

Mesoblast

Buy

Absolute performance

n/a

Short term (0-60 days)
Pharmaceuticals & Biotechnology
Australia
Price

A\$0.74

Target price

A\$1.50 (from A\$2.20)

Market capitalisation

A\$79.71m (US\$74.15m)

Avg (12mth) daily turnover

A\$0.12m (US\$0.10m)

Reuters

MSB.AX

Bloomberg

MSB AU

Two of a kind

MSB has recently released two items that continue to confirm the long-term potential of the business: positive results of its spinal fusion trial; and good results of its osteoarthritis of the knee trial. Buy maintained.

Key forecasts

	FY06A	FY07A	FY08F	FY09F	FY10F
EBITDA (A\$m)	-6.75	-7.90	-9.05 ▼	-9.68 ▼	0.27 ▼
Reported net profit (A\$m)	-8.30	-8.73	-10.4	-10.9	-1.47 ▼
Normalised net profit (A\$m) ¹	-8.30	-8.73	-10.4	-10.9	-1.47 ▼
Normalised EPS (c) ¹	-8.87	-8.20	-9.64	-8.44 ▲	-0.98
Normalised EPS growth (%)	498.2	-7.61	17.6	-12.5	-88.4
Dividend per share (c)	0.00	0.00	0.00	0.00	0.00
Dividend yield (%)	0.00	0.00	0.00	0.00	0.00
Normalised PE (x)	n/m	n/m	n/m	n/m	n/m
EV/EBITDA (x)	n/m	n/m	n/m	n/m	202.2
Price/net oper. CF (x)	-21.7	-9.65	-9.06 ▲	-10.4 ▼	20.5 ▲
ROIC (%)	-115.5	-135.7	-74.8	-51.0	-3.40

1. Pre non-recurring items and post preference dividends

Accounting Standard: IFRS

Source: Company data, ABN AMRO forecasts

year to Jun, fully diluted

MSB - the adult mesenchymal precursor cell company

MSB aims to capitalise on its patents that relate to the identification, extraction and culture of adult mesenchymal precursor cells (MPCs). MPCs can become any type of cell. MSB hopes to develop treatments for bone, joint and cardiovascular diseases.

MSB to accelerate Phase II spinal fusion trial

Recently, MSB announced that it would accelerate its clinical trial timetable, with the aim of commencing a Phase III clinical trial by mid-CY09. This is because no adverse effects have been noted in the five months of follow-up of the patients within this spinal fusion trial. A successful accelerated trial program should lead to an earlier-than-expected US Food and Drug Administration (FDA) submission process for a spinal intervertebral fusion product, which includes MSB's allogeneic stem cells.

Positive result of osteoarthritis trial

MSB's allogeneic cells were safe and effective over a wide range of doses tested at three, six and 12 months against osteoarthritis of the knee. The dose which showed maximal effectiveness and superiority over hyaluronic acid alone in protecting cartilage at three months continued to show superiority for between six and 12 months. On the basis of these results, Mesoblast will proceed to commence its Phase II clinical trial program for cartilage protection in patients with osteoarthritis of the knee.

Buy maintained, price target decreased to A\$1.50

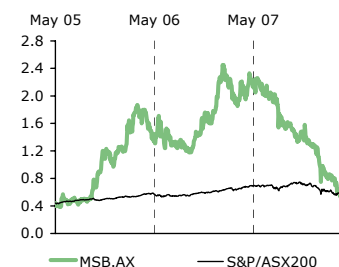
We believe this reinforces the potential value of the MSB technology, but have not changed our forecasts on the back of this news. We have also updated our forecasts in line with the release of the 3QFY08 result. In line with this, and with the change in ABN Amro's risk-free rate to 6.25% (from 5.75%), our valuation and 12-month target price for MSB has decreased 32% to A\$1.50. We continue to believe MSB is most likely to partner with an orthopaedic firm to take MPC to market. Should the technology prove scaleable, we believe MSB may become an acquisition target for an orthopaedic company.

Important disclosures can be found in the Disclosures Appendix.

Priced at close of business 30 April 2008. Use of ▲ ▼ indicates that the line item has changed by at least 5%.

Price performance (1M) (3M) (12M)

	1M	3M	12M
Price (A\$)	0.6	1.0	2.2
Absolute %	23.3	-24.5	-65.6
Rel market %	17.7	-23.0	-62.2
Rel sector %	20.4	-19.0	-59.9



Stock borrowing: Easy onshore,

Impossible offshore

Volatility (30-day): 93.65%

Volatility (6-month trend): ↑

52-week range: 2.39-0.51

S&P/ASX200: 5606.90

BBG AP Pharm & Biotech: 145.53

Source: ABN AMRO, Bloomberg

Analysts

Dr David Stanton
Zara Lyons

MSB - the adult mesenchymal precursor cell company

MSB aims to capitalise on its patents that relate to the identification, extraction and culture of adult mesenchymal precursor cells (MPCs). MPCs can become any type of cell. MSB hopes to develop treatments for bone, joint and cardiovascular diseases. We have also updated our forecasts in line with the release of the 3QFY08 result. The results of our changes to forecasts are shown below.

Table 1 : Changes to forecasts

	FY08F			FY09F			FY10F		
	Prev	Rev	Diff	Prev	Rev	Diff	Prev	Rev	Diff
EBIT (A\$m)	-8.6	-9.1	-0.5	-9.2	-9.7	-0.5	0.0	-0.6	-0.5
NPAT (A\$m)	-10.0	-10.4	-0.4	-10.6	-10.9	-0.3	-1.1	-1.5	-0.3
EPS (c)	-9.3	-9.6	-0.4	-8.8	-8.4	0.4	-0.9	-1.0	-0.1
DPS (c)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net op cash flow (A\$m)	-8.5	-9.2	-0.7	-9.1	-9.7	-0.6	5.1	4.6	-0.6

Source: Company data, ABN AMRO forecasts

MSB to accelerate Phase II spinal fusion trial

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Positive result of osteoarthritis trial

MSB's allogeneic cells were safe and effective over a wide range of doses tested at three, six and 12 months against osteoarthritis of the knee. The dose which showed maximal effectiveness and superiority over hyaluronic acid alone in protecting cartilage at three months continued to show superiority for between six and 12 months. On the basis of these results, Mesoblast will proceed to commence its Phase II clinical trial program for cartilage protection in patients with osteoarthritis of the knee.

Key outlook takeaways

- Strong growth rates predicted in volume and pricing of bone-graft technology** – Our analysis of bone-graft technology suggests pricing for these products will remain strong, driven by a lack of supply in a market with high barriers to entry. Indeed, discussions with industry contacts suggest that in a revision joint replacement, a bone-graft substitute is the most expensive piece of equipment used. The current price is A\$10,000 for a 10cc vial, and up to two vials of bone-graft substitute may be used in a single revision joint replacement.
- Free upside from heart research** – In developing our valuation for MSB, we have excluded any valuation of the company's development of a product to improve heart function. MSB's adult stem cells have been shown to result in significant improvement of heart function and to prevent heart-failure progression after heart attack. It is estimated that about 1m patients visit hospitals in the US each year with a heart attack.
- Strong levels of cash** – As at 30 March 2008, MSB has a net cash position of A\$15.6m. Going forward, we believe the cash requirements are likely to continue for MSB and may increase. At the rate of cash burn, and without further infusions

of cash, this suggests MSB has enough cash to continue operations for the next 18 to 24 months. After that time, the company may conduct another capital raising or might have secured funding from a partner. Based on our current rate of cash burn, we have factored in MSB conducting a A\$20m equity raising in 2H09.

- **Strong levels of IP protection** – We believe MSB’s principal US patent is 7,122,178. This was issued on 17 October 2006 after first being filed on 7 July 2000. Hence, we believe the patent will not expire in the US before 2020. The patent relates to MPCs and is a method of enriching the cells, including the step of enriching for cells based on at least two markers. Recent advances have led to the development of novel monoclonal antibodies (MAbs), which recognise antigens on MPCs. MSB has developed and patented an identifying antibody for MPCs.
- **There are other opportunities in cartilage regeneration** – Going forward, we believe MPC technology can be applied to types of cells other than bone and cardiac muscle. We continue to see opportunities for MSB’s technology in cartilage regeneration, to name just one potential application.

Buy maintained, price target decreased to A\$1.50

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On an industry-wide basis, the chances of getting a product to market from the Phase II stage are in the order of 30%. The reasons for this low rate are numerous. As a result, we believe the risk that MSB will be unable get a product to market is not inconsiderable. MSB’s patent position is strong, but we think the company is unlikely to be cash flow positive before 2011. Hence, we believe MSB is an investment opportunity for investors with a higher risk appetite. Our updated timeline for MSB’s opportunities is shown below.

Table 2 : Timeline and probability of MSB’s opportunities

Trial stage	Preclinical	Investigational New Drug application	Phase II trials	Clinical III trials
General time until cashflow	7 years+	5-7 years	3-5 years	1-2 years
General probability of product getting to market	c10%	c10-20%	c30%	c70%
Cost of trials	cA\$1m	cA\$2-3m	cA\$10m	cA\$50m
MSB products - indications and stages of development				
Spinal Fusion				
Long bone fractures				
Congestive Heart failure (via Angioblast)				
Heart attack (via Angioblast)				
Osteoarthritis knee				
Knee cartilage tears				
Peripheral arterial disease (via Angioblast)				
Other indications				

Source: Company data, ABN AMRO estimates

Finally, we enclose our valuation methodology for MSB.

Table 3 : MSB – financial summary

Metric	Weight	Valuation (A\$ per share)	Blended (A\$ per share)
P/E Valuation	0%		\$0.00
EV/EBITDA Valuation	0%		\$0.00
DCF Valuation	100%	\$1.55	\$1.55
Blended Equity Valuation	100%		\$1.55
Target Price			\$1.50

Source: ABN AMRO estimates

MSB – financial summary

Year to 30 Jun (A\$m)	AIFRS 2006A	AIFRS 2007A	AIFRS 2008F	AIFRS 2009F	AIFRS 2010F	Closing price (A\$)	0.74	Price target (A\$)	1.50				
Income statement						Valuation metrics							
Divisional sales	0.0	0.0	0.0	0.0	16.6	Preferred methodology	DCF	Val'n (A\$)	\$ 1.50				
Total revenue	2.2	0.7	0.2	0.2	16.8	DCF valuation inputs							
EBITDA	-6.8	-7.9	-9.0	-9.7	0.3	Rf	6.25%	10-year rate	6.25%				
Associate income	-1.9	-1.7	-1.7	-1.7	-1.7	Rm-Rf	4.50%	Margin	2.0%				
Depreciation	-0.1	-0.1	0.0	0.0	-0.8	Beta	1.50	Kd	8.25%				
EBITA	-6.9	-8.0	-9.1	-9.7	-0.6	CAPM (Rf+Beta(Rm-Rf))	13.0%	Ke	13.0%				
Amortisation/impairment	0.0	0.0	0.0	0.0	0.0	E/EV*Ke+D/EV*Kd(1-t)	NPV cash flow (A\$m)			155.3			
EBIT	-6.9	-8.0	-9.1	-9.7	-0.6	Equity (E/EV)	100.0%	Minority interest (A\$m)	0.0				
EBIT(incl associate profit)	-8.8	-9.7	-10.8	-11.4	-2.3	Debt (D/EV)	0.0%	Net debt (A\$m)	-12.1				
Net interest expense	0.4	0.9	0.4	0.6	0.8	Interest rate	8.25%	Investments (A\$m)	0.0				
Pre-tax profit	-8.3	-8.7	-10.4	-10.9	-1.5	Tax rate (t)	30.0%	Equity market value (A\$m)	167.4				
Income tax expense	0.0	0.0	0.0	0.0	0.0	WACC	13.0%	Diluted no. of shares (m)	107.7				
After-tax profit	-8.3	-8.7	-10.4	-10.9	-1.5	DCF valuation (A\$)				1.55			
Minority interests	0.0	0.0	0.0	0.0	0.0	Multiples				2007A	2008F	2009F	2010F
NPAT pre significant items	-8.3	-8.7	-10.4	-10.9	-1.5	Enterprise value (A\$m)	67.1	68.7	58.1	53.5			
Significant items	0.0	0.0	0.0	0.0	0.0	EV/Sales (x)				3.2			
Reported NPAT	-8.3	-8.7	-10.4	-10.9	-1.5	EV/EBITDA (x)	-8.5	-7.6	-6.0	200.2			
Cash flow statement						EV/EBIT (x)				-8.4	-7.6	-6.0	-93.6
EBITDA	-6.8	-7.9	-9.0	-9.7	0.3	PE (normalised) (x)	-9.0	-7.6	-8.7	-75.0			
Change in working capital	0.0	0.0	-0.1	0.0	4.3	PEG (normalised) (x)							
Net interest (pd)/rec	0.6	0.9	0.4	0.6	0.8	At target price				2007A	2008F	2009F	2010F
Taxes paid	0.0	0.0	0.0	0.0	0.0	EV/EBITDA (x)	-18.9	-16.7	-14.5	508.6			
Other oper cash items	0.0	0.0	0.0	0.0	0.0	PE (normalised) (x)	-18.3	-15.6	-17.8	-153.1			
Cash flow from ops (1)	-3.2	-8.2	-8.8	-9.1	5.4	Comparable company data (x)				2008F	2009F	2010F	
Capex (2)	0.0	-0.1	-0.1	0.0	-0.8	Alchemia	EV/EBITDA	-4.8	-37.4	1.4			
Disposals/(acquisitions)	-4.1	-3.9	-6.6	-0.2	0.0	Year to 30 Jun	EV/EBIT	-4.1	-16.0	1.5			
Other investing cash flow	0.1	-0.3	0.3	0.0	0.0		PE	-5.0	-22.6	1.3			
Cash flow from invest (3)	-4.1	-4.3	-6.4	-0.2	-0.8	pep.ax	PEG	-1.4	-6.5	0.4			
Incr/(decr) in equity	0.0	16.8	13.6	20.0	0.0	Year to acl.ax	EV/EBITDA						
Incr/(decr) in debt	0.0	0.0	0.0	0.0	0.0		EV/EBIT						
Ordinary dividend paid	0.0	0.0	0.0	0.0	0.0		PE						
Preferred dividends (4)	0.0	0.0	0.0	0.0	0.0		PEG						
Other financing cash flow	0.0	0.0	0.0	0.0	0.0	Per share data				2007A	2008F	2009F	2010F
Cash flow from fin (5)	0.0	16.8	13.6	20.0	0.0	No. shares	107.7	107.7	149.7	149.7			
Forex and disc ops (6)	0.0	0.0	0.0	0.0	0.0	EPS (cps)	-8.2	-9.6	-8.4	-1.0			
Inc/(decr) cash (1+3+5+6)	-7.2	4.3	-1.6	10.7	4.6	EPS (normalised) (c)	-8.2	-9.6	-8.4	-1.0			
Equity FCF (1+2+4)	-3.2	-8.3	-8.9	-9.1	4.6	Dividend per share (c)	0.0	0.0	0.0	0.0			
Balance sheet						Dividend payout ratio (%)				0.0	0.0	0.0	0.0
Cash & deposits	7.9	12.1	10.4	21.1	25.7	Dividend yield (%)	0.0	0.0	0.0	0.0			
Trade debtors	0.2	0.5	0.1	0.1	11.8	Growth ratios				2007A	2008F	2009F	2010F
Inventory	0.0	0.0	0.0	0.0	0.0	Sales growth	na	na	na	na			
Investments	7.5	7.7	14.1	14.3	14.3	Operating cost growth	17.0%	14.5%	7.0%	68.8%			
Goodwill	0.0	0.0	0.0	0.0	0.0	EBITDA growth	17.0%	14.5%	7.0%	^MISSING			
Other intangible assets	0.8	0.8	1.0	1.0	1.0	EBITA growth	15.8%	13.8%	7.0%	-94.1%			
Fixed assets	0.0	0.2	0.2	0.2	0.2	EBIT growth	15.8%	13.8%	7.0%	-94.1%			
Other assets	0.0	0.0	0.0	0.0	0.0	Norm. NPAT growth (pre GW)	5.2%	19.0%	4.6%	-86.5%			
Total assets	16.4	21.2	25.9	36.7	52.9	Norm. NPAT growth	5.2%	19.0%	4.6%	-86.5%			
Short-term borrowings	0.0	0.0	0.0	0.0	0.0	Norm. EPS growth (pre GW)	-7.6%	17.6%	-12.5%	-88.4%			
Trade payables	4.4	0.7	0.2	0.2	16.1	Norm. EPS growth	-7.6%	17.6%	-12.5%	-88.4%			
Long-term borrowings	0.0	0.0	0.0	0.0	0.0	Operating performance				2007A	2008F	2009F	2010F
Provisions	0.0	0.0	0.0	0.0	0.0	Asset turnover (%)	0.0	0.0	0.0	9.3			
Other liabilities	0.0	0.0	2.0	3.7	5.4	EBITDA margin (%)	na	na	na	1.6			
Total liabilities	4.4	0.7	2.1	3.8	21.5	EBIT margin (%)	na	na	na	-3.4			
Preference shares						Net profit margin (%)	na	na	na	-8.8			
Hybrid equity	0.0	0.0	0.0	0.0	0.0	Return on net assets (%)	-38.8	-38.2	-29.5	-1.8			
Share capital	20.7	37.4	51.0	71.0	71.0	Net debt (A\$m)	-12.1	-10.4	-21.1	-25.7			
Other reserves	1.1	1.6	1.6	1.6	1.6	Net debt/equity (%)	-58.7	-44.0	-64.2	-81.7			
Retained earnings	-9.8	-18.5	-28.9	-39.7	-41.2	Net interest/EBIT cover (x)	8.5	23.0	17.6	0.7			
Other equity	0.0	0.0	0.0	0.0	0.0	ROIC (%)	-135.7	-74.8	-51.0	-3.4			
Total equity	12.0	20.5	23.8	32.9	31.4	Internal liquidity				2007A	2008F	2009F	2010F
Minority interest	0.0	0.0	0.0	0.0	0.0	Current ratio (x)	18.0	5.0	5.5	1.7			
Total shareholders' equity	12.0	20.5	23.8	32.9	31.4	Receivables turnover (x)	na	0.0	0.0	2.8			
Total liabilities & SE	16.4	21.2	25.9	36.7	52.9	Payables turnover (x)	na	21.1	61.0	2.0			

Source: Company data, ABN AMRO estimates

Recommendation structure

Absolute performance, short term (trading) recommendation: A Trading Buy recommendation implies upside of 5% or more and a Trading Sell indicates downside of 5% or more. The trading recommendation time horizon is 0-60 days. For Australian coverage, a Trading Buy recommendation implies upside of 5% or more from the suggested entry price range, and a Trading Sell recommendation implies downside of 5% or more from the suggested entry price range. The trading recommendation time horizon is 0-60 days.

Absolute performance, long term (fundamental) recommendation: The recommendation is based on implied upside/downside for the stock from the target price. A Buy/Sell implies upside/downside of 10% or more and a Hold less than 10%. For listed property trusts (LPT) or real estate investment trusts (REIT) the recommendation is based upon the target price plus the dividend yield, ie total return. This structure applies to research on Asian and European stocks published from 1 November 2005; on Australian stocks from 7 November 2006; on continental European small and mid cap stocks from 23 November 2006; and on Brazilian stocks from 18 June 2007.

Performance parameters and horizon: Given the volatility of share prices and our pre-disposition not to change recommendations frequently, these performance parameters should be interpreted flexibly. Performance in this context only reflects capital appreciation and the horizon is 12 months.

Sector relative to market: The sector view relative to the market is the responsibility of the strategy team. Overweight/Underweight implies upside/downside of 10% or more and Neutral implies less than 10% upside/downside.

Target price: The target price is the level the stock should currently trade at if the market were to accept the analyst's view of the stock and if the necessary catalysts were in place to effect this change in perception within the performance horizon. In this way, therefore, the target price abstracts from the need to take a view on the market or sector. If it is felt that the catalysts are not fully in place to effect a re-rating of the stock to its warranted value, the target price will differ from 'fair' value.

Asset allocation: The asset allocation is the responsibility of the economics team. The recommended weight (Over, Neutral and Under) for equities, cash and bonds is based on a number of metrics and does not relate to a particular size change in one variable.

Stock borrowing rating: The stock borrowing rating is the subjective view and responsibility of the ABN AMRO equity finance team: Easy implies ready availability. Moderate implies some availability. Hard implies availability is tight. Impossible implies no availability.

Distribution of recommendations

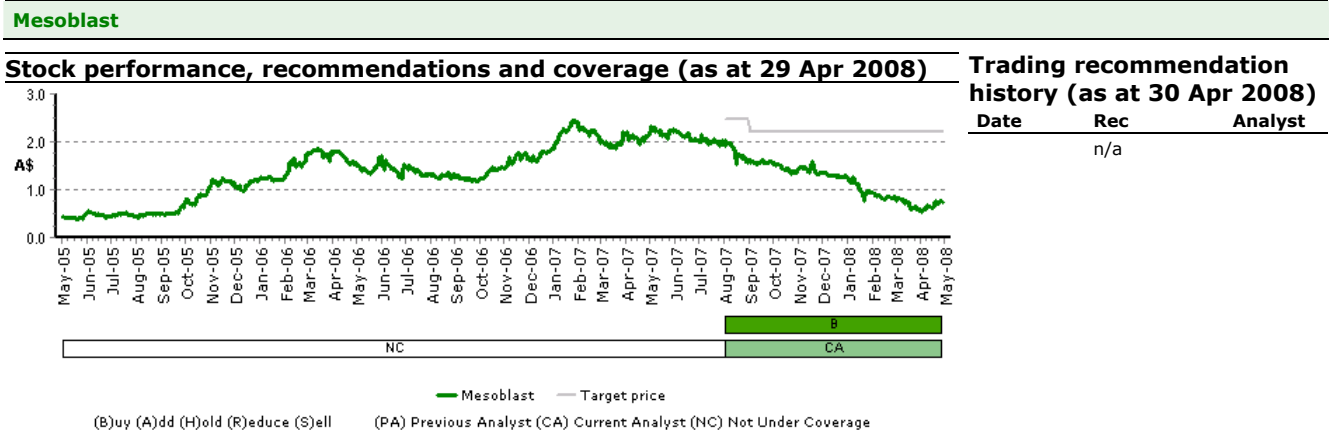
The tables below show the distribution of ABN AMRO's recommendations (both long term and trading). The first column displays the distribution of recommendations globally and the second column shows the distribution for the region. Numbers in brackets show the percentage for each category where ABN AMRO has an investment banking relationship.

Long Term recommendations (as at 30 Apr 2008)		
	Global total (IB%)	Asia Pacific total (IB%)
Buy	572 (5)	372 (1)
Add	0 (0)	0 (0)
Hold	422 (2)	245 (0)
Reduce	0 (0)	0 (0)
Sell	85 (0)	56 (0)
Total (IB%)	1079 (3)	673 (0)

Trading recommendations (as at 30 Apr 2008)		
	Global total (IB%)	Asia Pacific total (IB%)
Trading Buy	4 (0)	2 (0)
Trading Sell	1 (0)	0 (0)
Total (IB%)	5 (0)	2 (0)

Valuation and risks to target price

Mesoblast (RIC: MSB.AX, Rec: Buy, CP: A\$0.740, TP: A\$1.500): Our valuation of MSB is based on a discounted cash flow model, from which we derive our target price. Upside risks include the faster-than-expected progression to production of MSB's MPC technology, while downside risks include the lack of scalability of the manufacturing process.



Dr David Stanton started covering this stock on 2 Aug 07
New recommendation structure from 7 November 2005

Regulatory disclosures

Subject companies: **MSB.AX**

Global disclaimer

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