RBS Morgans

Phylogica (PYC)

Great deal with a major pharma

PYC has inked its fourth significant major pharma deal. The Collaboration and Option agreement is with Janssen Biotech Inc which is part of the Johnson & Johnson group. The agreement is the broadest scope of any of the previous collaborations and could lead to the development of multiple products. Financial details are not disclosed, however we can deduce from the recent shareholder update that approx A$1.3m in upfront payment was received from Janssen. Together with cash reserves and the recent A$2m placement, PYC is well funded and we expect will achieve cash sustainability in FY13. Buy recommendation is maintained.

Buy

Important: The above recommendation has been made on a 12 month view and may not suit your investment needs or timeframe. The basis it is prepared on is summarised on the last page of this report.
PLEASE CONTACT YOUR ADVISER TO DISCUSS THIS GENERAL RECOMMENDATION BEFORE ACTING ON IT.

Low-Mod **Volatility**

TP A$0.093

PYC120118

RBS Refiner

Price (close 05 Jan)	A$0.04
6M high/low	A$0.077/0.032
Market cap	A$17.4m
Av (12M) turnover	A$1,65m
Freefloat	100.0%
Reuters	PYC.AX
Bloomberg	PYC.AU
Net debt (cash) 30 Sep	(A$3.3m)
3yr EPS CAGR 12-14F	na
Income (2013F div yield)	na

Source: Bloomberg

Key events

Date	Event
Feb-2012	1HFY12 results

Source: Bloomberg

Event

In early January, PYC announced a Collaboration and Option agreement with Janssen Biotech, Inc., the pharmaceutical unit of Johnson & Johnson, to discover new classes of drugs derived from PYC's Phylomer peptide platform. In the initial stage of the collaboration, PYC will identify cell-penetrating Phylomer peptides. Under the terms of the agreement, Janssen could develop multiple Phylomer-based drug candidates and has the option to expand the scope of the collaboration to include additional cell-specific Phylomers for the development of a further ten drug candidates. Under the terms of this multi-product agreement, PYC will receive an initial technology access fee as well as committed research funding for a minimum period of 18 months of the collaboration. Pending ongoing discussions with Janssen regarding commercial terms, PYC could receive research funding over several years, license fees, milestone payments and royalties on worldwide sales.

Based on the terms of PYC's other collaborations, we estimate that the upfront payment from Janssen may have exceeded A$1m. Furthermore, the total potential value of this multi-product collaboration with Janssen could be many multiples of the value of the Company's previously announced deals that covered single products, ie: multiples of the deal values with MedImmune ($100m) or Pfizer ($135m). Hence, we view this transaction as very positive for PYC.

Further catalysts to come and cash sustainability in FY13

PYC expects to sign two additional collaboration deals with large pharmaceutical companies in 2HFY12, as well as expand current collaborations with two of its existing partners. Following a recent capital raising and payments from its Pharma partners, we estimate PYC has A$4.8m in cash (including near-term trade debtors since the Janssen deal was signed on the last day of the quarter) at 31 December and is now well funded to achieve cash flow sustainability in FY13.

Valuation

We have made no changes to our valuation of A$0.093, which is based on a comparative company analysis. The key risk to our price target is a delay in securing collaborations with large pharmaceutical companies. The share price has been weak since the A$2m placement in December which is disappointing. However we believe the market has not fully appreciated the significance of the Janssen deal and once more detail around additional commercial terms are completed the share price will move closer to our valuation.

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Recap on Phylogica (PYC)

Phylogica (PYC) is a biopharmaceutical company engaged in the discovery and development of novel biopharmaceuticals directed at proteins and their interactions. It was incorporated in 2001 as a spin out from Telethon Institute for Child Health Research and Fox Chase Cancer Center. PYC has discovered and developed a unique proprietary class of targeted peptide therapeutics (Phylomer® peptides). These peptides exhibit competitive therapeutic, manufacturing, and commercial advantages over other more traditional targeted biologics such as proteins, monoclonal antibodies and most current therapeutic peptides. Its Phylomer® Libraries consist of protein fragments, which have been sourced from an evolutionary diverse range of bacterial genomes. These bacteria have been collected from diverse and often harsh environments, in which their genomes have been subject to intense natural selection to evolve the most stable protein structures that facilitate their survival. The average Phylomer is about 30 amino acids long.

Recent partnering agreements

PYC has a track record in securing licensors of its proprietary Phylomer® drug discovery platform, with the goal of screening and (ideally) identifying Phylomer peptides suitable for further evaluation.

PYC has signed four partnerships in the last 24 months with Janseen, Roche, AstraZeneca (MedImmune) and Pfizer. Typically, PYC's partnering agreements have up-front fees (~US$750k – US$1m per drug target), contract revenue screening for one year (~US$750k – US$1m), milestone payments (up to US$100m) and on-going royalties (single digit %). Recent partnering deals include:

- Jassen Biotech Inc – PYC signed with Jassen Biotech Inc in January 2012. A Collaboration and Option agreement has been signed, to discover new classes of drugs derived from PYC's Phylomer peptide platform. In the initial stage of the collaboration, PYC will identify cell-penetrating Phylomer peptides. Under the terms of the agreement, Janssen could develop multiple Phylomer-based drug candidates and has the option to expand the scope of the collaboration to include additional cell-specific Phylomers for the development of a further ten drug candidates. Under the terms of this multi-product agreement, PYC will receive an initial technology access fee as well as research funding over the first 18 months of the collaboration.

- Pfizer – PYC signed with Pfizer in December 2010. This partnership was focussed on the discovery of novel peptide vaccines in major disease areas. The deal terms included: an upfront technology access payment of US$500k; the option to license the deal structure; commercial license, discovery, preclinical, clinical and other milestone payments of up to US$134m; and royalties on worldwide sales.

- MedImmune (biologics unit of AstraZeneca) – PYC signed with MedImmune in August 2010. This partnership was focussed on the discovery of novel antibiotics against hospital-acquired infection. The deal terms included: an upfront payment of US$750k; additional US$750k in committed funding (now received); development and commercial milestone payments of up to US$98m; and royalties on worldwide sales.

- Roche – PYC signed with Roche in December 2009. This partnership is focussed on the discovery of new cell penetrating peptides. The first stage of this project was completed in October 2010. Then in February 2011, it was announced that the two companies were discussing the expansion of their collaboration to include in vivo studies for identification of unique Phylomer peptides that cross the blood-brain barrier. The objective of such delivery is Phylogica | to develop novel treatments for neurological disorders using biologics.

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Investment View – no changes to valuation

Setting a fundamental valuation based on traditional DCF methodology is difficult given the early stage nature of the collaborations making the forecasting of future cashflows from milestone payments and royalties quite subjective. We prefer to compare PYC with other broadly similar companies with screening libraries and have updated the market capitalisation to sales multiple as a better guide to setting our near term price target, refer Table 1. From our previous research note in August 2011, we have noted that the market capitalisation to sales multiple for our European comparative companies was 4.5x. Then based on our estimated revenue of A$5m for FY12, we value PYC at A$22.5m (5.1 cps), which we believe does not fully reflect the inherent value given further collaborations are expected within 6 months. Therefore we will apply a 80% (was 40%) premium to base valuation of 5.1cps, to maintain the valuation and price target of A$0.093. Table 2 sets out historical and forecast changes. Our valuation methods are by design, relatively simple which can be reworked quickly to reflect changes in sentiment, deal flow and broader industry developments. The key risk to our price target is a delay in securing collaborations with large pharmaceutical companies.

Table 1 : Market Capitalisation to sales Multiple

	Mkt Cap	Sales for CY10	Multiple
Morphosys	€423m	€87m	4.9
Evolva	CHF131m	CHF18m	7.3
Evotec	€225m	€55m	4.1
Galapagos	€161m	€101m	1.6
Phylogica	A$17m	A$5 (estimate for FY12)	**4.2**

Source: Medtrack and RBS Morgans

Table 2: Key forecasts

year to Jun	FY10A	FY11A	FY12F	FY13F	FY14F
Revenue (A$m)	0.6	2.2	5.0	7.5	10.0
Normalised net profit (A$m)[1]	(4.1)	(3.6)	(1.8)	0.3	1.5
Norm fully diluted EPS (c)[1]	(0.18)	(0.12)	(0.04)	0.00	0.01
Normalised EPS growth	na	na	na	na	na
Dividend per share (c)	0.0	0.0	0.0	0.0	0.0
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0
Normalised PE	na	na	na	58.0	11.6

Source: Company data, RBS forecasts

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EDWARD STREET	(07) 3121 5677		
EMERALD	(07) 4988 2777	**ACT**	
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IPSWICH	(07) 3202 3995	**VICTORIA**	
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GOSFORD	(02) 4325 0884		
HURSTVILLE	(02) 9570 5755	**NORTHERN TERRITORY**	
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NEUTRAL BAY	(02) 8969 7500		
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REGULATORY DISCLOSURES

RBS Morgans Corporate Limited was a Lead Manager to the Phylogica Limited share placement in December 2011 and received fees in this regard.

RECOMMENDATION STRUCTURE

For a full explanation of the recommendation structure, refer to our website at https://www.rbsmorgans.com/research_disclaimer.

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