

Dermisonics, Inc.

Strengths and opportunities

- *Innovative solution for billion-dollar market:* The company's ultrasound technology has the potential to replace syringes as the means of administering medication in many areas.
- *Product diversification:* Besides the medical-technical U-Strip product, which is expected to improve insulin provision for diabetics, the company is already working on marketing the technology for the cosmetics industry. The considerably lower market entry hurdles means that there is already a significant sales potential for 2006/07.
- *Milestone reached:* Following the approval of further patient tests at the beginning November, the first phase of clinical testing for U-Strip is expected to be completed in Q1.

Weaknesses and risks

- *Risk finance:* In view of the early stage of product development, investing in the company is very much of a venture capital nature. It is not possible at present to forecast with certainty whether the company's technical solutions will meet the demands of the market and regulators.
- *High levels of investment required:* Taking the company's products through to a launch stage still requires considerable capital expenditure. If Dermisonics is unable to raise the required funds, this could jeopardize the company's future.

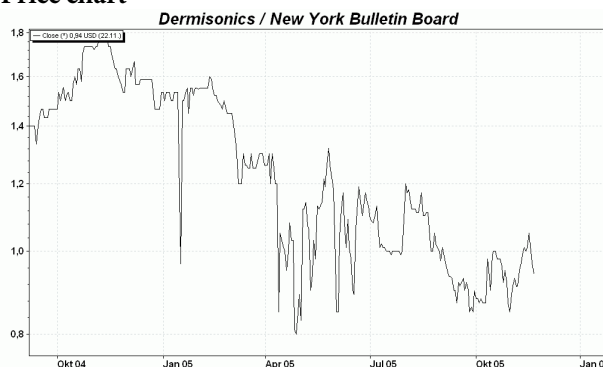
Speculative buy *(initial analysis)*

Current price **0.99 US dollars**

Overview

ISIN	US24983U1043
Industry	Medical technology
Corporate headquarters	West Conshohocken
Internet	www.dermisonics.com
Shares outstanding	40.84 million*
IPO date	June 2003
Market segment	Nasdaq OTC
Market capitalization	40.4 million US dollars*
Free float	55.9%

Price chart



High / Low (3 months)	1.05 US dollars / 0.85 US dollars
Performance (3 months)	-4.8%
Ave. trading (30 days)	approx. 65,000 US dollars / day

Key figures

Fiscal year (ends September 30)	03/04	04/05(e)	05/06(e)
Total sales (USD million)	0.0	0.0	4.5
EpS (USD)	-0.10	-0.13	-0.02
Price/Earnings Ratio	-	-	-
Price/Sales Ratio	-	-	9.0

*fully diluted

Company profile

Acquisition of patent rights

Dermisonics is based in Pennsylvania, USA, and was formally founded under the name of Second Stage Ventures in September 2000. At that time the company was regarded as a capital pool for investing in biotech companies and was licensed to trade on Nasdaq OTC in June 2003. The present business commenced exactly one year later, when the company acquired all the patent and marketing rights for an innovative ultrasound technology. The vendor, Springfield-based Encapsulation systems, had been working on its development since 1988, but was in bankruptcy proceedings at the time and hence forced to sell. The purchase price was agreed at about 19.5 million US dollars, largely payable in Dermisonics shares and about 2.5 million US dollars in installments.

Core Business Drug Delivery Systems

The transaction and further development of the acquired technology has given Dermisonics access to the market for drug delivery systems (DDS). In ordinary out-patient treatment until now, the syringe has been the common form of administering active pharmaceutical agents that cannot be taken orally. With the help of ultrasound technology this could however be revolutionized in the near future. "Sawtooth waves" enlarge the main pores to such an extent that even large molecule drugs can permeate through the skin. From there the drug enters the blood stream. Then "square waves" transport the drug to the desired destination in the body. The company's research to date indicates that this process does not cause any damage to either the skin or the drug.

Major application potential

According to the company management, the technology could be used for some 175 active agents. Ultrasound seems ideally suited for insulin delivery to diabetics, which today still primarily involves the classic syringe. With the "U-Strip" product line the company has tailored its first application especially to the needs of these patients. The Dermisonics system comprises two main elements: a small container, the so-called patch cap in which the active agent is stored, and a credit-card-sized device worn on the body to carry out and monitor the delivery of the drug to the organism. If the ongoing testing of the system's compatibility is successful, the Food and Drug Administration (FDA) could give its approval for the decisive clinical test phase II in the spring of 2006. As U-Strip is a medical-technical and not a medication development, approval involves fewer requirements, but even so could still involve at least a further year and the investment of several million US dollars.

Three product lines

The company is also working in parallel on the development of further product lines. The most advanced is the development of "U-Wand", a handheld device shaped like a toothbrush that also uses ultrasound to apply cosmetics and lotions to the skin. This technology enables the active agents to penetrate much deeper and have a greater effect. Unlike U-Strip however, U-Wand is only a cosmetic product, as the substances penetrate the skin without entering the

blood stream; and as such it is not subject to any regulatory requirements. The planned joint marketing with major cosmetic companies is however conditional on the product meeting their internal compatibility tests. Dermisonics' last application to date is "A-Wand", an ultrasound system for treating wounds with antiseptics and antibiotics. However, this project is still at a very early stage. The first clinical test phase is not scheduled until Q1 of next year.

High-quality management team

Apart from the three application areas already identified, there are probably many other ways the technology can be exploited. The strategic development of the company in new fields is primarily the responsibility of Dermisonics' Executive Vice President Bruce K. Redding, an engineer with scientific expertise and long years of experience in the field of ultrasound. Interim CEO Bruce Haglund from the law firm Gibson, Haglund & Paulson is a highly regarded expert for company and corporation law, in particular young growth companies, whose expertise will no doubt prove especially useful in the pending negotiations with potential marketing partners. In the medium term however the company is looking to fill the post with a full-time CEO who has appropriate experience in the industry. Additional support for the management team is provided by an advisor board set up by Dermisonics in January. On the board are various well-known experts from the pharmaceuticals industry, such as the leading diabetes specialist Dr. Rex K. Kessler and Silvio Inzucchi, Director of the Yale Diabetes Center.

Market and strategy

Core market diabetes

As demonstrated by the latest development A-Wand, the company's target markets in the medication field are highly diversified. Nevertheless, the diabetes market will probably provide the greatest potential for a successful market entry in the near term, which is why the company has driven the development of this application first. Diabetes is a physical malfunction that leaves the organism unable to properly control the blood-sugar level. This is done by the hormone insulin, which has to be supplied to the body externally in line with the current levels. In practice, patients continually measure their values and inject insulin when required. Surveys on satisfaction with injected delivery (for example: www.diabetes.de, as of November 12, 2005) show that only 30 percent of users are completely satisfied with this procedure. However, only a low percentage would like a new needle or syringe-based system. Despite the low satisfaction, users will probably be convinced by a new method only if it really does provide demonstrable improvements in ease of use.

Difficult establishment of new procedures

The only alternative to syringes to establish itself in the market to date are the so-called insulin pumps, for which the US company Medtronic is the market

leader with its Minimed product. Insulin pumps however have the disadvantage that an entry to the body must be established, and hence there is still a risk of infection. Major players such as Pfizer and Sanofi-Aventis are carrying out research into other solutions. As members of a consortium with California-based Nektar therapeutics, they are currently working on the approval of inhalable insulin. As the dosage and lung compatibility of this approach are disputed, the FDA has repeatedly required the consortium to present new studies. But even if this way of taking insulin is approved in the near future, it will not generate much competition for Dermisonics as inhalable insulin cannot completely replace injected insulin since it is designed only to reduce peaks at meal times (source: Deutsches Ärzteblatt, November 09, 2005).

Rival system solutions

Various other smaller companies that concentrate on research and development are working on system solutions in direct competition to U-Strip. Dermisonics sees in particular the independent US companies Altea, Sontra and SpectRx and also Johnson & Johnson subsidiary Alza as its most important competitors. Compared with rival technology, which in part is also based on ultrasound but also uses other technology such as electrophoresis, the company says that the U-Strip system offers clear advantages in the way it combines ease of use, dosing and undamaged insulin delivery. Nevertheless, it is still completely unclear at present which technology will ultimately emerge as the winner in the marketplace.

Strong market growth

Ultimately, the diabetes market should offer sufficient room for many different solutions. The demand is definitely immense and growing strongly on the back of the rising average population age, obesity and the lack of movement. Some 150 million people around the world are today already affected by the illness, and the WHO predicts that this figure could rise to 300 million by 2025 (source: www.diabetes.de). As the healthcare costs for people with diabetes – in particular from other illnesses resulting from incorrect treatment – are five times higher than for people without diabetes, there will also be a demand for accurate therapies from health insurance funds in industrialized countries which have an interest in reducing these costs.

Licensing with sales royalties

The strong rise in diabetes cases is already reflected in the rapid expansion of the DDS market. According to information supplied by the company, the US market for drug delivery devices is expected to grow on average by about 11.6 percent per annum between 2000 and 2007 to a value of some 41 billion US dollars. This multi-billion-dollar market cannot be served by a small company like Dermisonics on its own. Accordingly, the business model envisages the signing of strategic alliances with drug companies following successful approval. If taken up by these companies, Dermisonics would charge 5 million US dollars for the use of the active agents in U-Strips and also generate revenue from the ongoing

sales of devices and from 2.5% royalties on the sale of patches. The general interest in this model is shown by the fact that well-known companies like 3 M Corporation are already involved in the product development via cooperations.

Comparable potential in skin care

Dermisonics is looking to implement a similar revenue model for U-Wand as well. In the event of a successful market launch, revenue would again flow from the three elements device sales, license fees and royalties on patch sales. Even though there is still no solution comparable to U-Wand on the market, the potential for the technology is probably enormous. In the highly competitive skin care market, producers are desperately on the lookout for innovations that can improve the competitive position of their products. Hence, there should be no lack of possible cooperation partners after successful compatibility tests. The skin care market is also a very attractive high-growth segment within the overall cosmetics market. The targeted area for professional skin care grew by 80 percent to 285 million US dollars between 2003 and 2004 following the entry of major brand producers (source: Dermisonics).

Business developments

Balance sheet dominated by early stage

The company's potential is undeniably great in the light of its target markets. The actual figures from the company's balance sheets on the other hand document just how much a company specialized in research and development has to invest until its products reach market maturity. Whilst no revenue has yet been generated from core business, the cumulative loss since foundation amounts to some 8.85 million US dollars (as of: June 30, 2005). Of this, 4.4 million US dollars arose during the first nine months of FY 2004/05. Besides the expenses for testing, consulting and other fees, which make up the lion's share of the costs to date, a significant amount is incurred as interest on debt capital.

Capital endowment as critical success factor

As of June 30, liabilities of 2.32 million US dollars are disclosed in the balance sheet. In view of the company's potential revenues, this amount may seem relatively small, but Dermisonics currently has only low levels of cash available. According to the management's figures, a further 7.5 million US dollars, in particular for R&D, marketing and refinancing, will be required until the possible marketing of the products. The further financing is thus a critical success factor along with progress in product development. Against this background, the credit agreement signed with venture capitalists Berra Holdings in August can be seen as a significant step. This agreement extends Dermisonics a credit line of 1.5 million US dollars at 8 percent interest, of which 840,000 US dollars has been called down. In mid September, further finance was raised in the form of a 784,501 US dollar convertible bond. According to the management, other actions involving at least 800,000 US dollars are close to signing.

Progress in core business

These reports were flanked by good news on the marketing and development fronts. Above all, the strategic alliance with the British-based PharmaVentures in the summer of this year should significantly improve the prospects for finding partners in the industry. This globally active consulting specialist for the pharmaceuticals market will help identify suitable contract partners who may have an interest in the administering of their active agents using ultrasound technology. The first tangible result of this connection is the A-Wand product line, which has extended the application spectrum towards wound healing.

Tests successful to date

More important however is the progress in the research into the effectiveness of U-Strip. Various tests already completed as part of the first clinical test phase show that ultrasound technology has a high functionality. In mid November, the Investigative Review Board (IRB) of the Chesapeake Research Review was so convinced that it granted approval to move to the next test stage. As this study, which will test the effectiveness of U-Strip against other diabetes therapy methods, could mark the completion of the clinical test phase I, the approval is a milestone in the development of Dermisonics. If this test series is also successful, it will form the basis for the application to commence the final clinical test phase II, which involves continuous tests on hundreds of patients over several weeks.

Valuation

Simple earnings value model

We determined the fair value of Dermisonics using a simple earnings discounting model based on estimating the key value drivers sales, net return and equity capital costs. We waived the typical additional parameters and assumptions of the discounted free cash flow model, because this would not have improved the accuracy of our estimate owing to the company's relatively volatile free cash flow.

15.1% CAPM discount rate

To determine the discount rate as an indicator of the company's equity capital costs, we used the Capital Asset Pricing Model, assuming a risk-free rate of 4.5 percent (current yield on US 10-year treasury bonds) and a long-term equity risk premium of 5.3 percent. As a risk indicator based on historical market data, beta was less meaningful in part owing to the very low correlation. As a measure of the systematic risk we therefore relied on fundamental factors and applied a high value of 2.0 in view of the company's early development stage and a pronounced operative and financial risk. On the basis of these assumptions we arrived at a discount rate of 15.1 percent.

Forecast business developments

At present, the forecast for the success of further product development on the one hand and the subsequent market acceptance for U-Strip, U-Wand and A-

Wand on the other hand is subject to a high degree of uncertainty. In the light of the early stage of business development, there is always a possibility of survival-threatening setbacks in operative business or financing. However, success in only one of the three product lines under development would pave the way to a billion-dollar market. In order to map this difficult starting point, we developed and compared the following two scenarios. The following table is based on a projection of future business drawn up by the management in September. We have derived an indication for net margins from the published sales and EBITDA forecasts. At the end of the period estimated in detail by the company management, we have modeled a transition phase with declining sales growth and constant margin. We put the "perpetual growth" at the end of the forecast horizon at 1.5 percent.

Fiscal year (ends Sept. 30)	05/06	06/07	07/08	08/09	09/10	10/11	11/12	12/13
Total sales (USD million)	4.5	84.9	101.3	232.1	355.5	426.6	469.3	492.7
Sales growth	-	1786%	19.4%	129%	53.2%	20.0%	10.0%	5.0%
Net return	-	30.1%	34.4%	34.6%	34.3%	33.0%	31.0%	30.0%
Profit (USD million)	-1.0	25.6	34.8	80.2	122.1	140.8	145.5	147.8
Profit growth	-	-	36.2%	130%	52.3%	15.3%	3.3%	1.6%

Fair value 18.40 US dollars per share

This business development, which directly reflects the company's projections, shows an earnings value of 751.6 US dollars (18.40 US dollars per share). This valuation is much higher than the current market capitalization and underscores the immense upside potential on an optimistically estimated business development.

Retrograde valuation

This we compare with a business development that would justify the company's current value on the stock market:

Fiscal year (ends Sept. 30)	05/06	06/07	07/08	08/09	09/10	10/11	11/12	12/13
Total sales (USD million)	2.5	5.0	10.0	19.0	34.2	53.0	63.6	66.2
Sales growth	-	100%	100%	90%	80%	55%	20%	4%
Net return	-	5.0%	10.0%	12.5%	15.0%	15.0%	15.0%	15.0%
Profit (USD million)	-3.3	0.3	1.0	2.4	5.1	8.0	9.5	9.9
Profit growth	-	-	300%	138%	116%	55.0%	20.0%	4.0%

Indicators for market valuation

Such a business development is based on the assumption that although the company is successful in placing a product on the market, it captures only a minimum market share. Since none of the three product lines has a niche character but all have major market potential, we do not regard such a development as being realistic. Once the critical point approval – and compatibility test for U-Wand – has been overcome, there is a high probability of significant revenue potential. Nevertheless, the scenario is an interesting reference case that shows

what low absolute revenue has to be generated to justify the current company value.

*Past market
assessment pessimistic*

The results of the two models show that the market currently gives the Dermisonics business model only a low chance of success. At the current market capitalization of some 40 million US dollars, the successful outcome of the business development forecasted by the company management is attributed a probability of only 5.4 percent. The retrograde scenario on the other hand indicates that even a very low success – measured by market volume – would suffice to justify the current company valuation. If the management achieves results in the critical areas of raising finance and product approval during the next few months, the company should see itself being revalued. As there is considerable leverage from a positive business development, even a slight increase in the probability of a successful outcome would lead to considerable upward price potential.

*Our recommendation:
"Speculative buy"*

Investing in Dermisonics is of a pronounced venture capital nature. A great deal of work still has to be done in both product development and financing before the important products U-Strip and U-Wand are ready for launching. Nevertheless, the company has adopted an interesting and innovative approach in a large, high-growth market. The valuation figures show that successful implementation of the strategic plan would result in a value well above current market capitalization. If positive company releases lead to a raising of the probability of success estimated by the market, a part of this potential could be realized in the short term. We accordingly recommend the shares as a "speculative buy" to investors who are convinced by the concept of the enterprise and who are not put off by the high risks of the early stage of the company's development. As the currently low share price expresses the market's concern over the short-term financing of the company, the risk of a total loss must be countered by setting a stop loss.

About Performaxx

Performaxx Research GmbH conducts independent security and financial market analyses. Our services cover the entire spectrum of company- and capital-market-related analysis products, from customized research projects for institutional clients through to regular coverage of listed companies.

We work exclusively on behalf of professional market agents. With our project-related work, we focus on the customer's individual issues, which guarantees fast, flexible and cost-effective handling. Our services include:

- Pre-IPO research
- IPO research
- Follow-up research
- Market research

We will be glad to provide further details in a personal meeting. We can be reached at:

Performaxx Research GmbH
Innere Wiener Strasse 5b
81667 Munich

Tel.: + 49 (0) 89 / 44 77 16-0

Fax: + 49 (0) 89 / 44 77 16-20

Internet: <http://www.performaxx.de>

E-mail: kontakt@performaxx.de

Disclaimer

Exclusion of liability

The information published in this financial analysis does not constitute an invitation, offer or recommendation to purchase or sell investment instruments or carry out any other transactions. Furthermore, neither this publication nor the information therein constitutes the basis for a contract or obligation of any nature. All investments in shares, bonds or options involve risks. You should seek expert advice for your investment decisions.

The information and data in this financial analysis are derived from sources regarded as reliable by Performaxx Research GmbH. However, Performaxx Research GmbH provides no warranty for the accuracy and completeness of this information and data. The contents of this document reflect the authors' current assessment. This can change without prior notice. Neither the authors nor Performaxx Research GmbH are liable for losses or damages of any nature related to the contents or application of this financial analysis

All foreign capital market regulations relating to the production, content and selling of research are to be applied and complied with by provider and recipient alike in every respect.

Information in compliance with Section 34b German Securities Trading Act (WpHG) and Financial Analysis Ordinance (FinAnV)

All share prices stated in this financial analysis are closing prices as of the penultimate day before the publication date, except where stated otherwise. The main source of information for the financial analysis is the materials and information provided by the company and also information regarded as credible and reliable from third-party providers (e.g. news agencies, research houses, trade publications), which are cited where appropriate in the text of the study.

The study was written by Dipl.-Kaufmann Holger Steffen (financial analyst). The company responsible for its production is Performaxx Research GmbH. Performaxx Research GmbH anticipates producing and publishing one study and three updates a year on the analyzed company. **The exact dates of the next publications have not yet been decided.** During the past twelve months, Performaxx Research GmbH has published the following studies on the analyzed company:

<u>Date of publication</u>	<u>Share price at publication</u>	<u>Recommendation</u>
(none: initial analysis)		

Unless otherwise stated in the study text, the recommendation in this study is based on a long-term investment period of at least twelve months. Within this period, the recommendation "buy" means an expected increase in the share price of more than 25 percent, "overweight" an expected increase of between 10 and 25 percent, "hold" an expected increase up to 10 percent, "underweight" an expected decrease by up to 10 percent and "sell" an expected decrease of more than 10 percent. "Speculative buy" means an expected increase of more than 25 percent with above average investment risk owing to low forecast certainty.

Performaxx Research GmbH has an internal operating guideline for the preparation of financial analyses in place that is binding on all persons involved in the preparation of such studies and has taken regulatory steps to prevent and deal with conflicts of interest. The following conflicts of interest can in general arise at Performaxx Research GmbH in conjunction with the preparation of financial analyses:

- 1) The financial analysis was prepared on behalf of the analyzed company against payment.
- 2) The financial analysis was presented to the analyzed company before publication and amended in response to justified objections.
- 3) Performaxx Research GmbH and/or an affiliated company holds long or short positions in the analyzed company.
- 4) The author and/or persons/companies involved in the preparation hold long or short positions in the analyzed company.
- 5) Performaxx-Anlegermedien GmbH, an affiliated company of Performaxx Research GmbH, has recommended the analyzed company in its investment newsletter "Performaxx-Anlegerbrief" before publication of this study.

Of the above, the following conflicts of interest are possible: 1), 2), 4)

Copyright

This document and all parts thereof are protected by copyright. All and any use beyond the strict limitations of the Copyright Act without the permission of Performaxx is unauthorized and punishable by law. This applies in particular for reproductions, translations, microfilming and also storage and processing in electronic systems.