

PharmAust Ltd PAA (\$0.26)

S&P/ASX 300 = 4018.8

SPECULATIVE BUY

Generics to drive growth

Analyst: Kim Christie



Investment Summary

- ▲ PAA re-listed on the ASX at the end of November 2004 after completing a restructure of capital (one new share for 5 Echo shares), a name change and having raised \$5.5m.
- ▲ The company now has two primary businesses – Epichem Pty Ltd and PharmAust Manufacturing. Epichem provides organic and synthetic chemistry services and is expected to grow steadily over the next few years.
- ▲ PharmAust Manufacturing is currently rebuilding the former Ramprie Laboratories facility which manufactured over the counter medicines and cosmetics before a fire damaged the facility in 2003. PAA plan to re-register with the TGA once the facility has been completed. This should happen by mid 2005.
- ▲ PAA recently signed an exclusive 3 year agreement with Xepa-Soul Pattinson, a Malaysian pharmaceutical company for whom it will distribute a number of high profile generic drugs which are due to come off patent in the near future. It is expected that the Xepa agreement will drive revenue growth in the medium term. Approvals, however, have yet to be received from the TGA for the distribution of these drugs in Australia by PAA and as such, PAA is considered a speculative buy until these hurdles have been cleared.
- ▲ PAA has recently appointed a new CEO for the manufacturing business who is expected to drive the reconstruction of the factory and the TGA approvals. A new CEO for the combined business will also be announced in the New Year. This should be positive for the share price.
- ▲ PAA is expected to make its first notable earnings in FY06 with the company forecasting EBIT of \$1.5m in that year. Making some basic assumptions on earnings and margins, a valuation of \$0.32 has been reached.
- ▲ PAA is considered a speculative buy for the higher risk investor until the manufacturing business is up and running and TGA approvals have been received. After this has been achieved, the company has good upside in the medium term, particularly through the Xepa distribution agreement. A 12 month view, at least, should be taken on the stock.

In July 2004 Patersons Securities completed a private placement of 24 million Echo shares at 2.5c per share to raise \$600,000. The funds were used to progress the purchase of the Ramprie Laboratories and associated real estate, prior to the capital reconstruction and change of name to PharmAust Ltd, which occurred in November 2004. Patersons earned a fee for this service.

Company Statistics & Performance

Shares on Issue	68.2m	Daily Vol.	1,119,000
Market Cap.	\$18.1m	Net Cash	\$2.0m
52 Week Range	\$0.12 - \$0.31	NTA/ps	na



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Background

- ▲ PAA, previously Echo Technologies, recommenced trading on the 1st December 2004. The company raised \$5.5m at 20 cents via a Prospectus offering and changed its name to PharmAust Ltd. The offer was oversubscribed.
- ▲ The company's primary strategy is to develop a fully integrated pharmaceutical company with expertise in high value drug discovery and drug production. PAA plans to develop, manufacture and supply a range of high value patent-expired PBS medicines (including generics), over-the-counter medicines and specialised hospital lines with a view to development and expansion of drug discovery and drug manufacturing businesses in Australia and South East Asia.
- ▲ To implement this strategy, PAA has established 2 subsidiary companies – Epicchem and PharmAust Manufacturing.
- ▲ Epicchem provides highly specialised medicinal and synthetic chemistry services on a contract basis as well as developing drug discovery intellectual property. The division operates at Murdoch University where a specialised laboratory was completed in February 2004.
- ▲ PharmAust Manufacturing was established to acquire the business of Ramprie Laboratories, an Australian pharmaceutical operator. Ramprie experienced a fire in September 2003 which damaged the manufacturing facilities in Welshpool, WA. Ramprie voluntarily requested that the TGA suspend its license, and as such operations ceased at the site at that time. The site is currently being rebuilt with an estimated completion date of April 2005.

The Business

EPICHEM

- ▲ Epicchem was incorporated in October 2003 to provide specialist services in organic chemistry, with a focus on drug discovery and pharmaceutical industries. It was established by a group of people from the Chemistry Centre in WA who saw an opportunity to create a niche contract business in specialist organic and synthetic chemistry.
- ▲ The global market for drug outsourcing is estimated to be worth US\$3 billion per annum and is forecast to grow strongly over the next five years. At present there are just 3 small groups operating like type businesses in the Asia-Pacific region.
- ▲ The laboratory at Murdoch University opened for business in February 2004. The lab is well equipped having cost in excess of \$0.5m to establish. This was partly funded by Epicchem and partly by PharmAust.
- ▲ At present there are 7 full time Chemists working in the lab plus two senior managers (both Chemists) and one admin staff member. It is expected that there will be an additional Chemist added to the lab by June 2005 and further 2 by December 2005.
- ▲ Revenues are generated from the provision of chemistry services to a variety to companies, primarily drug discovery companies, who hire Epicchem to analyse compounds of interest to them but who do not necessarily have the chemistry expertise on hand to carry out the work themselves.

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- ▲ Apart from work for small drug discovery companies, Epichem was recently awarded a 5 year contract from a large US based pharmaceutical company.
- ▲ Current contract timeframes range anywhere from a couple of months to several years.
- ▲ Revenue is said to be proportional to the number of Chemists working in the lab. Epichem estimates that it will generate revenue of just under \$1m in the FY05 financial year and should make a small profit.
- ▲ In its second year, FY06, revenues are expected to rise 50% to about \$1.5m but profits should increase more given that the fixed costs will be covered by a larger number of chemists in the lab.
- ▲ In addition to providing contract services, a small proportion of revenues generated by the group are used to fund research into the development of intellectual property relating to parasitic diseases.
- ▲ This work is in the early stages at present although one project is a currently undergoing toxicology testing. Epichem note that they have the resources to possibly do small scale animal testing but would look to license out its IP prior to any Phase 1 clinical trial.
- ▲ Epichem's business, while new, should not be considered a start up business. The services it provides were exactly those provided by the same group of people through the WA Governments Chemistry Centre since 1994.
- ▲ The business is likely to grow strongly over the next couple of years and should provide PAA with a steady revenue and earnings stream going forward. The facilities it has at Murdoch are modern and well run.
- ▲ Epichem's client base is growing strongly at the moment simply by word of mouth but it is expected that a more active marketing strategy will be implemented in the near future.

PHARMAUST MANUFACTURING (PAM)

- ▲ In August 2004, PAA agreed to purchase the Ramprie Laboratories business for \$3.1m which included \$2.3m for the land and buildings and \$800,000 for the business assets, including \$600,000 in stock. PharmAust Manufacturing (PAM), a fully owned subsidiary of PAA was established to acquire this business
- ▲ Ramprie Laboratories was a manufacturer of a range of cosmetic, therapeutic and generic drugs for the pharmaceutical industry. It had TGA approval to manufacture 95 different therapeutic products before a fire in September 2003 resulted in a suspension of its TGA License. These products included sunscreens, cough mixtures, hospital grade disinfectants and dermatologicals.
- ▲ The insurance payout as a result of the fire in September 2003 is in the order of \$1.2m and reconstruction of the facility is currently underway. It is hoped that the operations will be complete by March / April 2005 at which point the TGA will need to inspect the facility before approving it for therapeutic manufacturing.
- ▲ This timetable is considered a bit optimistic in our view and we would not be surprised if the timetable is extended. There is also the possibility that the TGA will require some additional changes before it provides the company with a formal registration.

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- ▲ In the meantime, PAM is mixing and packaging small amounts of cosmetic products under existing contracts in a small section of the undamaged part of the facility. For example, it is currently supplying Barezone sunscreen to Kmart. Other orders are being met with the company outsourcing the process to other manufacturers.
- ▲ Prior to the fire, Ramprie was said to be making a profit although systems were inefficient with outdated businesses practices the norm. Orders were met, not always on time, and changes would have been required to ensure that the TGA regulations continued to be met.
- ▲ PAM is now working hard to reestablish the business by introducing new accounting systems and more efficient business processes. Unfortunately work is going on in a temporary office while construction is underway. There is also stock that has been damaged and needs resorting following the fire.
- ▲ In addition, contracts will require renegotiation and new business will need to be sought to bring the business to a profitable position. A new CEO was appointed about 2 weeks ago and his presence should assist in ensuring that things are kept on track over the next few months.
- ▲ It is this part of PAM's business which we view as having the greatest risk in the short term. Costs are being incurred while the factory is reestablished and large new contracts cannot realistically be sought until things are up and running.
- ▲ A key factor is the reinstatement of the TGA License and registration of the products it hopes to manufacture on the Australian Register of Therapeutic Goods (ARTG). This can be a lengthy and detailed process and there is no guarantee that it will occur.
- ▲ Having said this, management is working closely with the TGA to ensure it meets the requirements and is reasonably confident that it has the expertise to take the company through the process. The issue is more likely to be one of timing rather than whether it happens at all and realistically, the market should probably expect some delays to the timetable.
- ▲ Management is expecting to make a small profit from this business in FY05. Our view is that this could go either way given that it is likely to be a year of considerable change in terms of processes, business systems, shifting of products lines, all while the TGA approval process is underway.
- ▲ Assuming that the facility is complete and TGA registration received in the first half of next year, FY06 should generate in a reasonable increase in revenues. By FY08, PAM hopes to achieve revenues of around \$5m pa in this business. A profit should be generated in each of these years although this is difficult to quantify until there is further clarity on the products that the facility will manufacture. This is due to the large discrepancy in margins in relation to different products. PAM hopes it will ultimately focus on manufacturing high value products such as over the counter generic products and specialised hospital lines.
- ▲ PAM is likely to remain small in the short term but has the potential to generate steady returns in the future. It is considered higher risk than Epichem but given the changing market in regard to generics – and the exponential growth in this market – it has considerable upside in the event that the company can get the necessary approvals for manufacturing these products.



XEPA SOUL-PATTINSON AGREEMENT

- ▲ In September 2004 PAM entered into a distribution agreement with Xepa-Soul Pattinson (a wholly owned subsidiary of Apex Healthcare Berhad) in Malaysia. PharmAust has been appointed as Xepa's exclusive distributor and promoter of agreed high value pharmaceutical products in Australia for an initial 3 year term.
- ▲ The agreement initially covers two drugs being Melicron Gliclazide and Covastin Simvastatin. These products will need to be registered on the ARTG before distribution in Australia and PAM will seek to have the products listed on the PBS.
- ▲ IN FY04, 5.4m prescriptions were written for Simvastatin, generating \$360m in revenues in Australia. The drug is a serum lipid reducing agent used by patients with coronary heart disease, hypercholesterolemia and diabetes Covastin (Simvastatin) products come off patent in Australia in June 2005 and Melicron is already free of patents protection in Australia.
- ▲ PAM aims to be in a position to have met all regulatory registrations to be able to market and distribute in Australia in about July 2005.
- ▲ It is expected that the Xepa agreement will be expanded to other products over time. The decision to expand the product agreement is at the behest of PAA. At this stage, PAA has elected to start on a small scale in order to stay focused and achieve results across a few product lines. Once these products have been bedded down, PAA expects to expand to other products. Xepa currently has a portfolio of 200 products.
- ▲ It is the Xepa agreement where we see the greatest short term potential for revenue and profit growth. The first hurdle to be achieved is the Australian registration of these products. Once this is achieved, we would expect sales to increase relatively quickly going forward, particularly of Simvastatin.
- ▲ As part of the marketing strategy, products will be delivered to consumers at a discount to branded products. There is growing support in the Australian market for generic drugs and this will support growth in PAM's business going forward.
- ▲ PAM hopes that this distribution agreement will generate revenues in the order of \$3m in FY06, rising to \$5m by FY08.
- ▲ Apex Healthcare's Group Managing Director, Dr. Kirk Chin, has joined the PAA Board. He is a key addition in terms of experience but also signals the strength of the relationship between the two companies.

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Financial Comments

- ▲ Given that PAA has no operating track record and has yet to fully establish the business, a detailed model and valuation is somewhat difficult. With the help of the company, some estimates have been made regarding revenues and earnings over the next few years and these are provided in the table below. An estimate has been made in relation to margin but until PAM has refined its product profile, this will be subject to change going forward.

	FY05e	FY06e	FY07e	FY08e
PharmAust Manufacturing	1.8	6.7	10.3	14.8
Epichem Pty Ltd	1.0	1.5	2.2	2.9
Total Revenue	2.75	8.2	12.5	17.7
PharmAust	0.0	1.3	2.0	2.9
Epichem	0.1	0.3	0.5	0.8
Total EBIT	0.1	1.6	2.6	3.8
Margin	3.7%	19.2%	20.7%	21.4%

- ▲ From the table, it would appear that the manufacturing business, PAM, will drive the business going forward. However, the greater part of the revenue from this division is likely to come from the Xepa distribution agreement and the company has noted that if the Xepa deal turns out to be highly successful, this may take over from the manufacturing business over time. Nevertheless, it is still early days in this regard, with approvals yet to be received and as such PAA must pursue both avenues of potential revenue.
- ▲ PAA is not expected to report a notable profit in FY05, primarily due to the costs associated with the re-establishment of the Ramprie business. At this stage, it is hoped that it will do just a bit better than breakeven.
- ▲ EpiChem is expected to make a small profit in the current year, with a small but steady growth profile likely over the next few years. Much the same can be said for the Ramprie business, with the largest short to medium term upside likely to come from the Xepa distribution agreement.
- ▲ In coming to a valuation, it is assumed that the above estimates are met. Making some comparisons with other listed companies such as Lipa Pharmaceuticals (LIP), Genepharma Australia (GAA), Sigma (SIG) and Arrow Pharmaceuticals (AWP), it shows that PAA is very small in comparison. These companies are trading on PE multiples ranging from 21x for LIP and 67x for AWP. GAA is possibly the closest comparison with a market capitalisation of \$98m. It does not make a profit yet, but has a more advanced distribution strategy for generic drugs using its European namesake, Genepharma SA. It currently has 5 anti-cancer drugs going through the TGA registration process with others to follow. Genepharma SA provides the company with a ready source of generic drugs for distribution in Australia.

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- ▲ Assuming that PAA's FY06 target is met, and assuming a forecast PE of 20x, we arrive at a valuation of \$0.32 cents per share. This is a 23% premium to the current share price. Investors should also be aware that there is blue sky potential in the company's strategy, particularly in regard to the manufacturing business. However, there are short term risks regarding the start up of the manufacturing facility and the award of the necessary TGA approvals and as such, the stock is considered Speculative until these hurdles have been cleared. Investors should take, at least, a 12 month view on the stock.

Research

Rob Brierley

Phone: (+61 8) 9263 1239

Email: rob.brierley@patersonssecurities.com.au

Nick Allan

Phone: (+61 8) 9263 1664

Email: nick.allan@patersonssecurities.com.au

Hayden Bairstow

Phone: (+61 3) 8803 0117

Email: hayden.bairstow@patersonssecurities.com.au

Kim Christie

Phone: (+61 8) 9263 1263

Email: kim.christie@patersonssecurities.com.au

Robert Gee

Phone: (+61 8) 9263 1637

Email: robert.gee@patersonssecurities.com.au

Aaron Muller

Phone: (+61 3) 8803 0150

Email: aaron.muller@patersonssecurities.com.au

Simon Oaten

Phone: (+61 3) 8803 0144

Email: simon.oaten@patersonssecurities.com.au

Alex Passmore

Phone: (+61 8) 9263 1151

Email: alex.passmore@patersonssecurities.com.au

Rebecca Thompson

Phone: (+61 2) 8238 6245

Email: rebecca.thompson@patersonssecurities.com.au

Russell Wright

Phone: (+61 2) 8238 6219

Email: russell.wright@patersonssecurities.com.au

Institutional Dealing

Phil Schofield

Phone: (+61 2) 8238 6223

Email: phil.schofield@patersonssecurities.com.au

Dan Bahen

Phone: (+61 2) 8238 6237

Email: dan.bahen@patersonssecurities.com.au

Angus Bottrel

Phone: (+61 2) 8238 6244

Email: angus.bottrel@patersonssecurities.com.au

Paul Doherty

Phone: (+61 3) 8803 0108

Email: paul.doherty@patersonssecurities.com.au

Jason Lal

Phone: (+61 2) 8238 6276

Email: jason.lal@patersonssecurities.com.au

Trevor Pike

Phone: (+61 3) 8803 0110

Email: trevor.pike@patersonssecurities.com.au

Peter Talbot

Phone: (+61 2) 8238 6243

Email: peter.talbot@patersonssecurities.com.au

John Weingarth

Phone: (+61 2) 8238 6265

Email: john.weingarth@patersonssecurities.com.au

Andrew Frazer

Phone: (+61 8) 9263 1241

Email: andrew.frazer@patersonssecurities.com.au

Ric Klusman

Phone: (+61 2) 8238 6209

Email: ric.klusman@patersonssecurities.com.au

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PATERSONS
THE AUSTRALIAN STOCKBROKER

Western Australia

Perth - Head Office: Level 23, Exchange Plaza, 2 The Esplanade, Perth, Western Australia 6000
Ph: (+61 8) 9263 1111 Fax: (+61 8) 9325 6452 Email: patersons@patersonssecurities.com.au

Albany Office: Level 2, Middleton Centre, 184 Aberdeen Street, Albany, Western Australia 6330
Ph: (+61 8) 9842 4700 Fax: (+61 8) 9841 4211 Email: albany@patersonssecurities.com.au

Bunbury Office: Arrio Building, 7 Stirling Street, Bunbury, Western Australia 6230
Ph: (+61 8) 9791 7133 Fax: (+61 8) 9721 2599 Email: bunbury@patersonssecurities.com.au

Busselton Office: Suite 1, 72 Duchess Street, Busselton Western Australia 6280
Ph: (+61 8) 9754 0700 Fax: (+61 8) 9754 4333 Email: busselton@patersonssecurities.com.au

Kalgoorlie Office: 63 Hannan Street, Kalgoorlie, Western Australia 6430
Ph: (+61 8) 9021 1422 Fax: (+61 8) 9021 8133 Email: kalgoorlie@patersonssecurities.com.au

New South Wales

Sydney Office: Level 27, 264 George Street, Sydney New South Wales 2000
Ph: (+61 2) 8238 6222 Fax: (+61 2) 8238 6266 Email: sydney@patersonssecurities.com.au

Woy Woy Office: Suite 4, 92 Blackwall Road, Woy Woy New South Wales 2256
Ph: (+61 2) 4379 9999 Fax: (+61 2) 4379 9900 Email: woywoy@patersonssecurities.com.au

Victoria

Melbourne Office: Level 18, 90 Collins Street, Melbourne Victoria 3000
Ph: (+61 3) 8803 0100 Fax: (+61 3) 8803 0199 Email: melbourne@patersonssecurities.com.au

ACT

Canberra Office: Level 4, 53 Blackall Street, Barton ACT 2600
Ph: (+61 2) 6120 2222 Fax: (+61 2) 6273 3433 Email: canberra@patersonssecurities.com.au