

22 December 2009

Produced by: RBS Equities (Australia) Limited

Change of recommendation

Buy (from Hold)Target price
A\$1.60 (from A\$1.21)Price
A\$1.35Short term (0-60 days)
n/a

Mesoblast

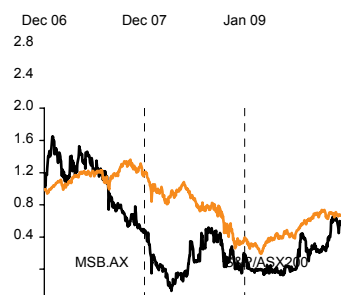
Diabetes – an expanding portfolio

A recent clinical trial indicates that the insulin-producing cells in the pancreas may be successfully regenerated by MSB's cells. This represents a potential treatment for diabetes, one of the developed world's most prevalent diseases. We believe this represents longer-term upside for MSB. Buy (from Hold).

Key forecasts

Price performance

	(1M)	(3M)	(12M)
Price (A\$)	1.44	1.12	0.85
Absolute (%)	-6.3	20.5	58.8
Rel market (%)	5.2	21.6	23.9
Rel sector (%)	-8.8	23.7	65.0

Market capitalisation
A\$183.26m (US\$162.28m)Average (12M) daily turnover
A\$0.14m (US\$0.11m)RIC: MSB.AX, MSB AU
Priced A\$1.35 at close 21 Dec 2009.
Source: Bloomberg

	FY08A	FY09A	FY10F	FY11F	FY12F
EBITDA (A\$m)	-8.69	-10.0	-10.9	-12.4	1.52
Reported net profit (A\$m)	-10.1	-12.3	-13.2	-14.5	-1.65
Normalised net profit (A\$m) ¹	-10.1	-12.3	-13.2	-14.5	-1.65
Normalised EPS (c) ¹	-8.81	-9.89	-9.71	-9.47	-1.04
Normalised EPS growth (%)	7.45	12.30	-1.78	-2.56	-89.0
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	102.9
Price/net oper. CF (x)	-28.8	-19.5	-18.3	-18.1	79.80
ROIC (%)	-73.0	-58.5	-83.1	-140	6.85

1. Pre non-recurring items and post preference dividends

year to Jun, fully diluted

Accounting standard: IFRS

Source: Company data, RBS forecasts

Statistically significant results announced – implications for Type 2 diabetes

MSB announced significant preclinical trial results in mice showing that the company's Mesenchymal Precursor Cells (MPCs) could be a potential treatment for diabetes. Diabetes was induced in 35 mice that were then randomised to receive either a single injection into the bloodstream of human MPCs or control. Three weeks later, MPC-treated diabetics demonstrated a 35% maximal reduction in blood glucose levels ($p=0.012$) and a 34% increase in blood insulin levels ($p=0.04$) compared with diabetic controls over the three weeks of follow-up. As a result, MSB will move into clinical trials.

Current treatment does not replace damaged cells, rather, it manages blood sugar

Diabetes is a group of diseases marked by high levels of blood glucose, also called blood sugar, resulting from defects in insulin production, insulin action, or both. Diabetes mellitus is a complex metabolic disease with an estimated worldwide prevalence of 171m cases in the adult population. To survive, some diabetics must have insulin delivered by injection or a pump.

Pancreatic cell replacement therapies are a potential cure for diabetes

Cell replacement therapies using pancreatic cell transplantation are a therapeutic alternative to providing insulin. There are number of clinical trials that aim to replace damaged insulin-producing cells. Injection of MPCs is one potential treatment modality.

Buy recommendation (from Hold), target price A\$1.60 (from A\$1.21)

Given the pre-clinical nature of the MSB trials in diabetes, we believe diabetes is a longer-term opportunity for MSB. At this stage, we believe the timeline for approval of this opportunity is likely to be from FY14. As a result, we increase our estimate of the number of treatments sold in FY14 by 15,000 to 60,000. Hence, our DCF-based target price and valuation increases to A\$1.60 (from A\$1.21).

Important disclosures can be found in the Disclosures Appendix.

Analysts

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Sugar free?

Diabetes is a group of diseases marked by high levels of blood glucose, also called blood sugar, resulting from defects in insulin production, insulin action, or both. Diabetes mellitus is a complex metabolic disease with an estimated worldwide prevalence of 171m cases in the adult population.

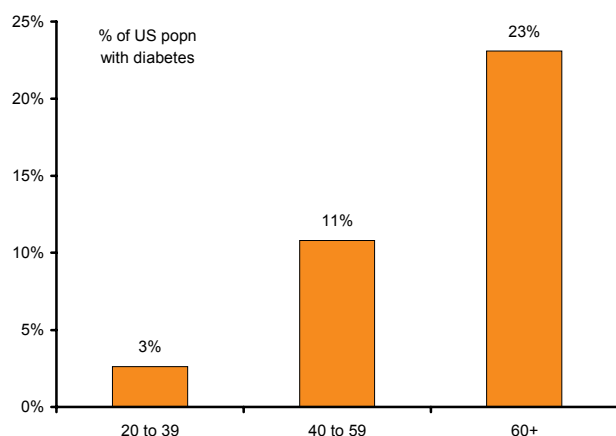
Cell replacement therapies using either pancreatic or islet transplantation are a therapeutic alternative to providing insulin. MSB announced significant preclinical trial results in mice showing that its MPCs could be a potential treatment for diabetes. In this note, we:

- describe the disease syndrome known as diabetes;
- outline current pancreatic cell replacement therapies being investigated as a treatment for diabetes;
- highlight MSB's potential therapeutic approach in this area; and
- summarise what we have done with our forecasts

1. What is diabetes?

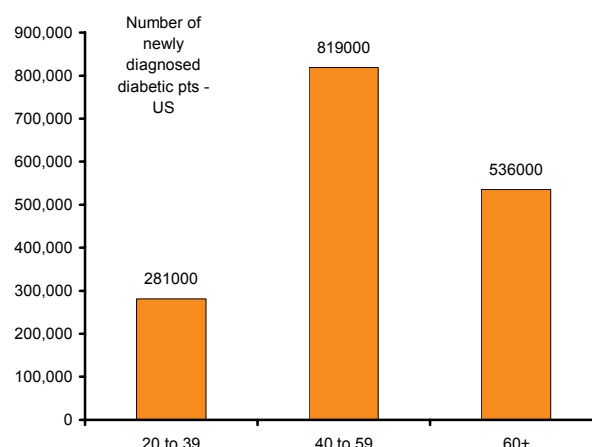
Diabetes is a group of diseases marked by high levels of blood glucose, also called blood sugar, resulting from defects in insulin production, insulin action, or both. Diabetes mellitus is associated with severe long-term vascular complications, and carries high rates of morbidity and mortality.

Chart 1 : US – estimated prevalence of diagnosed and undiagnosed diabetes in people aged 20+ (2007A)



Source: US NIH

Chart 2 : US – estimated no. new cases of diagnosed diabetics in people aged 20+ (2007A)



Source: US NIH

Types of diabetes

- **Type 1 diabetes:** this was previously called insulin-dependent diabetes mellitus (IDDM) or juvenile-onset diabetes. Type 1 diabetes develops when the body's immune system destroys pancreatic beta cells, the only cells in the body that make the hormone insulin that regulates blood glucose. This form of diabetes usually strikes children and young adults, although disease onset can occur at any age. In adults, Type 1 diabetes accounts for about 5% of all diagnosed cases of diabetes.
- **Type 2 diabetes:** this was previously called non-insulin-dependent diabetes mellitus (NIDDM) or adult-onset diabetes. In adults, Type 2 diabetes accounts for about 95% of all diagnosed cases of diabetes. It usually begins as insulin resistance, a disorder in which the cells do not use insulin properly. As the need for insulin rises, the pancreas gradually loses its ability to produce it.

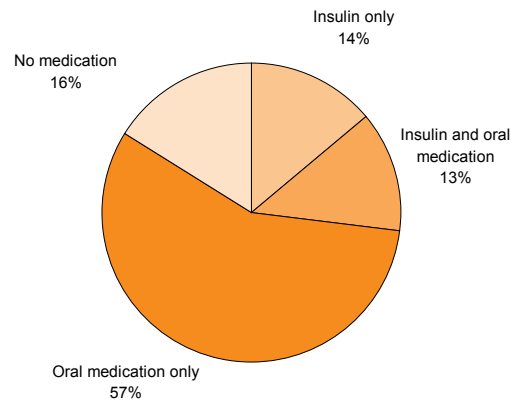
Current symptomatic treatment methodologies for diabetes

Diabetes can lead to serious complications, but people with diabetes can lower the occurrence of complications by controlling blood glucose, blood pressure and blood lipids by using the following:

- **Non-drug therapy:** many people with Type 2 diabetes can control their blood glucose by following a meal plan and exercise program and losing excess weight.

- **Oral medication:** some people with Type 2 diabetes may also need oral medication or injected insulin to control their blood glucose.
- **Insulin:** to survive, people with Type 1 diabetes must have insulin delivered by injection or a pump. The breakdown of medications used by the population affected by diabetes in the US is shown below.

Chart 3 : US – treatment with insulin or oral medication for adults with diagnosed diabetes (2006A)



Source: US NIH

2. Cell replacement therapies for diabetes

Current treatment does not replace damaged cells, rather, it manages blood sugar. Pancreatic cell replacement therapies are a potential cure for diabetes. Cell replacement therapies using either pancreatic or islet transplantation are a therapeutic alternative to providing insulin. There are a number of methods under development to replace pancreatic cells:

- **Human pancreatic transplantation:** with 6,600 transplant recipients, this has demonstrated partly successful results in reversing long-term renal and neural complications in selected diabetic patients.
- **Human islet transplantation:** this offers blood sugar control and sufficient prevention of hypoglycaemia without the need for insulin administration. However, the respective benefits from pancreatic or islet transplants are limited by complications associated with the transplant procedure and the need for life-long immunosuppressant therapy, with its adverse side-effects, and the difficulty of obtaining transplant material and organ donations.
- **Other stem-cell therapy:** in one field of study, embryonic stem cells are differentiated into pancreatic progenitor cells and then transplanted in a capsule, where the insulin cells are formed. This is being developed by US-based company Novocell. Future milestones include the development of a manufacturing centre for the cells, and a GMP process, followed by an FDA pre-registration, as well as safety, efficacy and dosing studies for an NDA filing in 2011-12. Adipose and umbilical cord blood are also potential areas for the development of stem-cell therapy for diabetes. We are aware of nine trials using stem-cell therapy to potentially treat diabetes.
- **Mesenchymal stem cells:** MPCs can be differentiated into insulin-producing cells (IPCs) by using a specific culture medium enriched with insulin-promoting factors. Other than MSB, US-based Osiris Therapeutics is enrolling patients in a Phase II trial to test the efficacy of its MPCs to treat Type I diabetes.

3. Mesoblast's approach

MSB announced significant preclinical trial results in mice showing that its MPCs could be a potential treatment for diabetes. Diabetes was induced in 35 mice that were then randomised to receive either a single injection into the bloodstream of human MPCs or control. Three weeks later, MPC-treated diabetics demonstrated a 35% maximal reduction in blood glucose levels ($p=0.012$) and a 34% increase in blood insulin levels ($p=0.04$) compared with diabetic controls over the three weeks of follow-up. As a result, MSB will move into clinical trials.

The main mechanism through which MPCs should be able to successfully treat diabetes has yet to be determined. It has been hypothesised that a possible indirect effect of differentiation of MPCs towards blood vessel wall cells could provide nutrient support for pancreatic-based stem cells.

4. What have we done with our forecasts?

Given the pre-clinical nature of the MSB trials in diabetes, we believe diabetes is a longer-term opportunity for the company. At this stage, we believe the timeline for approval of this opportunity is likely to be from FY14. As a result, we have increased our estimate of the number of treatments sold in FY14 by 15,000 to 60,000. Hence, our DCF-based target price increases to A\$1.60 (from A\$1.21).

Buy recommendation (from Hold)

We continue to believe MSB is most likely to partner to take MPC to market. Should the technology continue to progress through clinical trials, we believe MSB may become an acquisition target. On an industry-wide basis, the chances of getting a product to market from the Phase II stage are in the order of 30%. Hence, we believe the risk that MSB will be unable get a product to market is not inconceivable. MSB's patent position is strong, but we think the company is unlikely to be cash flow positive before FY12. We therefore believe MSB is an opportunity for investors with a higher risk appetite. Upside risks to our target price include faster-than-expected progression to production of MSB's MPC technology, while downside risks include a lack of scalability of the manufacturing process.

MSB – financial summary

Year to 30 Jun (A\$m)	AIFRS 2008A	AIFRS 2009A	AIFRS 2010F	AIFRS 2011F	AIFRS 2012F	Closing price (A\$)	1.35	Price target (A\$)	1.60	
Income statement						Valuation metrics				
Divisional sales	0.0	0.0	0.0	0.0	24.2	Preferred methodology	DCF	Val'n (A\$)	\$ 1.60	
Total revenue	0.0	0.2	0.2	0.2	24.4	DCF valuation inputs				
EBITDA	-8.7	-10.0	-10.9	-12.4	1.5	Rf	5.25%	10-year rate	5.25%	
Associate income	-2.1	-2.9	-2.9	-2.9	-2.9	Rm-Rf	6.00%	Margin	2.0%	
Depreciation	-0.2	-0.1	-0.1	0.0	-1.2	Beta	1.50	Kd	7.25%	
EBITA	-8.8	-10.1	-11.0	-12.4	0.3	CAPM (Rf+Beta(Rm-Rf))	14.2%	Ke	14.2%	
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)	204.6	
EBIT	-8.8	-10.1	-11.0	-12.4	0.3	Equity (E/EV)	100.0%	Minority interest (A\$m)	0.0	
EBIT(incl associate profit)	-11.0	-13.0	-13.9	-15.3	-2.6	Debt (D/EV)	0.0%	Net debt (A\$m)	-16.5	
Net interest expense	0.9	0.7	0.7	0.8	0.9	Interest rate	7.25%	Investments (A\$m)	0.0	
Pre-tax profit	-10.1	-12.3	-13.2	-14.5	-1.6	Tax rate (t)	30.0%	Equity market value (A\$m)	221.1	
Income tax expense	0.0	0.0	0.0	0.0	0.0	WACC	14.2%	Diluted no. of shares (m)	135.8	
After-tax profit	-10.1	-12.3	-13.2	-14.5	-1.6			DCF valuation (A\$)	1.60	
Minority interests	0.0	0.0	0.0	0.0	0.0					
NPAT pre significant items	-10.1	-12.3	-13.2	-14.5	-1.6	Multiples	2009A	2010F	2011F	2012F
Significant items	0.0	0.0	0.0	0.0	0.0	Enterprise value (A\$m)	166.7	161.8	158.2	156.8
Reported NPAT	-10.1	-12.3	-13.2	-14.5	-1.6	EV/Sales (x)				6.5
						EV/EBITDA (x)	-16.7	-14.9	-12.7	102.9
Cash flow statement	2008A	2009A	2010F	2011F	2012F	EV/EBIT (x)	-16.5	-14.7	-12.7	513.2
EBITDA	-8.7	-10.0	-10.9	-12.4	1.5	PE (normalised) (x)	-13.6	-13.9	-14.3	-129.6
Change in working capital	0.0	0.0	0.2	0.2	0.3	PEG (normalised) (x)				
Net interest (pd)/rec	0.8	0.7	0.7	0.8	0.9	At target price	2009A	2010F	2011F	2012F
Taxes paid	0.0	0.0	0.0	0.0	0.0	EV/EBITDA (x)	-20.0	-18.0	-15.5	125.2
Other oper cash items	0.0	0.0	0.0	0.0	0.0	PE (normalised) (x)	-16.2	-16.5	-16.9	-153.6
Cash flow from ops (1)	-5.4	-8.6	-10.0	-11.4	2.7	Comparable company data (x)	2010F	2011F	2012F	
Capex (2)	-0.1	-0.2	-0.1	0.0	-1.2	Alchemia	EV/EBITDA	-28.5	9.0	3.7
Disposals/(acquisitions)	-6.4	-0.2	0.0	0.0	0.0	Year to 30 Jun	EV/EBIT	-19.1	11.1	4.2
Other investing cash flow	0.3	0.0	0.0	0.0	0.0		PE	-22.6	11.3	5.3
Cash flow from invest (3)	-6.2	-0.4	-0.1	0.0	-1.2		PEG	-6.4	3.2	1.5
Incr/(decr) in equity	13.6	11.4	15.0	15.0	0.0	Tissue Therapies	EV/EBITDA	-2.8	-2.8	6.0
Incr/(decr) in debt	0.0	0.0	0.0	0.0	0.0	Year to 30 Jun	EV/EBIT	-2.8	-2.8	6.0
Ordinary dividend paid	0.0	0.0	0.0	0.0	0.0		PE	-3.4	-3.9	10.3
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	2009A	2010F	2011F	2012F
Cash flow from fin (5)	13.6	11.4	15.0	15.0	0.0	No. shares	124.2	147.3	158.4	158.4
Forex and disc ops (6)	0.0	0.0	0.0	0.0	0.0	EPS (cps)	-9.9	-9.7	-9.5	-1.0
Incr/(decr) cash (1+3+5+6)	2.0	2.4	4.9	3.6	1.5	EPS (normalised) (c)	-9.9	-9.7	-9.5	-1.0
Equity FCF (1+2+4)	-5.5	-8.8	-10.1	-11.4	1.5	Dividend per share (c)	0.0	0.0	0.0	0.0
						Dividend payout ratio (%)	0.0	0.0	0.0	0.0
Balance sheet	2008A	2009A	2010F	2011F	2012F	Dividend yield (%)	0.0	0.0	0.0	0.0
Cash & deposits	14.1	16.5	21.4	25.0	26.5	Growth ratios	2009A	2010F	2011F	2012F
Trade debtors	0.1	0.3	0.4	0.4	0.5	Sales growth	na	na	na	na
Inventory	0.0	0.0	0.0	0.0	0.0	Operating cost growth	15.2%	8.6%	14.2%	82.5%
Investments	12.8	9.3	9.3	9.3	9.3	EBITDA growth	15.2%	8.6%	14.2%	na
Goodwill	0.0	0.0	0.0	0.0	0.0	EBITA growth	14.5%	8.5%	13.0%	na
Other intangible assets	0.5	0.5	0.4	0.4	0.4	EBIT growth	14.5%	8.5%	13.0%	na
Fixed assets	0.2	0.2	0.2	0.2	0.2	Norm. NPAT growth (pre GW)	22.1%	7.3%	9.7%	-88.6%
Other assets	0.1	0.1	0.1	0.1	0.1	Norm. NPAT growth	22.1%	7.3%	9.7%	-88.6%
Total assets	27.8	27.0	31.9	35.6	37.1	Norm. EPS growth (pre GW)	12.3%	-1.8%	-2.6%	na
Short-term borrowings	0.0	0.0	0.0	0.0	0.0	Norm. EPS growth	12.3%	-1.8%	-2.6%	na
Trade payables	1.6	1.2	1.4	1.7	2.0	Operating performance	2009A	2010F	2011F	2012F
Long-term borrowings	0.0	0.0	0.0	0.0	0.0	Asset turnover (%)	0.0	0.0	0.0	16.6
Provisions	0.0	0.0	0.0	0.0	0.0	EBITDA margin (%)	na	na	na	6.3
Other liabilities	0.0	0.0	2.9	5.7	8.6	EBIT margin (%)	na	na	na	1.3
Total liabilities	1.6	1.2	4.3	7.4	10.6	Net profit margin (%)	na	na	na	-6.8
Preference shares						Return on net assets (%)	-39.3	-39.8	-44.2	1.2
Hybrid equity	0.0	0.0	0.0	0.0	0.0	Net debt (A\$m)	-16.5	-21.4	-25.0	-26.5
Share capital	51.0	62.5	77.5	92.5	92.5	Net debt/equity (%)	-64.1	-77.6	-88.9	-100.0
Other reserves	3.8	4.2	4.2	4.2	4.2	Net interest/EBIT cover (x)	14.4	16.6	15.3	-0.3
Retained earnings	-28.6	-40.8	-54.0	-68.5	-70.1	ROIC (%)	-58.5	-83.1	-140.5	6.9
Other equity	0.0	0.0	0.0	0.0	0.0	Internal liquidity	2009A	2010F	2011F	2012F
Total equity	26.2	25.8	27.6	28.1	26.5	Current ratio (x)	14.3	5.1	3.4	2.6
Minority interest	0.0	0.0	0.0	0.0	0.0	Receivables turnover (x)	na	0.0	0.0	50.0
Total shareholders' equity	26.2	25.8	27.6	28.1	26.5	Payables turnover (x)	na	8.3	7.9	12.1
Total liabilities & SE	27.8	27.0	31.9	35.6	37.1					

Source: RBS forecasts, company data

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 UK Mid/Small Cap Analysis a Buy/Sell implies upside/downside of 10% or more, an Add/Reduce 5-10% and a Hold less than 5%. For UK-based Investment Funds research the recommendation structure is not based on upside/downside to the target price. Rather it is the subjective view of the analyst based on an assessment of the resources and track record of the fund management company. 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.

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.

Distribution of recommendations

The tables below show the distribution of 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 there is an investment banking relationship.

Long term recommendations (as at 22 Dec 2009)

	Global total (IB%)	Asia Pacific total (IB%)
Buy	620 (10)	404 (0)
Add	0 (0)	0 (0)
Hold	398 (6)	221 (0)
Reduce	0 (0)	0 (0)
Sell	110 (0)	69 (0)
Total (IB%)	1128 (7)	694 (0)

Source: ABN AMRO

Trading recommendations (as at 22 Dec 2009)

	Global total (IB%)	Asia Pacific total (IB%)
Trading Buy	5 (0)	5 (0)
Trading Sell	0 (0)	0 (0)
Total (IB%)	5 (0)	5 (0)

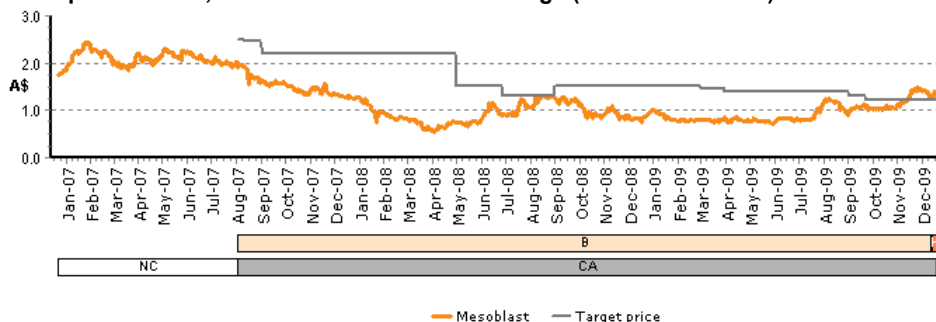
Source: ABN AMRO

Valuation and risks to target price

Mesoblast (RIC: MSB.AX, Rec: Buy, CP: A\$1.350, TP: A\$1.600): 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.

Mesoblast coverage data

Stock performance, recommendations and coverage (as at 21 Dec 2009)



(B)uy (A)dd (H)old (R)educe (S)ell (PA) Previous Analyst (CA) Current Analyst (NC) Not Under Coverage

Dr David Stanton started covering this stock on 2 Aug 07

Source: ABN AMRO

Trading recommendation history (as at 22 Dec 2009)

Date	Rec	Analyst
	n/a	

Source: ABN AMRO

Regulatory disclosures

Subject companies: **MSB.AX**

Global disclaimer

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