

Universal Biosensors

Major Deal with LifeScan (J&J)



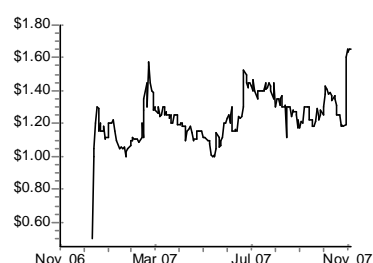
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\$1.65

BUY

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Price Performance



Security/Capital Details

ASX Code	UBI
Market Cap	\$266 M
Issued Shares	161.4 M
Avg Mth T'over	0.36 M
12 Mth High – Low	\$1.65 - \$0.50

Key Data/Ratios – FY 2007

EBITDA / Sales	N/A
EBIT / Sales	N/A
Net Debt / Equity	-78.2%
Interest Cover	x
ROE	-16.1%
EPS Growth	-15.3%
PEG Ratio	1.63 x
NTA / Share	\$ 0.40
DCF	\$ 2.26
12 Mth Price Target	\$ 2.60

BUY: Total return +10% or more over a 12 month period
HOLD: Total return expected to be between +10% to -10% over a 12-month period
SELL: Total return expected to be -10% or more over a 12 month period
TOTAL RETURN OR TSR = capital growth in share price + expected dividend yield in that period

Year to Dec	NPAT (Rep) \$M	EPS (Norm) c	EPS Growth %	PER x	P/CF x	EV/EBITDA x	DPS c	Div Yld %	Franking %
2006a	-2.9	-4.7		-35.5	-56.9	-78.7	0.0	0.0	0
2007e	-7.9	-5.4	-15.3	-30.8	-41.3	-27.7	0.0	0.0	0
2008e	-5.3	-3.3	39.4	-50.8	53.2	-54.4	0.0	0.0	0
2009e	9.7	6.0	285.5	27.4	25.8	16.7	0.0	0.0	0

Recommendation

We retain our **BUY** recommendation with a revised 12-month price target of **\$2.60** per share, following the signing of a Master Services and Supply Agreement with LifeScan Inc, a wholly owned subsidiary of Johnson & Johnson. We believe this deal validates UBI's technology, systems, and quality. It signifies to us that the technical development risk facing the company has been overcome, although there is still a small amount of regulatory risk to be overcome. As such we reduce our discount rate from 17% to 15% in our DCF valuation model. We believe there is upside risk to this valuation in the form of regulatory approval.

Key Points

UBI has announced that it has entered into an agreement with LifeScan – a wholly owned subsidiary of Johnson & Johnson – for the provision of certain services and products in the field of blood glucose monitoring. We view the signing of this agreement as a major validation of the company's technology, manufacturing process, and quality control procedures.

From LifeScan's point of view, UBI offers the opportunity to:

- Convert a large proportion of fixed costs to a variable cost base
- Re-build market share by concentrating on the merits of the product – i.e. improved accuracy and precision compared with competitor's products – while retaining the ability to acquire price leadership while maintaining margins
- Minimise risk in taking a new product to market. Given this is a new manufacturing process, but extremely scalable, one would expect LifeScan to structure an agreement of this kind to be back-ended in terms of payments to the counterparty. This is normal practice in the Life Sciences sector.

The company also intends raising \$30M-\$35M via a renounceable rights offer which we estimate will be at 120 cps. This capital is expected to be used to fund working capital requirements for the LifeScan deal, as well as further R&D for the PT and CRP projects.

We believe that the signing of this deal significantly reduces the risk facing the company. It signifies to us that the technical development risk facing the company has been overcome, although there is still a small amount of regulatory risk to be overcome. As such we reduce our discount rate from 17% to 15%. On the glucose product receiving either FDA approval or CE Mark, our discount rate would fall further, to around 13%.

On this basis and after making adjustments to our model we increase our valuation from \$1.70 per share to \$2.26 per share. This implies a 12-month price target of \$2.60. However, we would not be surprised if approval from at least major regulatory authority (either the FDA or CE Mark approval) is achieved within the next 12 months. In such a case, our valuation would increase to \$2.89, and a 12-month price target would be \$3.27 per share.



Signs Master Services and Supply Agreement with LifeScan Inc.

UBI has announced that it has entered into an agreement with LifeScan – a wholly owned subsidiary of Johnson & Johnson – for the provision of certain services and products in the field of blood glucose monitoring.

Under the agreement UBI will become a non-exclusive manufacturer of the test strips that were developed by UBI.

We view the signing of this agreement as a major validation of the company's technology, manufacturing process, and quality control procedures.

What does the deal mean for UBI?

One needs to appreciate the issues facing LifeScan to determine the merits of the deal. We believe LifeScan is losing market share in the glucose market – mainly due to the high fixed cost nature of manufacturing their current range of glucose strips, and better accuracy and precision from competitor's products. It must be remembered that all current strip manufacturing systems suffer from high a fixed cost base.

From LifeScans point of view, UBI offers the opportunity to:

- Convert a large proportion of fixed costs to a variable cost base
- Re-build market share by concentrating on the merits of the product – i.e. improved accuracy and precision compared with competitor's products – while retaining the ability to acquire price leadership while maintaining margins
- Minimise risk in taking a new product to market. Given this is a new manufacturing process, but extremely scaleable, one would expect LifeScan to structure an agreement of this kind to be back-ended in terms of payments to the counterparty. This is normal practice in the Life Sciences sector.

Our understanding of the deal and assumptions on the main issues in the face of scant information include:

- Upfront fee in the range of US\$2M-US\$3M on signing of the agreement. Management have confirmed that an upfront fee will be paid, but timing and value have not been disclosed.
- Payments to UBI when LifeScan achieves regulatory milestones in specified jurisdictions. While these jurisdictions or value of potential payments are not disclosed, it is reasonable to assume that the major jurisdictions are the US (FDA approval), Europe (CE Mark) and Canada, as these probably represent the largest markets for LifeScan. Payments are likely to be of a magnitude similar to that of the upfront payment.
- Payments for manufacture of the initial glucose strip, and payments for initial set of services calculated with reference to the number of strips sold to LifeScan.
 - We believe this is the area in which LifeScan would probably want to minimise risk as much as possible – as discussed above. As such it is reasonable to assume that LifeScan's success would be shared with UBI – as emphasised by UBI's chairman on numerous occasions. We believe this will result in decreased unit selling prices by UBI as sales volumes increase, but increasing service fees as volumes increase.

Sales Scenarios and Valuation

Based on our research we estimate that the strip market is growing by some 9% p.a. in the US. The entire glucose monitoring market in the US is estimated to be

worth approximately US\$4B, and strips account for 85% of this, i.e. US\$3.4B.

In 2004, it was estimated that LifeScan's share of the US strip market was 37%, i.e. US\$1.25B. This equates to around 1.74B strips in 2004. (Total US market in 2004 is estimated at 4.7B strips). We believe that since 2004, LifeScan has been losing market share, to the degree that on a global basis, the company's market share is around 25%. The US is estimated to account for around 65% of global demand, resulting in estimated global demand for strips to be approximately 7.2B strips p.a.

We estimate UBI's current capacity to be around 250M strips p.a., i.e. of the order of 3.5% of global demand.

We have modelled three scenarios for valuing the company. In all cases we assume LifeScan achieves either FDA or CE Mark approval in 2008, allowing them to begin selling product in the last quarter of 2008. A best case scenario allows for UBI to reach maximum production capacity with its current equipment 2 years post-launch, i.e., towards the end of 2010.

Assumed capacity utilisation under the scenarios for glucose is shown in Table 1.

Table 1: Valuation Scenarios

	Scenario	% utilisation						
		2008	2009	2010	2011	2012	2013	2014
	Best	40%	70%	80%	80%	70%	75%	80%
	Base	20%	35%	40%	40%	50%	50%	50%
	Worst	10%	15%	20%	20%	15%	15%	15%
Capacity (M strips p.a.)		250	750	750	750	1500	1500	1500
Pdtn (M strips p.a.)	Best	100	525	600	600	1050	1125	1200
	Base	50	262.5	300	300	750	750	750
	Worst	25	112.5	150	150	225	225	225

Source: WHTM

The resulting DCF valuations based on various discount rates and a 2% perpetuity are shown in Table 2.

Table 2: DCF Valuations

Discount rate	Best scenario (\$/share)	Base scenario (\$/share)	Worst scenario (\$/share)
13%	3.64	2.89	2.07
14%	3.22	2.55	1.82
15%	2.87	2.26	1.61
16%	2.57	2.02	1.43
17%	2.31	1.82	1.28
18%	2.09	1.64	1.15
19%	1.90	1.48	1.04
20%	1.73	1.35	0.94

Source: WHTM

Other assumptions include:

- PT and CRP tests are approved for marketing in 2010, and gross margins for these products are approximately 95% each
- Gross margin for the glucose strip are of the order of 50%. We believe this is low, but due to lack of information regarding cost of goods, and the split between revenue per strip and a service fee, we have deliberately taken a conservative stance.

Our model does not attempt to differentiate between any geographic markets, and therefore assumes a constant price. All revenues and costs are assumed to be in US\$, and converted into A\$ at a rate of A\$/US\$ of 90 cents.

We believe that the signing of this deal significantly reduces the risk facing the company. It signifies to us that the technical development risk facing the company has been overcome, although there is still a small amount of regulatory risk to be overcome.

As such we reduce our discount rate from 17% to 15%. On the glucose product receiving either FDA approval or CE Mark, our discount rate would fall further, to around 13%. Major changes we made to our model include assuming that UBI now enters the global market for glucose, as the agreement is a "global master agreement", and changing the A\$/US\$ exchange rate from 70 cents to 90cents.

On this basis and after making adjustments to our model we increase our valuation from \$1.70 per share to \$2.26 per share. This implies a 12-month price target of \$2.60. However, we would not be surprised if approval from at least major regulatory authority (either the FDA or CE Mark approval) is achieved within the next 12 months. In such a case, our valuation would increase to \$2.89, and a 12-month price target would be \$3.27 per share.

There are however risks facing the company. These revolve around development of the C-Reactive Protein (CRP) and Prothrombin Time test strips, as well as acceptance of the CRP test as a marker for cardiac disease.

Rights Offer

The company has also announced that it intends raising \$30M-\$35M via a renounceable rights offer. The shares will be issued at the 5 day VWAP ending on 29 October 2007, which we estimate to be around 120 cps. The funds are expected to be used for working capital and to fund further development of the prothrombin time test (PT) and C-Reactive protein test strips. Further details of the rights issue have yet to be disclosed. However, our valuation assumes the rights offer has taken



place – i.e. the valuation reflects the diluted value.

UBI's Technology

UBI's technology allows it to manufacture electrochemical test strips at a fraction of the cost of conventional methods. It is applicable to a wide range of point-of-care (PoC) diagnostic tests.

We consider the lower cost of manufacture to be a key value driver for UBI, as it opens the way for the company to develop new PoC markets. PoC offers significant advantages over conventional pathology laboratory testing. These include:

- Real-time analysis
- Immediate clinical decision making

The benefits these advantages impart are substantial and include:

- Quicker and more effective response to clinical need
- Longer periods within a therapeutic range. The best example of this is the treatment of blood clots. Patients at risk are typically being treated with warfarin on a chronic basis. Too much warfarin, and they run the risk of internal bleeding. Too little warfarin, and the patient is still at risk of developing blood clots. As such, the PT test should be readily accepted in the market.

The above points lead to improved clinical outcomes, which in turn lead to improved economic outcomes.

Universal Biosensors (UBI : \$1.65)

INVESTMENT FUNDAMENTALS

Yr Ending Dec	2005A	2006A	2007E	2008E	2009E
EPS Reported (c)		-4.5	-5.4	-3.3	6.0
EPS Normalised (c)		-4.7	-5.4	-3.3	6.0
EPS Growth (%)	N/A	N/A	-15.3%	39.4%	285.5%
PER Normalised (x)		-35.5	-30.8	-50.8	27.4
DPS (c)	0.0	0.0	0.0	0.0	0.0
Payout (%)		0.0%	0.0%	0.0%	0.0%
Yield (%)		0.0%	0.0%	0.0%	0.0%
Franking (%)	0%	0%	0%	0%	0%

VALUATION DATA

Yr Ending Dec	2005A	2006A	2007E	2008E	2009E
EV / EBITA (x)		-65.7	-25.2	-40.9	18.4
EV / EBITDA (x)		-78.7	-27.7	-54.4	16.7
CFPS (c)		-2.9	-4.0	3.1	6.4
Price / CF		-56.9	-41.3	53.2	25.8
Book Value / Share (\$)		0.3	0.4	0.4	0.4
Price / Book (x)		6.2	4.1	4.5	3.8

PROFIT & LOSS (\$m)

Yr Ending Dec	2005A	2006A	2007E	2008E	2009E
Sales Revenue	0.0	0.0	0.0	4.4	31.1
EBITDA	0.1	-2.3	-7.8	-3.9	12.6
Depreciation	0.3	0.5	0.8	1.3	1.1
EBITA	-0.2	-2.8	-8.6	-5.3	11.4
Amortisation	0.0	0.0	0.0	0.0	0.0
EBIT	-0.2	-2.8	-8.6	-5.3	11.4
Net Interest Expense	0.0	0.0	-0.8	0.0	0.0
Pre-tax Profit	-0.2	-2.7	-7.8	-5.3	11.4
Tax	0.0	0.2	0.0	0.0	1.7
Tax rate (%)	0.0%	-8.0%	-0.3%	0.0%	15.0%
Minorities / pref divs	0.0	0.0	0.0	0.0	0.0
Equity accounted NPAT	0.0	0.0	0.0	0.0	0.0
Net Profit	-0.2	-2.9	-7.9	-5.3	9.7
Abn's / Extraord's	0.0	0.0	0.0	0.0	0.0
Reported Net Profit	-0.2	-2.9	-7.9	-5.3	9.7
Revenue Growth (%)	N/A	N/A	N/A	N/A	600.1%
EBIT Growth (%)	N/A	-	-211.2%	39.0%	318.0%
NPAT Growth (%)	N/A	-	-172.8%	33.3%	285.3%

PROFITABILITY RATIOS

Yr Ending Dec	2005A	2006A	2007E	2008E	2009E
EBIT / Sales (%)				-118.1%	36.8%
ROA (%)	N/A	-74.3%	-70.8%	-31.0%	57.3%
ROE (%)	N/A	-16.9%	-16.1%	-8.6%	15.4%
ROFE (%)	N/A	-114.0%	-91.9%	-52.3%	128.1%

INTERIMS (\$m)

Half Yr	Jun 06	Dec 06	Jun 07	Dec 07	Jun 08
Yr Ending Dec	1H A	2H A	1H A	2H E	1H E
Sales Revenue	0.0	0.0	0.0	0.0	2.2
EBIT	-1.2	-1.6	-4.6	-4.0	-2.5
Net Profit	-1.2	-1.7	-3.9	-4.0	-2.5
EBIT / Sales (%)					-112.5%

BALANCE SHEET (\$m)

Yr Ending Dec	2005A	2006A	2007E	2008E	2009E
Cash	0.0	29.2	49.6	52.1	56.3
Receivables	0.0	0.0	0.0	0.2	1.6
Inventories	0.0	0.0	0.0	0.4	3.1
Other	0.0	0.6	0.0	0.0	0.0
Current Assets	0.0	29.8	49.6	52.7	61.0
Net PPE	0.0	6.8	15.0	16.3	17.6
Investments	0.0	0.0	0.0	0.0	0.0
Intangibles	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	1.9	0.0	0.7
Non-current Assets	0.0	6.8	16.9	16.3	18.3
Total Assets	0.0	36.7	66.5	69.0	79.3
Current Payables	0.0	1.5	3.0	1.9	7.7
Current Debt	0.0	0.0	0.0	0.0	0.0
Non-Current Debt	0.0	0.0	0.0	0.0	0.0
Provisions	0.0	0.2	0.0	8.8	3.6
Other	0.0	0.9	0.0	0.0	0.0
Total Liabilities	0.0	2.6	3.0	10.8	11.3
Equity	0.0	36.3	73.2	73.2	73.2
Reserves	0.0	0.5	0.7	0.7	0.7
Retained Profits	0.0	-2.7	-10.3	-15.6	-5.9
Minorities	0.0	0.0	0.0	0.0	0.0
Total Equity	0.0	34.1	63.5	58.2	68.0
Total Funds Employed	0.0	4.9	13.9	6.2	11.7

LIQUIDITY & LEVERAGE RATIOS

Yr Ending Dec	2005A	2006A	2007E	2008E	2009E
Net Debt (Cash) (\$m)	0.0	-29.2	-49.6	-52.1	-56.3
Net Debt / Equity (%)		-85.8%	-78.2%	-89.4%	-82.8%
Interest Cover (x)					
Debt / CashFlow (x)	0.0	0.0	0.0	0.0	0.0

CASHFLOW (\$m)

Yr Ending Dec	2005A	2006A	2007E	2008E	2009E
EBIT	-0.2	-2.8	-8.6	-5.3	11.4
Dep'n and Amort'n	0.3	0.5	0.8	1.3	1.1
Net Int Rec'd (Paid)	0.0	0.0	0.8	0.0	0.0
Tax Paid	0.0	0.0	0.2	0.0	0.0
Dec / (Inc) W'kg Cap	0.0	-0.4	0.0	-2.0	-8.0
Other	0.2	0.8	1.0	10.9	5.7
Operating Cash Flow	0.3	-1.9	-5.9	5.0	10.3
Capital Expenditure	-0.3	-4.1	-7.6	-2.6	-6.1
Asset Sales	0.0	0.0	0.0	0.0	0.0
Investments	0.0	0.0	0.0	0.0	0.0
Other Inv. Flows	0.0	0.0	0.0	0.0	0.0
Investing Cash Flow	-0.3	-4.1	-7.6	-2.6	-6.1
Equity Raised	0.0	30.8	35.0	0.0	0.0
Inc / (Dec) in Loans	0.0	0.0	0.0	0.0	0.0
Dividends Paid	0.0	0.0	0.0	0.0	0.0
Other Fin. Flows	0.0	0.0	-1.8	0.0	0.0
Financing Cash Flow	0.0	30.8	33.3	0.0	0.0
Net Cash Flow	0.1	24.8	19.8	2.4	4.2

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