

27 February 2009

Produced and issued by: ABN AMRO Equities Australia Ltd

Mesoblast

1H09: spine is fine

Buy

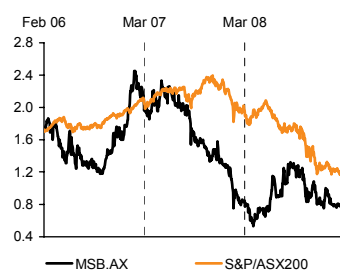
Target price
A\$1.45 (from A\$1.50)

Price
A\$0.79

Short term (0-60 days)
n/a

Price performance

	(1M)	(3M)	(12M)
Price (A\$)	0.80	0.81	0.83
Absolute (%)	-1.2	-1.9	-5.4
Rel market (%)	-1.3	3.8	60.2
Rel sector (%)	13.4	7.5	21.1



Market capitalisation
A\$90.23m (US\$58.45m)

Average (12M) daily turnover
A\$0.09m (US\$0.08m)

RIC: MSB.AX, MSB.AU
Priced at close of business 26 Feb 2009.
Source: Bloomberg

Analysts

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MSB continues to progress its anterior cervical spine interbody fusion opportunity, having presented it at a number of orthopaedic meetings. We believe the competitor's FY08 cervical fusion sales were cA\$325m, but has been forced to exit the market, and we believe is less likely to re-enter.

Key forecasts

	FY07A	FY08A	FY09F	FY10F	FY11F
EBITDA (A\$m)	-7.90	-8.69	-9.07	-9.86	8.57
Reported net profit (A\$m)	-8.73	-10.1	-10.6	-11.1	4.31
Normalised net profit (A\$m) ¹	-8.73	-10.1	-10.6	-11.1	4.31
Normalised EPS (c) ¹	-8.20	-8.81	-8.31	-7.39	2.71
Normalised EPS growth (%)	-7.61	7.45	-5.63	-11.1	n/a
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	29.10
EV/EBITDA (x)	n/m	n/m	n/m	n/m	5.97
Price/net oper. CF (x)	-10.3	-16.8	-12.5	-14.0	15.00
ROIC (%)	-135	-73.0	-53.3	-71.4	67.90

1. Pre non-recurring items and post preference dividends

year to Jun, fully diluted

Accounting standard: IFRS

Source: Company data, ABN AMRO forecasts

1H09 result – in line with our forecasts

MSB posted an NPAT of -A\$6.9m for 1H09, with a loss in line with our forecast of -A\$6.5m. We believe MSB has sufficient cash (A\$9.6m in 1H09) to fund its clinical programme for the next one to two years.

Near-term cervical spine opportunity

The major near-term opportunity relates to an indication for MSBs osteoinductive adult mesenchymal precursor cells (MPCs). MSB has issued data showing that MSB's MPCs achieved a statistically significant improvement in cervical fusion rates compared to Medtronic's osteoconductive bulking agent (MasterGraft Granules). This has also been recently presented at a number of prestigious orthopaedic meetings. Given the recent issues with Medtronic's osteoinductive rhBMP product (also used in cervical fusion operations) we continue to believe a significant opportunity exists with MSB's MPCs being potentially useful over the medium term in anterior cervical interbody fusion operations.

MSB's MPCs may address the gap in the market for cervical fusion

In July 2008, the US FDA issued a statement that the safety and effectiveness of rhBMP in the cervical spine had not been demonstrated and these products were not approved by FDA for this use. We believe the anterior interbody cervical spine fusion market for BMPs is worth cUS\$325m. As a result of the FDA decision, we believe there is currently no synthetic bone graft approved for anterior interbody cervical spine fusions. Medium-term, MSB's MPCs may address this gap in the market.

Buy rating maintained, target price A\$1.45 (from A\$1.50)

We have made minimal operational changes to our MSB model. The net interest balance has been adjusted for new cash balances for the end of the period. As a result of changes to forecasts, our DCF valuation and 12-month target price have decreased by 3.3% to A\$1.45.

Important disclosures can be found in the Disclosures Appendix.

The result

MSB posted an EBIT of -A\$5.8m for 1H09, with a loss below our forecast of -A\$6.5m. At the NPAT level, MSB reported a loss of A\$6.9m, with a loss in line with our forecast of -A\$6.5m. The 1H09 net operating cash outflow was A\$5.4m, compared to our forecast of A\$5.0m. We believe MSB has sufficient cash (A\$9.6m in 1H09) to fund its clinical programme for the next one to two years. The changes to our forecasts are shown in the following table. We have made minimal operational changes to our MSB model. The net interest balance has been adjusted for new cash balances for the end of the period.

Table 1 : Changes to forecasts

	FY09F			FY10F			FY11F		
	Prev	Rev	Diff	Prev	Rev	Diff	Prev	Rev	Diff
EBIT (A\$m)	-9.2	-9.2	0.0	-10.0	-10.0	0.0	7.0	7.0	0.1
NPAT (A\$m)	-10.6	-10.6	0.0	-11.1	-11.1	0.0	4.2	4.3	0.1
EPS (c)	-8.4	-8.3	0.1	-7.6	-7.4	0.2	2.7	2.7	-0.0
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)	-8.8	-8.8	0.0	-9.5	-9.5	0.0	8.9	9.0	0.1

Source: ABN AMRO estimates, company data

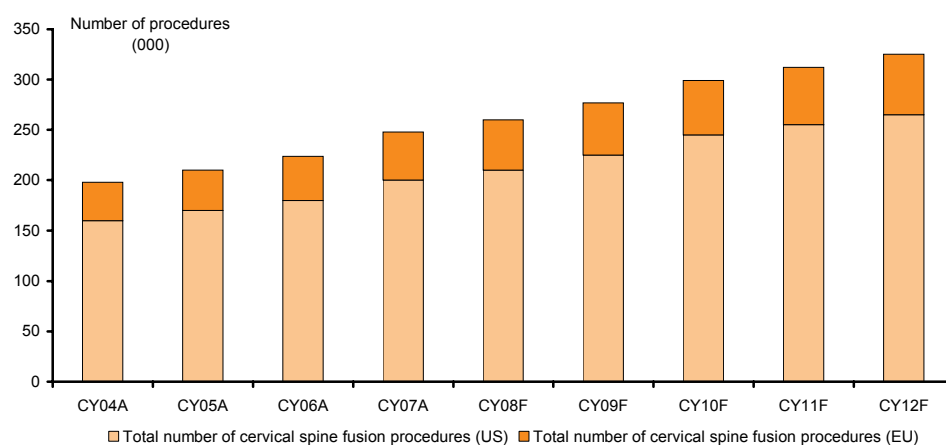
What is MSB?

Mesoblast (MSB) aims to capitalise on its patents that relate to the identification, extraction and culture of adult mesenchymal precursor cells (MPCs). MPCs are not fixed as to potential cell-line development (ie, they can become any type of cell, rather than being a mixture of committed types of cells). MSB hopes to develop treatments for bone/joint and cardiovascular diseases. Given the ageing of the western world population, we believe this is an attractive market segment. In the orthopaedic market, we believe the value of osteoinductive agents (MPCs are a sub-class of this market) will continue to grow.

1. Cervical spine opportunity

We believe MSB's major opportunity relates to a new indication for MSB's MPCs. MSB has issued data that showed that MSB's osteoinductive MPCs inserted in an interbody cage achieved a statistically significant improvement in cervical fusion compared to Medtronic's Mastergraft osteoconductive bulking agent. This has also been presented at a number of prestigious orthopaedic meetings. We enclose the number of current and forecast cervical spine fusion procedures in the EU and US.

Chart 1 : Combined number of cervical spine fusion procedures (US and EU)



Source: ABN AMRO estimates, Frost & Sullivan

FDA issues a warning that Bone Morphogenic Proteins are not approved for use in the cervical spine

The US FDA has issued a statement that the safety and effectiveness of osteoinductive rhBMP in

the cervical spine had not been demonstrated and that these products were not approved by the FDA for this use. The FDA had received at least 38 reports of complications during the last four years regarding the use of rhBMP in cervical spine fusion. These complications were associated with swelling of neck and throat tissue, which resulted in compression of the airway and/or neurological structures in the neck. Some reports describe difficulty in swallowing, breathing or speaking. The mechanism of action is unknown, and characteristics of patients at increased risk have not been identified.

The Medtronic Biologics division, which includes rhBMP, generated sales of US\$815m in 2008. Given the recent issues with Medtronic's product, we continue to believe a significant opportunity exists with MSB's MPC being potentially used over the medium-term in anterior cervical interbody fusion. We believe the anterior interbody cervical spine fusion market for BMPs is a cUS\$325m market, as c40% of total fusions are in the cervical region of the spine. As a result of the FDA decision, we believe there is currently no synthetic bone graft approved for anterior interbody cervical spine fusions. Longer term, MSB's MPCs may address this gap in the market.

MSB product – significant results in spinal fusion

MSB initiated trials at Monash University to determine the safety and efficacy profile of its MPCs in cervical fusion. 24 sheep were randomised to one of the four treatment arms: osteoconductive/osteoinductive autograft, osteoconductive bone graft substitute (Medtronic MasterGraft granules), and allogeneic osteoinductive Mesoblast cells at doses of 5 million or 10 million cells implanted in an FDA-approved interbody cage. The trial was completed in three months.

Significantly, no cell-related adverse events were noted throughout the study. Groups receiving either dose of MSB's allogeneic cells had earlier and more robust fusion than the other groups:

- **CT scanning:** By CT scan at three months, 9/12 cell-treated animals had continuous interbody bony bridging compared with only 1/6 autograft and 2/6 with bone graft substitute ($p=0.019$ and $p=0.043$ respectively);
- **X-rays:** Functional x-rays at three months showed that cell-treated subjects had significantly reduced flexion/extension at the C3/4 level compared with the other groups ($p=0.007$), indicating significantly superior fusion outcomes.

Interestingly, the numbers of cells used in the MPC arm of the trial were 7% and 13% of the number of cells previously suggested as the minimum number of cells required for fusion. This has also been recently presented at a number of prestigious orthopaedic meetings.

We believe the US FDA reimburses US\$5,000 per interbody level, and we believe MSB would be likely to only have 10 million cells per interbody treatment. We note that the majority of variable costs for MSB are related to the number of cells per treatment – hence if MSB can decrease the number of cells per treatment, then profit per treatment should increase.

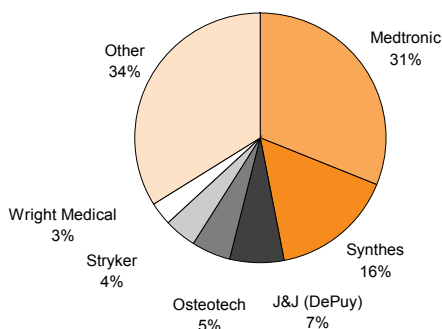
MSB to move to Phase III trial in anterior interbody cervical spine fusion

Mesoblast believes that this clinical indication may provide an accelerated path to regulatory market approval of its product. Hence, MSB plans to pursue formal regulatory discussions regarding initiation of a Pivotal/Phase 3 clinical trial protocol for use of its MPC cells for cervical fusion. This is likely to start in 2HCY09, and is likely to involve 300 higher-risk anterior interbody cervical spine fusion patients (this group would include smokers and diabetics, who generally have lower rates of allograft fusion). The clinical end-point for the trial is likely to be a year after the trial is fully recruited.

What does this mean for MSB?

Should trials prove successful, then MSB may become an acquisition target for an orthopaedic company: We continue to believe MSB is most likely to partner with an orthopaedic firm to take MPC to market. Should the technology continue to progress through clinical trials, we believe MSB may become an acquisition target for an orthopaedic company. The estimated market shares of the bone graft market are shown below.

Chart 2 : 2007 – estimated market shares of the bone graft market



Source: ABN AMRO

2. Other key outlook takeaways

- **Phase II clinical trials** – MSB has entered Phase II clinical trials for lumbar spinal fusion and long bone fractures. We assume an accelerated approval process from the US FDA as we believe MSB’s product will be classified as a device rather than a pharmaceutical product;
- **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; and
- **Levels of cash** – As at 31December 2008, MSB had a net cash position of A\$9.6m. Going forward, we believe the cash requirements will likely 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 12-18 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, and a A\$15m equity raising in FY10.

Model changes

The major changes to our model for MSB are shown below:

- **Net interest balance** – This has been adjusted for new cash balances for the end of the period.
- **Number of shares** – This has been updated for period-end balances.

Buy rating maintained; target price A\$1.45

As a result of changes to forecasts, our DCF valuation and 12-month target price have decreased by 3.3% to A\$1.45 per share. 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 risks that MSB will be unable get a product to market are not inconsiderable. MSB’s patent position is strong, but we think the company is unlikely to be cash flow positive before FY11. Hence, we believe MSB is an opportunity for investors with a higher risk appetite.

Table 2 : Updated 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 (cervical/lumbar)	→			
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

MSB - financial summary

Year to 30 Jun (A\$m)	AIFRS 2007A	AIFRS 2008A	AIFRS 2009F	AIFRS 2010F	AIFRS 2011F	Closing price (A\$)	0.79	Price target (A\$)	1.45	
Income statement						Valuation metrics				
Divisional sales	0.0	0.0	0.0	0.0	30.7	Preferred methodology	DCF	Val'n (A\$)	\$ 1.45	
Total revenue	0.7	0.0	0.2	0.2	30.8	DCF valuation inputs				
EBITDA	-7.9	-8.7	-9.1	-9.9	8.6	Rf	5.25%	10-year rate	5.25%	
Associate income	-1.7	-2.1	-2.1	-2.1	-2.1	Rm-Rf	6.00%	Margin	2.0%	
Depreciation	-0.1	-0.2	-0.2	-0.2	-1.5	Beta	1.50	Kd	7.25%	
EBITA	-8.0	-8.8	-9.2	-10.0	7.0	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)	171.7	
EBIT	-8.0	-8.8	-9.2	-10.0	7.0	Equity (E/EV)	100.0%	Minority interest (A\$m)	0.0	
EBIT(incl associate profit)	-9.7	-11.0	-11.3	-12.1	4.9	Debt (D/EV)	0.0%	Net debt (A\$m)	-14.1	
Net interest expense	0.9	0.9	0.7	1.0	1.2	Interest rate	7.25%	Investments (A\$m)	0.0	
Pre-tax profit	-8.7	-10.1	-10.6	-11.1	6.2	Tax rate (t)	30.0%	Equity market value (A\$m)	185.8	
Income tax expense	0.0	0.0	0.0	0.0	-1.8	WACC	14.2%	Diluted no. of shares (m)	128.1	
After-tax profit	-8.7	-10.1	-10.6	-11.1	4.3			DCF valuation (A\$)	1.45	
Minority interests	0.0	0.0	0.0	0.0	0.0					
NPAT pre significant items	-8.7	-10.1	-10.6	-11.1	4.3	Multiples	2008A	2009F	2010F	2011F
Significant items	0.0	0.0	0.0	0.0	0.0	Enterprise value (A\$m)	76.1	64.5	58.0	51.2
Reported NPAT	-8.7	-10.1	-10.6	-11.1	4.3	EV/Sales (x)				1.7
						EV/EBITDA (x)	-8.8	-7.1	-5.9	6.0
Cash flow statement	2007A	2008A	2009F	2010F	2011F	EV/EBIT (x)	-8.6	-7.0	-5.8	7.3
EBITDA	-7.9	-8.7	-9.1	-9.9	8.6	PE (normalised) (x)	-9.0	-9.5	-10.7	29.1
Change in working capital	0.0	0.0	0.3	0.3	0.4	PEG (normalised) (x)				
Net interest (pd)/rec	0.9	0.8	0.7	1.0	1.2					
Taxes paid	0.0	0.0	0.0	0.0	-1.8	At target price	2008A	2009F	2010F	2011F
Other oper cash items	0.0	0.0	0.0	0.0	0.0	EV/EBITDA (x)	-17.4	-15.4	-13.5	14.8
Cash flow from ops (1)	-8.2	-5.4	-8.1	-8.5	8.4	PE (normalised) (x)	-16.5	-17.4	-19.6	53.5
Capex (2)	-0.1	-0.1	-0.1	-0.1	-1.5					
Disposals/(acquisitions)	-3.9	-6.4	-2.2	0.0	0.0	Comparable company data (x)	2009F	2010F	2011F	
Other investing cash flow	-0.3	0.3	0.0	0.0	0.0	Alchemia	EV/EBITDA	-1.6	-5.1	3.6
Cash flow from invest (3)	-4.3	-6.2	-0.3	-0.1	-1.5	Year to 30 Jun	EV/EBIT	-1.3	-3.5	5.7
Incr/(decr) in equity	16.8	13.6	20.0	15.0	0.0		PE	-2.4	-2.3	2.0
Incr/(decr) in debt	0.0	0.0	0.0	0.0	0.0		PEG	-0.7	-0.6	0.6
Ordinary dividend paid	0.0	0.0	0.0	0.0	0.0	Tissue Therapies	EV/EBITDA	-2.7	6.0	4.5
Preferred dividends (4)	0.0	0.0	0.0	0.0	0.0	Year to 30 Jun	EV/EBIT	-2.7	6.0	4.5
Other financing cash flow	0.0	0.0	0.0	0.0	0.0		PE	-2.3	6.4	4.2
Cash flow from fin (5)	16.8	13.6	20.0	15.0	0.0		PEG			
Forex and disc ops (6)	0.0	0.0	0.0	0.0	0.0					
Incr/(decr) cash (1+3+5+6)	4.3	2.0	11.7	6.4	6.8	Per share data	2008A	2009F	2010F	2011F
Equity FCF (1+2+4)	-8.3	-5.5	-8.1	-8.6	6.8	No. shares	114.2	141.9	158.9	158.9
						EPS (cps)	-8.8	-8.3	-7.4	2.7
Balance sheet	2007A	2008A	2009F	2010F	2011F	EPS (normalised) (c)	-8.8	-8.3	-7.4	2.7
Cash & deposits	12.1	14.1	25.8	32.2	39.0	Dividend per share (c)	0.0	0.0	0.0	0.0
Trade debtors	0.5	0.1	0.1	0.2	0.2	Dividend payout ratio (%)	0.0	0.0	0.0	0.0
Inventory	0.0	0.0	0.0	0.0	0.0	Dividend yield (%)	0.0	0.0	0.0	0.0
Investments	7.7	12.8	13.0	13.0	13.0	Growth ratios	2008A	2009F	2010F	2011F
Goodwill	0.0	0.0	0.0	0.0	0.0	Sales growth	na	na	na	na
Other intangible assets	0.8	0.5	0.4	0.3	0.3	Operating cost growth	10.0%	4.3%	8.7%	124.1%
Fixed assets	0.2	0.2	0.2	0.2	0.2	EBITDA growth	10.0%	4.3%	8.7%	na
Other assets	0.0	0.1	0.1	0.1	0.1	EBITA growth	11.1%	4.2%	8.6%	na
Total assets	21.2	27.8	39.6	46.0	52.8	EBIT growth	11.1%	4.2%	8.6%	na
Short-term borrowings	0.0	0.0	0.0	0.0	0.0	Norm. NPAT growth (pre GW)	15.3%	5.8%	4.5%	-138.7%
Trade payables	0.7	1.6	1.9	2.3	2.7	Norm. NPAT growth	15.3%	5.8%	4.5%	-138.7%
Long-term borrowings	0.0	0.0	0.0	0.0	0.0	Norm. EPS growth (pre GW)	7.4%	-5.6%	-11.1%	na
Provisions	0.0	0.0	0.0	0.0	0.0	Norm. EPS growth	7.4%	-5.6%	-11.1%	na
Other liabilities	0.0	0.0	2.1	4.2	6.4	Operating performance	2008A	2009F	2010F	2011F
Total liabilities	0.7	1.6	4.0	6.5	9.1	Asset turnover (%)	0.0	0.0	0.0	15.5
Preference shares						EBITDA margin (%)	na	na	na	28.0
Hybrid equity	0.0	0.0	0.0	0.0	0.0	EBIT margin (%)	na	na	na	22.9
Share capital	37.4	51.0	71.0	86.0	86.0	Net profit margin (%)	na	na	na	14.0
Other reserves	1.6	3.8	3.8	3.8	3.8	Return on net assets (%)	-33.8	-25.9	-25.4	16.1
Retained earnings	-18.5	-28.6	-39.2	-50.3	-46.0	Net debt (A\$m)	-14.1	-25.8	-32.2	-39.0
Other equity	0.0	0.0	0.0	0.0	0.0	Net debt/equity (%)	-53.8	-72.4	-81.6	-89.2
Total equity	20.5	26.2	35.6	39.4	43.8	Net interest/EBIT cover (x)	9.7	13.2	9.9	-5.6
Minority interest	0.0	0.0	0.0	0.0	0.0	ROIC (%)	-73.0	-53.3	-71.4	67.9
Total shareholders' equity	20.5	26.2	35.6	39.4	43.8	Internal liquidity	2008A	2009F	2010F	2011F
Total liabilities & SE	21.2	27.8	39.6	46.0	52.8	Current ratio (x)	9.1	6.5	5.0	4.3
						Receivables turnover (x)	na	0.0	0.0	156.3
						Payables turnover (x)	na	5.2	4.7	8.9

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 UK Small/Mid-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 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 27 Feb 2009)		
	Global total (IB%)	Asia Pacific total (IB%)
Buy	467 (4)	296 (0)
Add	0 (0)	0 (0)
Hold	393 (1)	246 (0)
Reduce	0 (0)	0 (0)
Sell	163 (1)	100 (1)
Total (IB%)	1023 (3)	642 (0)

Source: ABN AMRO

Trading recommendations (as at 27 Feb 2009)		
	Global total (IB%)	Asia Pacific total (IB%)
Trading Buy	3 (0)	3 (0)
Trading Sell	1 (0)	1 (0)
Total (IB%)	4 (0)	4 (0)

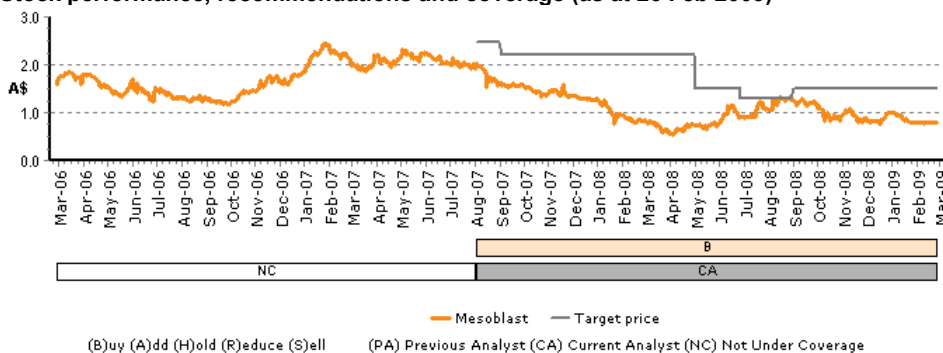
Source: ABN AMRO

Valuation and risks to target price

Mesoblast (RIC: MSB.AX, Rec: Buy, CP: A\$0.790, TP: A\$1.450): 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 26 Feb 2009)



Trading recommendation history (as at 27 Feb 2009)

Date	Rec	Analyst
	n/a	

Source: ABN AMRO

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

Regulatory disclosures

Subject companies: **MSB.AX**

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