



CogState Limited (CGS)

Speculative Buy

FY06 Turnaround Lays the Foundation for Profitability in FY07

\$0.26

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FY06 Overview

CogState has reported a FY06 NPAT Loss of \$1.6 million, a 34.5% improvement on FY05, and 9.9% better than expectations.

Recognised sales revenues of \$2.1 million was up 104.2% pcp, with total revenues of \$2.4 million up 59.4% and within expectations.

Excellent 2H with NPAT loss reduced to \$0.35 million, with OCF close to break even.

Current order book for FY07 stands at \$2.3 million, with approximately \$1.6 million to be recognised in FY07.

No profit guidance for FY07 was forthcoming.

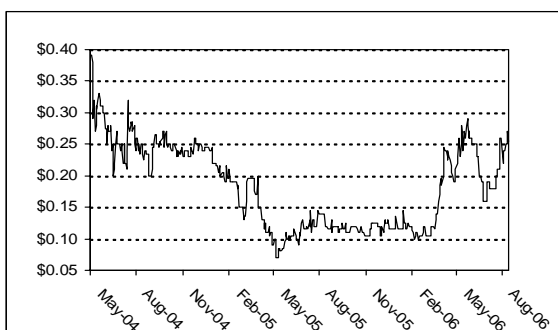
Summary

Market Capitalisation (M)	\$11.1
Share Price	\$0.26
Valuation Per Share	\$0.42
Cash (M) as at 30/6/06	\$2.7
Ave Monthly Volume (Yr Rolling)(M)	0.97
Year High	\$0.30
Year Low	\$0.10
Market Cap: Cash Ratio	4.1
Market Cap: Cash Ratio (Sector)	14.2

Key Financials (A\$'000)

Year End	2005	2006	2007
	Actual	Actual	Est.
Revenue	1,525	2,433	4,370
Net Op. Rev	(2,301)	(1,642)	233
R&D Expenses	(260)	(237)	(50)
EBITD	(2,782)	(2,023)	23
EBIT	(2,896)	(2,099)	(52)
NPAT pre Net R&D	(2,307)	(1,544)	490
Reported Profit	(2,278)	(1,603)	440
Reported EPS (c)	(6.4)	(4.1)	1.0
PE Ratio (x)	n/a	n/a	26.3
EPS pre R&D (c)	(6.5)	(3.9)	1.1
PE Ratio pre R&D (x)	n/a	n/a	23.6
ROE (%)	-45.9%	-46.3%	14.0%

Share Price Graph (A\$)



Our View

- CogState has delivered an excellent FY06 result, particularly given the business restructure and new focus was implemented during 1H06. This delivered tangible benefits in the 2H, with the Company reporting only a small loss, and very minor operating cash burn. The revised FY06 business model of focusing considerable resources towards ClinIT product sales revenues for the key Central Nervous System (CNS) clinical trial testing market has been vindicated. Indeed the Company recently executed another deal with a first time partner, namely the pure play CNS pharma company, namely Lundbeck A/S (OMX:LUN).
- We remain comfortable that further clinical trial deals will be announced through FY07 and have largely factored this into our model. At this juncture, we believe there are not only significant business development opportunities with existing clients (Pfizer, GSK, J&J, Lundbeck) but sourcing new CNS companies for cognition testing deals. Examining the CNS market, possible future suitors include Merck, AstraZeneca, Eli Lilly, Sanofi Aventis and Forest Labs.
- ClinIT continues to form the majority of our FY07 (81.2%) and FY08 (90.1%) product revenue estimates. We maintain our overall FY07 NPAT of \$0.4 million, though have made adjustments on the downside (4.1%) to our revenue expectations, largely offset through reduced operating expenditures. CogState is currently trading on 26.3x our forecast FY07 EPS, with estimated FY07 free cash flows of \$1.0 million. As a result of renewed confidence in the business and cash flow generation, we have upgraded our 12 month price target derived from our DCF valuation by 7.7% to \$0.42. CogState is currently trading at a 38.1% discount to our valuation and we continue with our Speculative Buy recommendation.

FY06 Overview

FY06 NPAT Loss of \$1.6 million, 9.9% ahead of expectations.

Closing cash of \$2.7 million.

CogState has reported a FY06 NPAT loss of \$1.6 million, which was 9.9% above our estimates and a significant reduction (34.5%) compared with pcp. Product revenues were \$2.1 million, up 104.2% pcp. The primary driver of revenue growth was increased access to the clinical trial testing market, where ClinIT product revenues grew 97.5% pcp. Operating cash burn was reduced by 32.6% to \$0.8 million in FY06, with the Company OCF break even in the 2H. The Company remains debt free with closing cash at a respectable \$2.7 million.

CogState has provided strong evidence to the market that the new business model announced in late 1Q FY06 is bearing fruit. The Company decided to cease expenditure on drug development and focus on developing business in the high growth segment of cognition testing services to the clinical trial market. This market is dominated by pharmaceutical companies, though a new market has formed around a smaller number of nutraceutical companies

Substantial uplift in product revenues via new clinical strategy in 1H06.

GSK and Lundbeck signed up.

Excellent 2H, driven by strong product revenue growth into clinical trials market.

Drug development divestment complete.

seeking to find clinical evidence for particular food groups (also known as “functional foods”). As a result, CogState has significantly increased product revenues in FY06, via contracts in this market; a trend we expect to continue into FY07 and FY08 (see above).

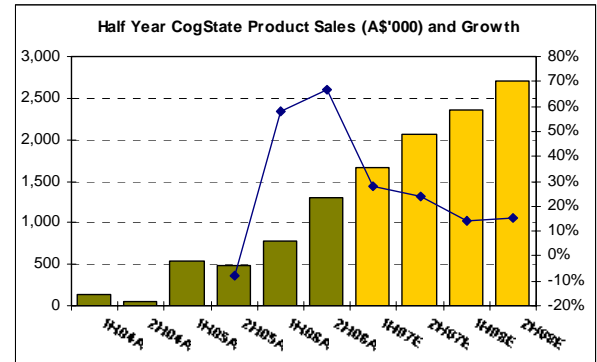
During the year, CogState signed additional clinical trial contracts with Glaxo SmithKline (GSK) and Alza Corporation and a further \$1.28 million, three year deal with Pfizer to develop novel paediatric cognition tests and speech acoustic technology. The bulk of historical clinical trial revenues have traditionally come from a relationship with Pfizer. Two functional food deals were also executed during the year and a major distribution deal for product roll out in Japan.

2H Confirms Positive Trends

CogState has recorded an impressive 2H, with the NPAT loss reduced to just \$0.35 million. Half on half sales revenue growth of 50.7% was recorded, with a considerable reduction in salaries and benefits expense to \$1.1 million, down 34.9% on the 1H. As presented (above) we believe the Company will continue product revenue growth through FY07 and FY08, principally the result of further clinical trial deals. 2H product revenues for CogHealth (memory monitoring product) also benefited from a \$0.2 million payment from CogState’s distribution partner in Japan. We are forecasting minimal if any growth in CogHealth and CogSport products moving forward, though we note a further \$0.2 million will be recognised in FY07 and FY08 as part of that Japanese deal.

Bon Voyage Drug Development

CogState recently announced it had completed the divestment of its two drug development projects, namely AT4 and NLT. As a result no further costs will be incurred on therapeutic drug development. In consideration for licensing AT4 to Pacific Northwest Biotechnology, CogState will receive a small milestone based payments and a 1% royalty. No consideration was forthcoming on NLT, which was returned to the licensor. CogState can now be considered a pure play cognition testing business.

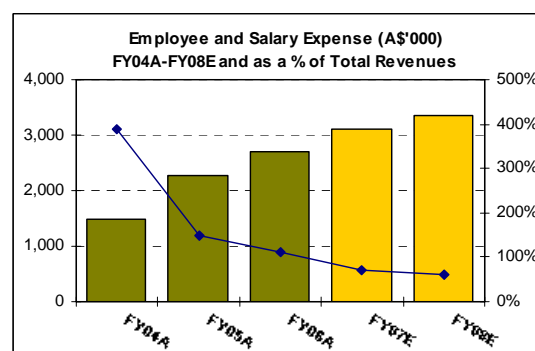


* FY06-FY08 ex Pfizer grant; Source: Taylor Collison estimates

Employee Salaries and Benefits

Salaries the single biggest cost, representing 67.2% of total operating expenditure.

CogState is essentially a service based business, with 67.2% of total operating expenditure (ex R&D in FY06) attributable to salaries and employee benefits. As a percentage of total revenues, salaries are trending down (see across), indicating the Company is generating more bang for the buck with their installed human capital. Salaries grew 19.4% pcp, with product revenues up 104.2%, virtually all attributable to servicing the clinical trials testing market. Despite this, we believe the Company will need to bring in additional personnel over the next 12-18 months to meet expected future product sales demand.



Source: Taylor Collison estimates

Significant revenue kicker per employee.

Management has indicated a desire to manage employee growth via appointments made on secured clinical trial contracts, which typically last between 1-3 years, clinical phase dependent. Based on our modelling, we believe up to \$0.6 million per person per year in additional ClinIT revenues is achievable, with a typical salary increment of approximately \$0.1 million. Therefore, we are not forecasting significant additional employee expense for the period FY06-FY08 (CAGR 11.8%) versus product sales revenue (CAGR 56.1%) over the same reporting period.

R&D Expenditure

CogState continues to invest in developing innovative new cognitive testing batteries for the clinical trial testing market. As CogState's revenues have expanded through FY05 and FY06, R&D spend has continued to remain relatively consistent (see below). Management has indicated R&D expenditure will not be pegged to sales or a fixed amount per annum, but rather expenditure will be based on the identification of specific new areas of interest or further innovation in the existing product offering.

Further, management has indicated the majority of future R&D expenses associated with cognition testing (as drug development has now been completely divested) will be included with salaries and employee expenses. We are therefore forecasting very minor allocated FY07 and FY08 R&D expenditure, though we would not be surprised if no allocation to this expense line is made.

R&D to form part of salaries and employees expense in FY07 onwards.

\$'000	FY04A	FY05A	FY06A	FY07E	FY08E
R&D	41	260	237	50	53
% of Revenues	10.6%	17.0%	9.7%	1.1%	1.0%

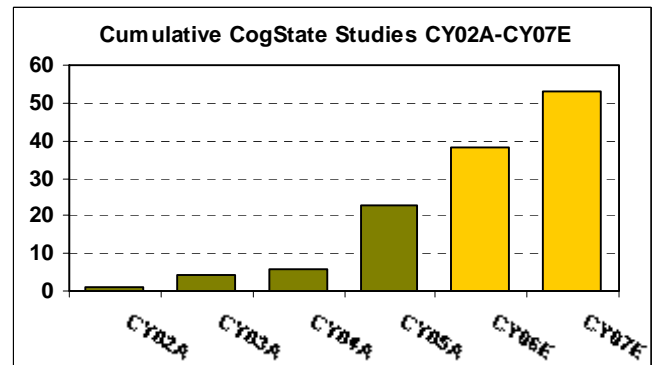
A \$1.28 million non dilutive grant from Pfizer will allow CogState to develop paediatric cognitive tests designed specifically for the neuropsychological of children in clinical trial settings. It is important to ensure that new therapies will not interfere with a child's cognition and school performance. A second application will revolve around the speech acoustic technology is currently used for the measurement of disease progression and treatment response in Parkinson's Disease patients. It has the potential for further applications in other neurological disorders. We believe approximately \$0.6 million will be recognised from the Pfizer grant in FY07 and FY08

Up to \$0.6 million in unrecognised Pfizer grant revenues in FY07 and FY08.

Growing Recognition of CogState Tests

CogState tests have been used to study cognition in all phases of clinical drug development, with the company recording strong growth in cumulative third party studies, since the revised business plan targeting the clinical trial market was introduced in CY05 (see across). We note more recent deals with two new major pharmaceutical companies, namely Glaxo SmithKline (GSK) and Lundbeck. Both have solid CNS pipelines which we believe have maximum exploitable cognition revenues of A\$7.7 million (Lundbeck) and A\$32.5 million (GSK) for drugs in the pipeline. In our view, as the Company continues to receive third party validation through clinical trials then the more likely further trial deals will result.

Two recent deals with GSK and Lundbeck.



Source: Taylor Collison

Moreover, the consistent use of CogState's testing battery will build awareness within the key US and European regulatory bodies (FDA, EMEA), such that the use of the test in submitted Investigational New Drug (IND) clinical trials will be familiar, and ultimately as widespread as archaic "pencil & paper" cognition tests. From our discussions with companies seeking cognition testing batteries as part of their clinical trial needs, the familiarity of the test with the FDA is a key factor. This explains why the Cognitive Drug Research (CDR) test has been used in over 500 clinical trials and is now a well known battery within regulatory and industry circles.

Business Outlook

We continue to remain impressed with new management's ability to deliver on the revised business model targeting ostensibly the clinical trial testing market. We have previously valued the CNS clinical trial testing market at US\$90 million. 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. We note the recent deal with GSK, who has traditionally utilised CDR (UK domiciled) for their cognition testing needs.

Value the market at US\$90 million.

At present, CogState has penetrated less than 1% of the potential total clinical trial market. The market is dominated by antiquated cognition batteries, namely "pencil & paper" testing. We believe there are key drivers to convert such regimes to computer based testing and CogState is very well positioned to capitalise on this trend.

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. Indeed, in terms of consistency of methodology by the investigator company (i.e. the pharma) we believe such cognition tests have potential to become "embedded" in the clinical trial process through to eventual market approvals. This is particularly true post Phase 2 in our view. Further, successful use of ClinIT in a new client's organisation could presumably open access to testing with new drugs entering the clinic, or drugs in clinical trials where alternative testing batteries have proved problematic.

Repeat business likely for ClinIT.

We remain comfortable that further clinical trial deals will be announced through FY07 and have largely factored this into our model. ClinIT continues to form the majority of our FY07 (81.2%) and FY08 (90.1%) product revenue estimates. We maintain our overall FY07 NPAT of \$0.4 million; though have made adjustments on the downside (4.1%) to our revenue expectations, largely offset through reduced operating expenditures.

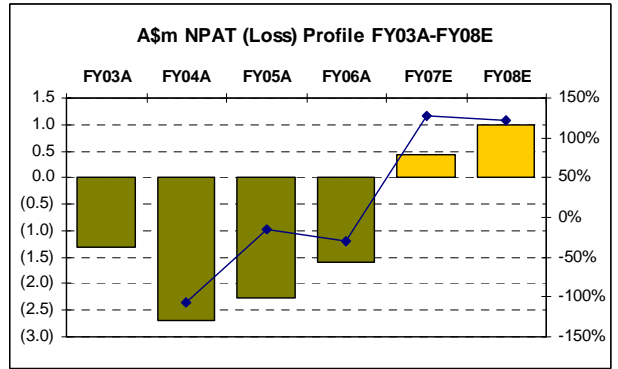
Forecast FY07 NPAT of \$0.4 million.

The chart across highlights the historical NPAT losses the Company has recorded, with our expectations into FY07 and FY08. In our view, the focus on the clinical trial testing market will provide the necessary driver to profitability in FY07 onwards.

CGS trading on 26.3x FY07 EPS.

Upgraded valuation to \$0.42, maintain Speculative Buy.

CogState is currently trading on 26.3x our forecast FY07 EPS, with estimated FY07 free cash flows of \$1.0 million. As a result of renewed confidence in the business and cash flow generation, we have upgraded our 12 month price target derived from our DCF valuation by 7.7% to \$0.42. CogState is currently trading at a 38.1% discount to our valuation and we continue with our Speculative Buy recommendation.



Source: Taylor Collison estimates

CGS - Summary of Forecasts

CGS \$ 0.26

PROFIT & LOSS SUMMARY (A\$000s)				
Period	FY05A	FY06A	FY07E	FY08E
Total Revenue	1,525	2,433	4,370	5,396
<i>Growth (pcp)</i>	296.1%	59.6%	79.6%	23.5%
Net Operating Revenue	(2,301)	(1,642)	233	1,145
Direct R&D Expenses	(260)	(237)	(50)	(53)
EBITD	(2,782)	(2,023)	23	874
Dep'n/Other Amort'n	(51)	(76)	(56)	(102)
EBIT	(2,896)	(2,099)	(52)	753
Net Interest	221	144	160	218
Pre-Tax Profit	(2,675)	(1,955)	108	971
Tax Expense	397	352	332	0
Minorities	0	0	0	0
NPAT	(2,278)	(1,603)	440	971
<i>Growth (pcp)</i>	14.9%	29.6%	n/a	120.9%
Net Abnormals	0	0	0	0
Reported Profit	(2,278)	(1,603)	440	971
NPAT pre Net R&D	(2,307)	(1,544)	490	1,024

PER SHARE DATA				
Period	FY05A	FY06A	FY07E	FY08E
Reported EPS (c)	(6.4)	(4.1)	1.0	2.2
<i>Growth (pcp)</i>	-53.5%	n/a	n/a	120.9%
EPS Pre-Net R&D (c)	(6.5)	(3.9)	1.1	2.3
<i>Growth (pcp)</i>	0.0%	n/a	n/a	109.0%
Dividend (c)	0.0	0.0	0.0	0.0
Franking	0%	0%	0%	0%
Gross CF per Share (c)	(5.9)	(3.6)	2.4	2.5
NTA per share (c)	9.7	6.9	6.3	8.4

KEY RATIOS				
Period	FY05A	FY06A	FY07E	FY08E
EBITD/Sales Margin %	-182.5%	-83.2%	0.5%	16.2%
EBIT/Sales Margin %	-189.9%	-86.3%	-1.2%	14.0%
Current ratio (x)	6.9	4.7	2.4	2.5
Net Debt : Equity (%)	-29.2%	-85.9%	-113.6%	-113.3%
ROE (%)	-45.9%	-46.3%	14.0%	26.7%
Dividend Payout Ratio (%)	0.0%	0.0%	0.0%	0.0%

VALUATION MULTIPLES				
Period	FY05A	FY06A	FY07E	FY08E
PE Ratio (x)	n/a	n/a	26.3	11.9
Dividend Yield (%)	0.0%	0.0%	0.0%	0.0%
EV/EBITD (x)	n/a	n/a	341.2	7.9
EV/EBIT (x)	n/a	n/a	n/a	9.2

CAPITAL RAISING ASSUMPTIONS				
Period	FY05A	FY06A	FY07E	FY08E
Shares Issued (m)	0.0	8.6	0.0	0.0
Issue Price (A\$)	0.00	0.10	0.00	0.00
Cash Raised (A\$m)	0.0	0.86	0.0	0.0

BALANCE SHEET SUMMARY				
Period	FY05A	FY06A	FY07E	FY08E
Cash	1,119	2,661	3,635	4,629
Receivables	344	434	780	1,062
Pre Paymenrs	0	22	0	0
Inventories	0	0	0	0
Investments	2,311	0	0	0
Other	47	77	0	0
Total Current Assets	3,821	3,194	4,414	5,691
Investments	0	0	0	0
Inventories	0	0	0	0
Property Plant & Equip	139	170	256	302
Intangibles	375	402	382	363
Deferred Tax Assets	55	46	46	46
Other	0	0	0	0
Total Non-Current Assets	569	618	684	711
TOTAL ASSETS	4,390	3,812	5,098	6,402
Accounts Payable	290	279	743	1,012
Revenue in Advance	107	302	743	759
Borrowings	0	0	0	0
Deferred Tax Liabilities	0	2	2	2
Provisions	155	93	371	506
Total Current Liab	552	676	1,859	2,278
Borrowings	0	0	3	6
Provisions	8	39	39	39
Other	0	0	0	0
Total Non-Current Liab	8	39	42	45
TOTAL LIABILITIES	560	715	1,901	2,323
TOTAL EQUITY	3,830	3,096	3,197	4,079

CASH FLOW SUMMARY				
Period	FY05A	FY06A	FY07E	FY08E
EBIT (excl Abs/Extr)	(2,896)	(2,099)	(52)	753
Add: Depreciation	51	76	56	102
Change in Pay.	160	(11)	464	269
Change in Rev. in Ad.	107	195	441	16
Less: Tax paid	397	352	332	0
Net Interest	221	144	160	218
Change in Rec.	(222)	(90)	(346)	(282)
Change in Inv.	0	0	0	0
Gross Cashflows	(2,119)	(1,433)	1,074	1,094
Capex	(124)	(108)	(100)	(100)
Free Cashflows	(2,243)	(1,541)	974	994
Dividends Paid	0	0	0	0
Net Cash Flow	(2,243)	(1,541)	974	994

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