, with a solid growth outlook in a largely under penetrated market. The maiden multiple compares favourably with sector (Healthcare Equipment & Services) FY09 PE multiples of 15.8x, especially given the growth profile of the business. We have upgraded our DCF valuation and price target by 4.7% to \$0.45 per share (fully diluted). We continue with our Speculative Buy recommendation.

1H09 Overview

1H09 NPAT of \$1.3m, \$0.65m ex-FX gains.

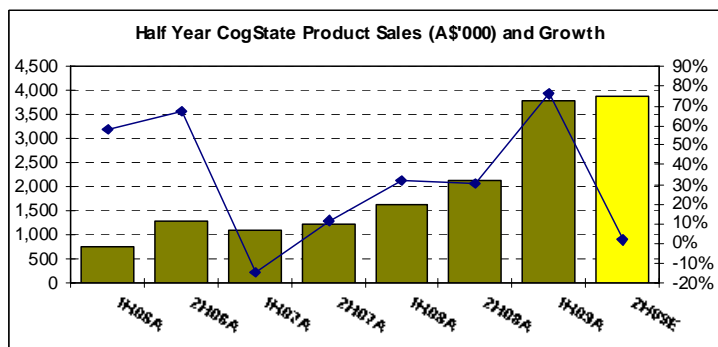
Pharmaceutical clinical trials market still targeted.

CogState has reported a 1H09 NPAT of \$1.3m, a significant turnaround on the 1H08 loss and within expectations. Underlying NPAT (ex FX gains of \$0.65m) of \$0.65m, was largely the result of increased revenue collections (up 134.8% on pcp) and a relatively low increase (relative to revenue growth) in the operating cost base of 39.0% on pcp. The chart across highlights the significant reduction in losses and maiden 1H09 NPAT attributable to targeting pharma clinical contracts and associated services.



As mentioned, the primary driver of the 1H09 result was at the top line, with revenue growth once again significantly increased on pcp and half on half owing to increased access to the clinical trial testing market, where CogState continued to drive sales to key customers (see across). However, unlike previous reporting periods, the growth is now coming from later stage, higher value Phase 2/3 clinical trial contracts.

Growth driven by higher value, later stage Phase 2/3 clinical trial contracts.



Source: Taylor Collison

Such contracts are typically amortised over a longer period, with an increased contribution of associated services. This embedment strategy is now bearing fruit. By way of background, CogState instigated a strategy of winning business in early, low cost Phase 1 trials to validate the ClinIT platform in FY05, FY06 and FY07 across a number of customers. As a result of both trial success, but also client satisfaction to utilise the platform in later stage trials, by FY08 CogState was embedded into 13 Phase 2 trials (FY07=0) and more recently secured its first Phase 3 global study.

Since 1H05, CogState has steadily grown its product revenues into the global pharmaceutical clinical trials market. While business conditions for typical cash intensive biotech customers have deteriorated, we note the majority of CogState's customers are well capitalised pharmaceutical companies, who continue to invest into their R&D pipelines. In this regard, CogState has recorded negligible bad debt expense since 1H05.

Gross margin expansion a highlight of 1H09.

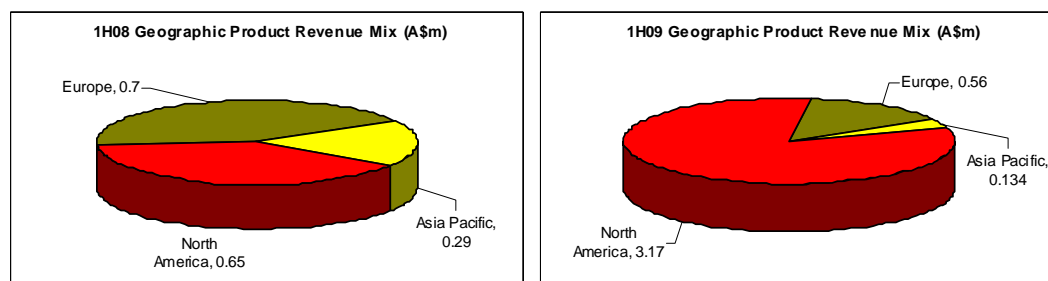
Re-stated gross margins for 1H09 (see below) were up significantly on 1H08, which we attribute to incremental increase in direct staffing costs providing a substantial uplift to product sales (ex UBC relationship, see below). CogState does not hold inventory for sale to customers, with the business strictly a device-oriented organisation in our view.

\$ million	1H08A	1H09A	Change
Product Sales	1.6	3.9	134.8%
COGS*	(0.64)	(1.01)	58.6%
Gross Margin	61.1%	73.3%	

* Re-stated in 1H09 accounts inc direct salaries, travel + depreciation

US/Canadian clinical revenues comprised 82.1% of total.

The Company has experienced a significant surge in clinical trial revenues out of the USA and Canada (82.1% of total), which in our view has justified its expenditure the expansion of the US sales office (see below). European sales of \$0.56m (14.4% of total) was down 20.2% on pcp. The decline was interesting in light of the European sales office expansion in the UK and an increased focus on European pharmaceutical companies. The Company recorded a significant decline in Asia Pacific sales, which represents a suite of CogState's alternative product offerings including CogResearch, Workplace and CogSport – targeted towards researchers or individuals via healthcare providers, and are considered niche.



Source: Taylor Collison

1H09 employee benefits expense (ex-direct costs into COGS) was 17.0% up on pcp (see below), largely the result of the Company expanding its operations in the UK/USA. We note that salaries as a percentage of total revenues continues to trend downwards. Increased salary expense was complemented with a 114% increase in travel costs to \$0.3m, associated with an increase in trial sites/centres and business development. Headcount increased by two FTEs to 27 (25 at FY08).

Employee benefits as a percent of revenues continues to decline despite sales infrastructure adding capacity.

\$ million	1H08A	1H09A	Change
Employee benefits	(0.92)	(1.08)	17.0%
% of Total Revenues	55.0%	23.5%	

Operating cash flows of \$0.5m was a significant turnaround on pcp, where \$1.2m in outflows was recorded. Outstanding receivables of \$1.2m, 90% of which was <30 days old was recorded for the half. Closing cash of \$2.78m was up 224% on pcp; however, when normalised for the UBC placement and rights issue, cash increased by 67.8%.

Significant operating leverage within the business.

In examining our forward model, we note a +/- 10% change in our forecast FY09, FY10 and FY11 sales results in an EBIT change of +/- \$0.70m (FY09), \$0.84m FY10 and \$0.92m FY11, respectively, implying the degree of operating leverage within CogState stands at 4.1 in FY09, 4.4 in FY10 and 3.6 in FY11.

United BioSource International (UBC) Deal Terminated

UBC relationship terminated recently.

In February, CogState announced its strategic relationship to co-market and co-deliver CogStates ClinIT cognitive testing platform had been terminated. UBC retain a 16.5% ownership stake in CogState, though we do not believe UBC are an immediate seller of this stake. CogState has asserted the termination of the agreement will not materially effect both revenue and profitability for FY09 and beyond, implying the majority of contracted revenues on CogState's books are internally generated.

No impact on FY09 financial results or beyond.

We view the potential downside to the relationship is the effect on CogState's cost base, which reduces the capacity of CogState to enhance its operating leverage. We note one of the key tenets of the UBC relationship was the ability of CogState to dovetail into UBC's operating infrastructure to offer and sell its ClinIT software in larger scale, global Phase 3 clinical trials. CogState has indicated that current staff utilisation rates (the majority of the cost base) is such that in order to meet increased demand for services, USA and UK additions need to be made.

Cost base to expand, but operating leverage remains significant.

1H09 Results Summary

A Table of CogState's reported line items versus our estimates are shown below. Overall, NPAT came in at the high end of guidance, and right on our expectations. CogState altered the presentation of its accounts for 1H09 to allow for direct costs (salaries, travel and depreciation) associated with servicing pharma contracts to be re-stated into COGS.

1H09 – a result in line across all major TC estimated line items.

Maiden EBIT margins provide promise.

1H09 Results Summary (\$m)

	TC Est.	Actual	Change (%)
Product Revenues	3.87	3.87	-0.08%
COGS	0.15	1.01	*
Gross Margin	96.0%	73.3%	*
Total Operating Exp	3.15	3.10	-1.68%
EBITDA	1.31	1.42	8.02%
EBITDA Margin	28.9%	31.0%	+210 bps
EBIT	1.22	1.32	7.87%
EBIT Margin	26.9%	28.8%	+190 bps
NPAT	1.29	1.29	0.08%

* COGS re-stated 1H09 accounts to inc. direct exp. on salaries, travel + depreciation

Source: Taylor Collison, Company

Key Changes to Forecasts

Following the 1H09 result, we have made the following changes to our forecasts:

- No significant changes to FY09 forecast both at the revenue and expense level.
- 10.4% reduction in FY09 free cash flow estimates a consequence of higher than expected FY CAPEX based on 1H09 figures. CAPEX principally on laptops for delivery of proprietary cognition testing platform to clinical staff, which is expected to grow in line with increased trials and trial sites.
- Upgraded FY10, FY11 product sales revenues on increased confidence in business model, translating to significantly increased EBITDA and NPAT.

Higher than expected CAPEX, expected to reduce FY09 free cash flows to \$1.6m.

The Net impact of these changes is highlighted in the Table (below).

Changes to Forecasts

A\$m	FY09			FY10			FY11		
	Prev	New	% Change	Prev	New	% Change	Prev	New	% Change
Sales Revenue	7.4	7.4	0.3%	7.9	8.9	12.8%	9.0	9.7	8.2%
EBITDA	1.7	1.9	10.7%	1.6	2.3	43.8%	2.4	2.8	17.6%
EBIT	1.5	1.7	12.7%	1.4	1.9	36.7%	2.2	2.6	16.0%
NPAT	1.7	1.7	2.0%	1.6	2.1	31.1%	2.5	2.9	13.3%
EPS (cps)	2.7	2.7	-0.4%	2.4	3.2	33.2%	3.9	4.4	12.0%
Free Cash Flow	1.8	1.6	-10.4%	1.7	2.4	39.6%	2.7	3.0	11.0%

Source: Taylor Collison estimates

FY10, FY11 EPS estimates increased by 0.8c and 0.5c, respectively on sales outlook.

Outlook

We have previously commented on the fact that CogState offers excellent defensive characteristics for investors because (1) pharmaceutical companies are investing heavily in pipeline development to offset major cannibalisation of key marketed drugs by generics; (2) CNS clinical trials are one of the fastest growing medical indications; (3) outsourcing of clinical trials by pharmaceutical companies to third parties has increased in line with business models and (4) evidence of increased adoption of computerised cognition testing versus antiquated pencil/paper tests. We now add a fifth facet, namely a trend towards tighter regulation and a safety focus for pharmaceutical drug trials by the FDA. This is expected to significantly increase drug costs and timelines, which provides upside to vendors such as CogState.

5 Key tenets underpin the business model and outlook in our view.

Minimal impact on major revenue sources, viz Phase 2/3 trials from global slowdown.

CogState has indicated its market in early stage (Phase 1 trials), which typically contract at the rate US\$0.1-US\$0.3m and amortise over ~12 months are likely to decline in the coming months. However, the outlook for Phase 2 or Phase 3 trials remains robust. This highlights our belief that CogState's embedment strategy into many pharmaceutical drug trials at an early stage has significantly reduced both risk to revenues and reliance on several key customers. Importantly, this has also provided the necessary validation to drive CogState's business model and later stage introduction to Phase 2/3 trials.

The Company continues to demonstrate the utility of operating in a highly defensive, oligopolistic market; viz computerised cognition testing services to the global pharmaceutical clinical trials market. While some impact on Phase 1 contracts is expected (typically US\$0.1-\$0.3m contracted value) from the global slowdown, the Company continues to benefit from new sales opportunities in larger value/duration Phase 2/3 trials.

We are forecasting an FY09E NPAT of \$1.74m, at the top end of guidance, which we believe is conservative given the order book/outlook and the fact it represents a maiden earnings forecast by management. Though our FY09 earnings estimates remain largely unchanged, we have upgraded our FY10, FY11 EPS estimates by 0.8c and 0.5c, respectively.

12 month price target of \$0.45.

Maintain Speculative Buy recommendation.

CogState remains debt free, and currently trades on a forecast 8.2x FY09 EPS, with a solid growth outlook in a largely under penetrated market. The maiden multiple compares favourably with sector (Healthcare Equipment & Services) FY09 PE multiples of 15.8x, especially given the growth profile of the business. We have upgraded our DCF valuation and price target by 4.7% to \$0.45 per share (fully diluted). We continue with our Speculative Buy recommendation.

CGS - Summary of Forecasts

CGS \$ 0.22

PROFIT & LOSS SUMMARY (A\$000s)							
Period	FY07A	1H08A	FY08A	1H09A	FY09E	FY10E	FY11E
Total Revenue	2,605	1,670	3,932	4,568	8,195	9,100	9,986
<i>Growth (pcp)</i>	7.1%	34.1%	50.9%	173.5%	108.4%	11.0%	9.7%
Net Operating Revenue	(1,769)	(558)	(916)	1,471	2,007	2,460	3,093
Direct R&D Expenses	(106)	0	0	0	0	0	0
EBITDA	(1,980)	(589)	(975)	1,415	1,882	2,272	2,798
Depn/Other Amort'n	(92)	(39)	(127)	(99)	(191)	(359)	(223)
EBIT	(2,072)	(628)	(1,102)	1,316	1,691	1,913	2,576
Net Interest	105	31	59	56	125	185	292
Pre-Tax Profit	(1,967)	(597)	(1,043)	1,372	1,816	2,098	2,868
Tax Expense	314	(7)	297	(81)	(81)	0	0
Minorities	0	0	0	0	0	0	0
NPAT	(1,653)	(604)	(746)	1,291	1,735	2,098	2,868
<i>Growth (pcp)</i>	n/a	31.5%	54.9%	n/a	n/a	21.0%	36.7%
Net Abnormals	0	0	0	0	0	0	0
Reported Profit	(1,653)	(604)	(746)	1,291	1,735	2,098	2,868

PER SHARE DATA							
Period	FY07A	1H08A	FY08A	1H09A	FY09E	FY10E	FY11E
Reported EPS (c)	(3.7)	(1.3)	(1.5)	2.1	2.7	3.2	4.4
<i>Growth (pcp)</i>	n/a	-28.2%	-60.4%	n/a	n/a	18.9%	36.7%
EPS Pre-Net R&D (c)	(3.8)	(1.3)	(1.6)	2.1	2.7	3.2	4.4
<i>Growth (pcp)</i>	n/a	6923.6%	-56.8%	n/a	n/a	18.9%	36.7%
Dividend (c)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Franking	0%	0%	0%	0%	0%	0%	0%
Gross CF per Share (c)	(3.0)	(3.6)	(2.0)	0.8	3.1	3.8	4.7
NTA per share (c)	2.7	3.3	3.0	6.8	7.3	10.0	14.3

KEY RATIOS							
Period	FY07A	1H08A	FY08A	1H09A	FY09E	FY10E	FY11E
EBITD/Sales Margin %	-76.0%	-35.3%	-24.8%	31.0%	23.0%	25.0%	28.0%
EBIT/Sales Margin %	-79.5%	-37.6%	-28.0%	28.8%	20.6%	21.0%	25.8%
Current ratio (x)	2.3	2.7	2.2	6.5	2.9	3.5	4.5
Net Debt : Equity (%)	-78.9%	-42.7%	-54.4%	-59.3%	-81.1%	-93.3%	-97.5%
ROE (%)	-70.6%	-28.7%	-42.5%	0.0%	49.3%	34.7%	34.3%
Dividend Payout Ratio (%)	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

VALUATION MULTIPLES							
Period	FY07A	1H08A	FY08A	1H09A	FY09E	FY10E	FY11E
PE Ratio (x)	n/a	n/a	n/a	n/a	8.2	6.9	5.0
Dividend Yield (%)	n/a	n/a	n/a	n/a	0.0%	0.0%	0.0%
EV/EBITDA (x)	n/a	n/a	n/a	n/a	5.3	3.4	1.7
EV/EBIT (x)	n/a	n/a	n/a	n/a	5.9	4.0	1.8

CAPITAL RAISING ASSUMPTIONS							
Period	FY07A	1H08A	FY08A	1H09A	FY09E	FY10E	FY11E
Shares Issued (m)	0.0	7.4	7.4	13.7	13.7	0.0	0.0
Issue Price (A\$)	0.00	0.135	0.135	0.10	0.10	0.00	0.00
Cash Raised (A\$m)	0.0	1.0	1.0	1.4	1.4	0.0	0.0

BALANCE SHEET SUMMARY							
Period	FY07A	1H08A	FY08A	1H09A	FY09E	FY10E	FY11E
Cash	1,250	857	1,048	2,778	4,175	6,548	9,546
Receivables	204	1,124	613	1,198	1,485	1,782	1,938
Pre Payments	25	72	23	79	25	0	0
Inventories	0	0	0	0	0	0	0
Investments	0	0	0	0	0	0	0
Other	215	46	147	74	74	74	74
Total Current Assets	1,694	2,099	1,831	4,129	5,759	8,404	11,558
Investments	0	0	0	0	0	0	0
Inventories	0	0	0	0	0	0	0
Property Plant & Equip	215	303	478	689	898	509	354
Intangibles	401	402	402	402	402	402	382
Deferred Tax Assets	47	46	66	61	66	66	66
Other	0	0	0	0	0	0	0
Total Non-Current Assets	663	751	946	1,152	1,366	977	802
TOTAL ASSETS	2,357	2,850	2,777	5,281	7,125	9,381	12,360
Accounts Payable	433	413	526	251	1,559	1,872	2,035
Revenue in Advance	159	251	74	47	0	0	0
Borrowings	0	0	0	31	31	31	31
Income Tax Payable	0	0	32	53	32	32	32
Deferred Tax Liabilities	3	4	3	3	3	3	3
Provisions	139	124	207	247	371	446	485
Total Current Liab	734	792	842	632	1,996	2,383	2,586
Borrowings	0	0	0	0	0	0	0
Provisions	39	49	10	17	17	17	17
Other	0	0	0	0	0	0	0
Total Non-Current Liab	39	49	10	17	17	17	17
TOTAL LIABILITIES	773	841	852	649	2,013	2,400	2,603
TOTAL EQUITY	1,584	2,009	1,925	4,632	5,112	6,981	9,757

CASH FLOW SUMMARY							
Period	FY07A	1H08A	FY08A	1H09A	FY09E	FY10E	FY11E
EBIT (excl Abs/Extr)	(2,072)	(628)	(1,102)	1,316	1,691	1,913	2,576
Add: Depreciation	92	39	127	99	191	359	204
Change in Pay.	154	(20)	93	(275)	1,033	312	164
Change in Rev. in Ad.	(143)	(255)	(85)	(27)	(74)	0	0
Less: Tax paid	314	(7)	297	(81)	(81)	0	0
Net Interest	105	31	59	56	125	185	292
Change in Rec.	230	(920)	(409)	(585)	(872)	(297)	(156)
Change in Inv.	0	0	0	0	0	0	0
Gross Cashflows	(1,320)	(1,760)	(1,020)	503	2,013	2,472	3,098
Capex	(137)	(121)	(373)	(287)	(400)	(100)	(100)
Free Cashflows	(1,457)	(1,881)	(1,393)	216	1,613	2,372	2,998
Dividends Paid	0	0	0	0	0	0	0
Net Cash Flow	(1,457)	(1,881)	(1,393)	216	1,613	2,372	2,998

Disclaimer

Warning (General Advice Only): Past performance is not a reliable indicator of future performance. This report is a private communication to clients and intending clients and is not intended for public circulation or publication or for the use of any third party, without the approval of Taylor Collison Limited ABN 53 008 172 450 ("Taylor Collison"), an Australian Financial Services Licensee and Participant of the ASX Group. While the report is based on information from sources that Taylor Collison considers reliable, its accuracy and completeness cannot be guaranteed. This report does not take into account specific investment needs or other considerations, which may be pertinent to individual investors, and for this reason clients should contact Taylor Collison to discuss their individual needs before acting on this report. Those acting upon such information and recommendations without contacting one of our advisors do so entirely at their own risk.

Any opinions, conclusions, forecasts or recommendations are reasonably held at the time of compilation but are subject to change without notice and Taylor Collison assumes no obligation to update this document after it has been issued. Except for any liability which by law cannot be excluded, Taylor Collison, its directors, employees and agents disclaim all liability (whether in negligence or otherwise) for any error, inaccuracy in, or omission from the information contained in this document or any loss or damage suffered by the recipient or any other person directly or indirectly through relying upon the information.

Disclosure: Taylor Collison is retained by the Company to provide general advisory services for a quarterly fee. Analyst remuneration is not linked to the rating outcome. Taylor Collison may solicit business from any company mentioned in this report. For the securities discussed in this report, Taylor Collison may make a market and may sell or buy on a principal basis. Taylor Collison, or any individuals preparing this report, may at any time have a position in any securities or options of any of the issuers in this report and holdings may change during the life of this document.

Analyst Interests: The Analyst(s) may hold the product(s) referred to in this document, but Taylor Collison Limited considers such holdings not to be sufficiently material to compromise the rating or advice. Analyst(s)' holdings may change during the life of this document.

Analyst Certification: The analyst(s) certify that the views expressed in this document accurately reflect their personal, professional opinion about the financial product(s) to which this document refers.

Date Prepared: February 2009

Analyst: Thomas Duthy

Release Authorised by: David Whiting

Taylor Collison Limited
Sharebrokers and Investment Advisers
A.B.N. 53 008 172 450 AFSL No. 247083

Level 16, 211 Victoria Square
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

Level 10, 167 Macquarie 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

Participant of the Australian Stock Exchange Group
www.taylorcollison.com.au
ESTABLISHED 1928