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CogState Limited (CGS)

Speculative Buy

1H07 Negatively Impacted by US/European Summer; Expect Improved 2H

$0.19

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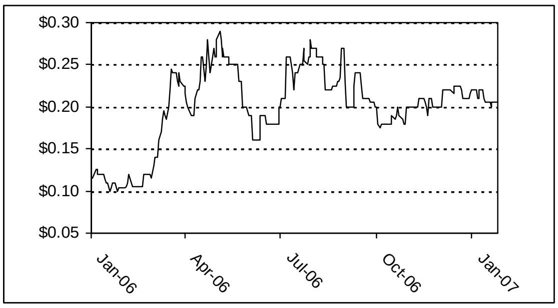
Summary

Market Capitalisation (M)	**$8.7**
Share Price	**$0.19**
Valuation Per Share	**$0.39**
Cash (M) as at 31/12/06	**$1.6**
Ave Monthly Volume (Yr Rolling)(M)	0.91
Year High	$0.30
Year Low	$0.10
Market Cap: Cash Ratio	5.4
Market Cap: Cash Ratio (Sector)	14.2

Key Financials (A$'000)

Year End	2006 Actual	1H07 Actual	2007 Est.
Revenue	**2,433**	**1,285**	**3,010**
Net Op. Rev	(1,642)	(802)	(1,194)
R&D Expenses	(237)	(106)	(156)
EBITDA	**(2,023)**	**(965)**	**(1,449)**
EBIT	(2,099)	(1,002)	(1,517)
NPAT pre Net R&D	**(1,544)**	**(882)**	**(1,013)**
Reported Profit	**(1,603)**	**(948)**	**(1,089)**
Reported EPS (c)	**(4.1)**	**(2.2)**	**(2.4)**
PE Ratio (x)	**n/a**	**n/a**	**n/a**
ROE (%)	-46.3%	-36.0%	-42.8%

Share Price Graph (A$)



1H07 Overview

CogState has reported a 1H07 NPAT Loss of $0.94 million, a 21.1% improvement pcp but below our expectations.

Top line product revenues of $1.2 million, up 43.5% pcp though below expectations due to soft trading conditions in the 1Q ex Europe/US.

Salary and employee expenses down 25.7% pcp to $1.2 million, 23.3% better than our expectations.

Contracted future revenues exceeds $2.1 million, with $1.1 million to be recognised in the 2H.

Our View

- CogState has delivered a 1H result that was below our expectations. While top line growth remains strong pcp, CogState's 1H07 ClinIT cognition testing revenues were impacted with a much softer than anticipated 1Q, where revenues fell 46.3% quarter on quarter to $0.37 million. Management has indicated the decline was attributable to the European/US holiday season, where initiation of new clinical trials utilising the ClinIT cognition testing system was constrained. We note 2Q revenues recovered to $0.82 million, which is largely in line with the historic growth in ClinIT revenues since 1Q CY05. Importantly, the economic dependence of CogState's product revenues on contracts with Pfizer (NYSE:PFE) is actively being diversified away from 1H06 to 1H07 (TC estimates from +80% to 57%, respectively). We understand from management that the opportunity pipeline remains very robust beyond FY07, though actual guidance on potential FY07 and FY08 revenues was not forthcoming.

- In our view, CogState continues to demonstrate traction in the A$120 million cognition testing clinical trial testing market (which it only entered in 1Q FY06). We estimate CogState's penetration into this market to FY07 will be 1.9%. However, we believe the Company is very unlikely to record a profit for FY07. While we remain comfortable with our forward cost estimates, product revenue growth has not kept pace with our expectations. As a result, we have downgraded our FY07 NPAT from $0.4 million to a NPAT loss of $1.1 million. With a 2H R&D tax rebate we expect CogState to record a very small NPAT loss of $0.1 million in the 2H. We have also downgraded our DCF valuation and price target by 7.1% to $0.39. Despite this, CogState continues to trade at a discount to our adjusted valuation, with good growth prospects from new and existing customers in an emerging market. We therefore continue with our Speculative Buy recommendation.

1H07 Overview

FY06 NPAT Loss of $0.94 million, 21.1% improvement pcp.

CogState has reported a F1H07 NPAT loss of $0.94 million, a 21.1% improvement pcp but significantly below our expectations. Product revenues were $1.2 million, up 43.5% 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.

Gross margin improvement to 90%

$ million	1H06A	1H07A	Change
Product Sales	0.8	1.1	42.8%
COGS	(0.1)	(0.1)	-14.0%
Gross Margin	83.4%	90.0%	

New Datapoint system to drive future operating margin expansion.

During the 1H, CogState signed its first clinical trial contracts with Abbott (NYSE: ABT), Merck (NYSE:MRK) and Lundbeck. The Company also launched 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. 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). Into the future we believe labour savings via streamlined reporting should allow CogState to increase its contracts under management per person.

Salaries reduced by 25.7% pcp, with revenue growth.

1H07 salaries expense was 25.7% less than pcp (see below), largely the result of the Company changing strategic direction towards targeting the clinical trial testing market rather than drug development. We note that salaries as a percentage of total revenues continues to trend downwards.

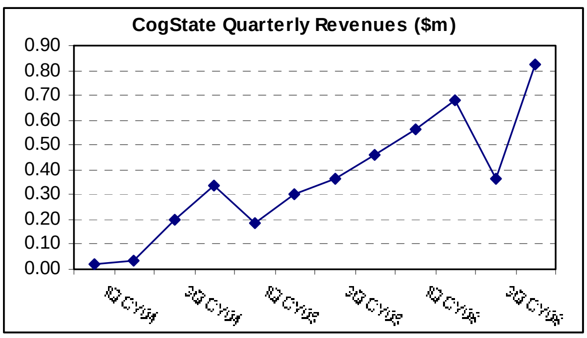
$ million	1H06A	1H07A	Change
Employee benefits	(1.60)	(1.19)	-25.7%
% of Total Revenues	162.1%	95.3%	

Operating cash burn was reduced by 35.9% pcp to $0.9 million in 1H06, which was higher than our expectations (see below). We note a receivable of $0.74 million at balance date which CogState of which approximately 55% was collected in January.

OCB down 35.9% pcp to $0.91 million.

$'000	1H06A	1H07A	Change
OCB	(1,425)	(913)	-35.9%

We have examined CogState's quarterly product revenues from 1Q CY04 to the present (see across). The chart indicates that CogState's restructured business model announced in 1Q FY06 that seeks to focus on the clinical trial testing market is continuing to drive revenue growth. As indicated, management attributes the decline in 3Q CY06 revenues to the Northern Hemisphere holiday season.



Outlook

We continue to remain impressed with management's ability to deliver on the revised business model targeting ostensibly the clinical trial testing market. We value the total cognition testing clinical trial market at ~A$120 million. On a pro-forma basis, we believe as at FY07, CogState will have penetrated approximately 1.9% of the total market. At present, the market is dominated by archaic "pencil and paper" testing batteries rather than computerised testing regimes. We note that CogState essentially operates in an oligopoly with two other private UK domiciled competitors. For a relatively new entrant into the clinical trials testing market, CogState appears to be gaining real traction.

Market penetration to FY07 estimated at 1.7%.

Oligopoly market structure remains, trending to computerised cognition testing.

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.

ClinIT revenues will continue to drive revenue growth in medium term.

ClinIT continues to form the majority of our FY07 (83.2%) and FY08 (89.4%) product revenue estimates. From a cash flow perspective, the business remains attractive, given up to 80% of the cash is collected within the first 3 months of the clinical trial contract, with revenues progressively recognised throughout the length of the trial.

Downgraded FY07 NPAT expectations to a $1.1 million loss.

We have downgraded our FY07 NPAT from $0.4 million to a NPAT loss of $1.1 million. With a 2H R&D tax rebate we expect CogState to record a very small NPAT loss of $0.1 million in the 2H. We have also downgraded our DCF valuation and price target by 7.1% to $0.39. Despite this, CogState continues to trade at a discount to our adjusted valuation, with good growth prospects from new and existing customers in an emerging market. We therefore continue with our Speculative Buy recommendation.

CGS - Summary of Forecasts CGS $ 0.19

PROFIT & LOSS SUMMARY (A$000s)					
Period	**1H06A**	**FY06A**	**1H07A**	**FY07E**	**FY08E**
Total Revenue	**985**	**2,433**	**1,285**	**3,010**	**4,700**
Growth (pcp)	*38.7%*	*59.6%*	*30.5%*	*23.7%*	*56.1%*
Net Operating Revenue	**(1,359)**	**(1,642)**	**(802)**	**(1,194)**	**577**
Direct R&D Expenses	(210)	(237)	(106)	(156)	(164)
EBITDA	**(1,640)**	**(2,023)**	**(965)**	**(1,449)**	**322**
Dep'n/Other Amort'n	(31)	(76)	(37)	(68)	(119)
EBIT	**(1,671)**	**(2,099)**	**(1,002)**	**(1,517)**	**203**
Net Interest	71	144	57	99	92
Pre-Tax Profit	**(1,600)**	**(1,955)**	**(945)**	**(1,418)**	**295**
Tax Expense	348	352	(3)	329	205
Minorities	0	0	0	0	0
NPAT	**(1,252)**	**(1,603)**	**(948)**	**(1,089)**	**500**
Growth (pcp)	*10.0%*	*29.6%*	*24.3%*	*n/a*	*145.9%*
Net Abnormals	0	0	0	0	0
Reported Profit	**(1,252)**	**(1,603)**	**(948)**	**(1,089)**	**500**
NPAT pre Net R&D	**(1,128)**	**(1,544)**	**(882)**	**(1,013)**	**664**

PER SHARE DATA					
Period	**1H06A**	**FY06A**	**1H07A**	**FY07E**	**FY08E**
Reported EPS (c)	**(3.5)**	**(4.1)**	**(2.2)**	**(2.4)**	**1.1**
Growth (pcp)	*-12.7%*	*n/a*	*143.4%*	*n/a*	*-145.9%*
EPS Pre-Net R&D (c)	**(0.0)**	**(3.9)**	**(0.0)**	**(2.3)**	**1.5**
Growth (pcp)	*0.0%*	*n/a*	*-36.0%*	*n/a*	*-165.5%*
Dividend (c)	0.0	0.0	0.0	0.0	0.0
Franking	0%	0%	0%	0%	0%
Gross CF per Share (c)	(3.9)	(3.6)	(2.1)	(2.2)	1.9
NTA per share (c)	7.5	6.9	4.1	3.6	4.6

KEY RATIOS					
Period	**1H06A**	**FY06A**	**1H07A**	**FY07E**	**FY08E**
EBITD/Sales Margin %	-166.5%	-83.2%	-75.1%	-48.1%	6.9%
EBIT/Sales Margin %	-169.7%	-86.3%	-78.0%	-50.4%	4.3%
Current ratio (x)	3.4	4.7	2.6	2.5	2.2
Net Debt : Equity (%)	-74.5%	-85.9%	-74.8%	-76.8%	-93.6%
ROE (%)	0.0%	-46.3%	-36.0%	-42.8%	22.7%
Dividend Payout Ratio (%)	0.0%	0.0%	0.0%	0.0%	0.0%

VALUATION MULTIPLES					
Period	**1H06A**	**FY06A**	**1H07A**	**FY07E**	**FY08E**
PE Ratio (x)	n/a	n/a	n/a	n/a	16.9
Dividend Yield (%)	0.0%	0.0%	0.0%	0.0%	0.0%
EV/EBITD (x)	n/a	n/a	0.0	n/a	19.2
EV/EBIT (x)	n/a	n/a	0.0	n/a	30.4

CAPITAL RAISING ASSUMPTIONS					
Period	**1H06A**	**FY06A**	**1H07A**	**FY07E**	**FY08E**
Shares Issued (m)	3.0	8.6	0.0	0.0	0.0
Issue Price (A$)	0.10	0.10	0.00	0.00	0.00
Cash Raised (A$m)	0.3	0.86	0.0	0.0	0.0

BALANCE SHEET SUMMARY					
Period	**1H06A**	**FY06A**	**1H07A**	**FY07E**	**FY08E**
Cash	2,278	2,661	1,646	1,527	2,261
Receivables	1,122	434	737	564	942
Pre Paymenrs	0	22	65	0	0
Inventories	0	0	0	0	0
Investments	0	0	0	0	0
Other	28	77	99	99	99
Total Current Assets	3,428	3,194	2,547	2,190	3,303
Investments	0	0	0	0	0
Inventories	0	0	0	0	0
Property Plant & Equip	165	170	235	249	249
Intangibles	402	402	402	402	382
Deferred Tax Assets	37	46	47	46	46
Other	30	0	0	0	0
Total Non-Current Assets	634	618	684	697	677
TOTAL ASSETS	**4,062**	**3,812**	**3,231**	**2,887**	**3,980**
Accounts Payable	319	279	378	349	673
Revenue in Advance	567	302	506	403	673
Borrowings	0	0	0	0	0
Deferred Tax Liabilities	0	2	5	2	2
Provisions	110	93	104	107	180
Total Current Liab	996	676	993	862	1,528
Borrowings	0	0	0	0	0
Provisions	8	39	37	37	37
Other	0	0	0	0	0
Total Non-Current Liab	8	39	37	37	37
TOTAL LIABILITIES	**1,004**	**715**	**1,030**	**899**	**1,565**
TOTAL EQUITY	**3,058**	**3,096**	**2,201**	**1,988**	**2,415**

CASH FLOW SUMMARY					
Period	**1H06A**	**FY06A**	**1H07A**	**FY07E**	**FY08E**
EBIT (excl Abs/Extr)	**(1,671)**	**(2,099)**	**(1,002)**	**(1,517)**	**203**
Add: Depreciation	31	76	37	68	100
Change in Pay.	29	(11)	99	70	324
Change in Rev. in Ad.	567	195	204	101	270
Less: Tax paid	348	352	(3)	329	205
Net Interest	71	144	57	99	92
Change in Rec.	(778)	(90)	(303)	(130)	(378)
Change in Inv.	0	0	0	0	0
Gross Cashflows	(1,403)	(1,433)	(911)	(980)	834
Capex	(55)	(108)	(97)	(147)	(100)
Free Cashflows	(1,458)	(1,541)	(1,008)	(1,127)	734
Dividends Paid	0	0	0	0	0
Net Cash Flow	**(1,458)**	**(1,541)**	**(1,008)**	**(1,127)**	**734**

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