

7 April 2008

Asterand

| Year End | Revenue (£m) | PBT* (£m) | EPS* (p) | DPS (p) | PE (x) | Yield (%) |
|----------|--------------|-----------|----------|---------|--------|-----------|
| 12/06 | 7.5 | (1.9) | (1.7) | 0.0 | N/A | N/A |
| 12/07 | 7.6 | (1.3) | (1.2) | 0.0 | N/A | N/A |
| 12/08e | 10.9 | 0.3 | 0.4 | 0.0 | 10.6 | N/A |
| 12/09e | 12.4 | 0.8 | 0.8 | 0.0 | 5.3 | N/A |

Note: *PBT and EPS are normalised, excluding goodwill amortisation and exceptional items.

Investment summary: Set for maiden profit

Asterand's full-year results indicate that the company is on track to record a maiden net profit in 2008, having restructured its UK service operations, saving £700k a year, and entered the current year with over £1m of service revenue already on its order book. Asterand's investment case relies on it becoming profitable quickly, before expanding its share of a fragmented but fast-growing market.

Cost savings kick in

The £700k annualised cost savings have been realised without affecting the UK division's core service offering, with the company's new management team aiming to make Asterand cash flow positive this year. We are forecasting a maiden net profit for 2008, and once the company has been repositioned, further growth could come through acquisitions within the fragmented tissue supply sector.

BMS master agreement renewed

Asterand's clients have included all of the top 30 big pharma firms, which remain the largest contributor to revenues and a key driver of growth. One valuable contract, a master service agreement with Bristol-Myers Squibb covering PhaseZERO research services and the XpressBANK tissue repository, has been extended by three years.

Progress on AFIP contract

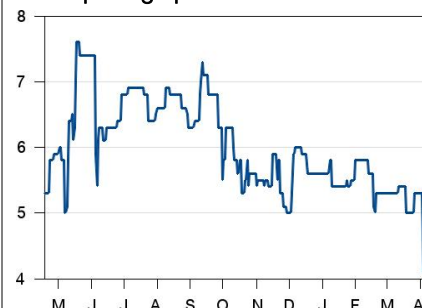
Since September 2007, Asterand has been assessing the US Armed Forces Institute of Pathology's (AFIP's) vast repository of human tissue samples, having been awarded a prestigious \$2.8m contract by the Department of Defense. The company says it plans to use the AFIP as a foundation client in a new service contract involving biorepository-specific consulting services.

Valuation: DCF estimate of £20m

A discounted cash flow valuation suggests around £20m, indicating a fourfold upside, and further value could be generated from additional milestone payments from BTG, IP licensing and contracts of the type signed with the AFIP.

Price 4.25p
Market Cap £5m

Share price graph



Share details

Code ATD
Listing Full
Sector Pharmaceuticals & biotechnology
Shares in issue 110m

Price

52-week High 7.62p Low 4.25p

Balance Sheet as at 31 December 2007

Debt/Equity (%) N/A
NAV per share (p) 5.4
Net cash (£m) 2.1

Business

Asterand supplies human tissue and tissue-related products as well as tissue testing-based services to R&D companies, many of them big pharmas. It was formed in January 2006 through the reverse takeover of Pharmagene of the UK by the private US firm Asterand.

Valuation

| | 2007 | 2008e | 2009e |
|--------------|------|-------|-------|
| P/E relative | N/A | 94% | 46% |
| P/CF | N/A | N/A | 4.2 |
| EV/Sales | 0.3 | 0.3 | 0.2 |
| ROE | N/A | N/A | N/A |

Geography based on revenues

| | UK | Europe | US | Other |
|--|----|--------|-----|-------|
| | 9% | 7% | 81% | 3% |

Analyst

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Investment summary: Human tissue/services supplier

As a specialist provider of human tissue samples and associated services, Asterand offers customer companies years of expertise in this highly fragmented market, having the advantage of a large tissue biobank and an extensive tissue procurement network. Its investment case relies on it becoming profitable quickly on the back of a restructuring implemented by the new management team, before growing its market share and turning to possible acquisitions. The current market is highly fragmented but growing fast, fuelled by big pharma's drive to cut drug development times and increase R&D productivity, as well as a growing focus on biomarkers.

Asterand operates a profitable tissue sample supply business in the US, and a UK CRO/service offering carrying out studies for client companies (see Exhibit 1).

Exhibit 1: Asterand's business offering

| "Product" | Description | Business unit | Location |
|--------------------|---|-------------------|-------------------|
| XpressBANK | Biobank of over 200,000 tissue samples and associated clinical and pathology data. Available fixed (in paraffin blocks) or flash frozen in nitrogen; or as Quad Sets (matched pairs of diseased and adjacent normal tissue; see below). Blood, sputum and tissue derivatives (RNA, DNA, cell lines etc) also available. | Tissue products | Detroit, Michigan |
| ProCURE | An on-demand service for clients wanting samples not currently in Asterand's biobank. Asterand effectively uses its network to procure the desired tissue. | Tissue products | Detroit, Michigan |
| Target validation | CRO service comprising gene expression and gene and protein localisation work focusing on identifying where targets are expressed in tissue/disease types. | PhaseZERO service | Royston, UK |
| Compound profiling | CRO service dealing with work on live tissues/live cells. Involves investigating drug candidates' pharmacology, looking at mechanical responses in whole tissue preparations or biochemical responses in isolated cells or fractions. | PhaseZERO service | Royston, UK |
| ADMET | CRO work on drug metabolism, absorption and interaction, <i>in vitro</i> toxicity and safety pharmacology. | PhaseZERO service | Royston, UK |

Source: Company presentation; Edison Investment Research

Full-year results in line

Asterand's 2007 financial results came in broadly in line with our forecasts, although owing to the type of work carried out under the contract with the US AFIP around £200k of revenue will be booked in 2008 rather than in 2007 (Exhibit 2). Under IFRS the company now recognises grant funding as part of top-line revenue, while previously this was included as an offset against expenses. 2007 revenue also includes a £250k milestone payment from BTG following the entry of a migraine project licensed from Asterand into Phase I studies.

The only other significant change from the forecasts made in our Outlook note involves the value of Asterand's inventory of biological materials. After an audit of the samples contained in the biorepository the value of this asset on the balance sheet has been reduced from £3.4m to £2.8m; many older samples have been disposed of, and the £2.8m represents a solid estimate of the asset value. Under the firm's accounting policy, costs incurred for tissue acquisition are capitalised as an asset and then written off over three years as the likelihood of the sample being sold diminishes, down to a nominal value of \$50 per sample. For the purposes of financial modelling we have assumed that the balance sheet value of this inventory remains at around £2.8m.

Around £700k a year has been trimmed from costs at Asterand's UK operations, with the restructuring seeing staff numbers cut to a more realistic level and one of two buildings closed, leaving a core laboratory. Since October 2007 there has been a sharp increase in the number and

overall value of service projects signed. The restructuring gave rise to one-off costs of £570k, in line with previous estimates.

Asterand says it continues to make progress in improving the efficiency of its tissue supply business, making the supply chain leaner and reducing turnaround time at the Detroit facility to enable material that comes in to be processed and sold as quickly as possible, using a 'lean six sigma' business review. The lab processing turnaround time has been cut by 60%, and the goal is for it to reach 7 days.

Asterand has announced the appointment of Dr Peter Coggins as a Non-Executive Director. It also said Jack Davis, currently Senior Independent Director, would be elected Chairman from 7 May, replacing David Lee, who is not standing for re-election. Dr Coggins has 35 years' experience in biotechnology and the life sciences, including as president of PerkinElmer's life and analytical sciences division.

Consortium bid approach

In May 2007, Asterand received a takeover approach from a consortium of its investors, and after due diligence this bid was increased to a level that management potentially found acceptable; however, it then became apparent that the consortium was unable to make a proposal that would lead to an offer, and after being issued with an ultimatum under the UK takeover code it agreed to withdraw from bidding for six months.

This six-month period has just expired, and given that Asterand's share price has continued to come under pressure in the general adverse market environment for healthcare-related stocks, we view the possibility of further takeover attempts and the associated expense, distraction and time constraints these put on management as a key sensitivity for Asterand in the near term.

Nevertheless, the company says all the shareholders involved in the consortium have maintained their equity stakes and continue to support current management strategy.

Further sensitivities to our forecasts – both on the upside and the downside – include tissue supply bans in Russia and other relatively unstable countries, although Asterand is working to broaden and diversify its procurement network. Asterand's revenue growth strategy depends on increased take-up and acceptance from big pharma. Meanwhile, the sale of remaining Pharmagene intellectual property could provide further upside and potential payments under any further licensing deals for Asterand's non-core IP are not factored into the current financial model. Similarly, future milestone fees for rights licensed to BTG for the migraine project offer potential upside.

A key element of our financial forecasts, which show no additional funding requirement, is the achievement of positive cash flow from Q208 onwards. Our figures for 2005 comprise a pro forma combination of Pharmagene and the private Asterand Inc.

Exhibit 2: Asterand financial forecasts

Note: In 2005 Asterand Inc and Pharmagene existed as separate entities, and their figures have been combined below. 2006 cash flow shows merger and Pharmagene cash under financing.

| Year ending Dec 31 | £'000s | 2005 (combined) | 2006 IFRS | 2007 IFRS | 2008e IFRS | 2009e IFRS |
|---|--------|--------------------|----------------|----------------|----------------|----------------|
| PROFIT & LOSS | | | | | | |
| Revenue | | 5,630 | 7,535 | 7,608 | 10,907 | 12,440 |
| Cost of sales | | (3,480) | (3,731) | (4,112) | (6,107) | (6,900) |
| Gross profit | | 2,150 | 3,804 | 3,496 | 4,800 | 5,540 |
| EBITDA | | (6,827) | (1,541) | (991) | 646 | 1,082 |
| Operating profit (before GW and except.) | | (7,371) | (2,086) | (1,381) | 346 | 832 |
| Goodwill amortisation | | 0 | 0 | (14) | 0 | 0 |
| Exceptionals | | (2,369) | (463) | (570) | 0 | 0 |
| Other | | 40 | (36) | (108) | (100) | (100) |
| Operating profit | | (9,700) | (2,585) | (2,073) | 246 | 732 |
| Net interest | | 536 | 225 | 150 | 65 | 100 |
| Profit before tax (norm) | | (6,795) | (1,897) | (1,339) | 311 | 832 |
| Profit before tax (FRS 3) | | (9,164) | (2,360) | (1,923) | 311 | 832 |
| Tax | | 401 | 187 | (24) | (15) | (25) |
| Profit after tax (norm) | | (6,434) | (1,674) | (1,255) | 396 | 907 |
| Profit after tax (FRS3) | | (8,763) | (2,173) | (1,947) | 296 | 807 |
| Average number of shares outstanding (m) | | N/A | 99.4 | 106.2 | 110.0 | 110.0 |
| EPS - normalised (p) | | N/A | (1.7) | (1.2) | 0.4 | 0.8 |
| EPS - FRS 3 (p) | | N/A | (2.2) | (1.8) | 0.3 | 0.7 |
| Gross margin (%) | | 38.2% | 50.5% | 46.0% | 44.0% | 44.5% |
| EBITDA margin (%) | | (121.3%) | (20.5%) | (13.0%) | 5.9% | 8.7% |
| Operating margin (before GW and except.) (%) | | (130.9%) | (27.7%) | (18.2%) | 3.2% | 6.7% |
| BALANCE SHEET | | | | | | |
| Fixed assets | | 1,182 | 1,321 | 1,134 | 1,101 | 1,101 |
| Intangible assets | | 0 | 611 | 672 | 612 | 612 |
| Tangible assets | | 1,182 | 710 | 462 | 489 | 489 |
| Investment in associates | | 0 | 0 | 0 | 0 | 0 |
| Unquoted investments | | 0 | 0 | 0 | 0 | 0 |
| Current assets | | 7,650 | 10,255 | 7,620 | 6,650 | 7,599 |
| Stocks | | 2,777 | 2,613 | 2,821 | 2,800 | 2,800 |
| Debtors | | 4,025 | 2,734 | 2,600 | 2,200 | 2,215 |
| Cash | | 848 | 4,908 | 2,199 | 1,650 | 2,583 |
| Other | | 0 | 0 | 0 | 0 | 0 |
| Current liabilities | | (6,009) | (3,500) | (2,858) | (1,700) | (1,842) |
| Creditors | | (1,726) | (661) | (543) | (300) | (342) |
| Other creditors | | (4,283) | (2,682) | (2,257) | (1,400) | (1,500) |
| Short-term borrowings | | 0 | (157) | (58) | 0 | 0 |
| Minority interests | | 0 | 0 | 0 | 0 | 0 |
| Long-term liabilities | | (224) | (35) | 0 | 0 | 0 |
| Long-term borrowings | | (213) | (34) | 0 | 0 | 0 |
| Other long-term liabilities | | (11) | (1) | 0 | 0 | 0 |
| Net assets | | 2,599 | 8,041 | 5,896 | 6,051 | 6,858 |
| CASH FLOW | | | | | | |
| Operating cash flow | | (10,448) | (5,413) | (3,088) | (191) | 1,108 |
| Net interest | | 658 | 225 | 150 | 65 | 100 |
| Tax | | 599 | 95 | 550 | (15) | (25) |
| Capex | | (424) | (112) | (149) | (350) | (250) |
| Acquisitions/disposals | | 0 | 387 | (65) | 0 | 0 |
| Financing | | 2,154 | 8,878 | (107) | 0 | 0 |
| Dividends | | 0 | 0 | 0 | 0 | 0 |
| Other | | 0 | 0 | 0 | 0 | 0 |
| Net cash flow | | (7,461) | 4,060 | (2,709) | (491) | 933 |
| Opening net debt/(cash) | | (16,561) | (635) | (4,717) | (2,141) | (1,650) |
| HP finance leases initiated | | 0 | 0 | 0 | 0 | 0 |
| Other | | (8,465) | 22 | 133 | 0 | 0 |
| Closing net debt/(cash) | | (635) | (4,717) | (2,141) | (1,650) | (2,583) |

Source: Company accounts/Edison Investment Research

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