Edison investment research

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Sareum Holdings

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	PE (x)	Yield (%)
06/06	1.5	(0.8)	(0.2)	0.0	N/A	N/A
06/07	2.5	(0.7)	(0.1)	0.0	N/A	N/A
06/08e	2.0	(1.4)	(0.2)	0.0	N/A	N/A
06/09e	2.2	(1.7)	(0.2)	0.0	N/A	N/A

Note: *PBT and EPS are normalised, excluding goodwill amortisation and exceptional items.

Investment summary: Cancer focus emerges

Sareum has evolved from a structure-based drug discovery services business into an early-stage biotech company focused on oncology. It has used its expertise in structure-based drug design to identify 'best in class' compounds that address a number of novel but well-validated kinase drug targets in cancer. Sareum hopes to conclude licensing deals for one or more of these programmes in the short term to provide capital to allow it to further develop other internal candidates.

Six drug discovery programmes

Sareum has six novel small molecule drug development programmes, three of which are approaching the candidate nomination stage. Its lead programme is a joint venture with the ICR/CRT.

Significant industry interest

Management asserts that there is significant potential partner interest in three of its programmes – a reflection of the fact they address high-profile kinase targets. Sareum's fee-for-service business also provides visibility with a number of key potential partners. Its negotiating position is, however, likely to be hampered by a lack of negotiating capital and could also be hostage to results of clinical trials of competitor products with the same mechanism.

Early-stage licensing deals

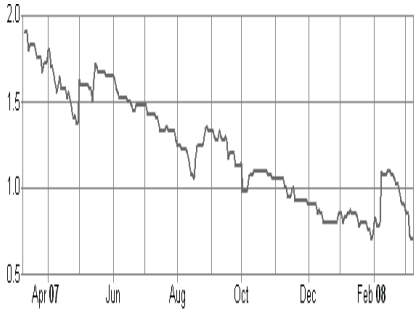
In recent years, preclinical stage licensing deals in cancer have become more common and have achieved some highly attractive economic terms.

Valuation

Sareum's valuation has hitherto at best been driven by its services business, with no value realistically attributable to its R&D pipeline. Though early stage, its attractive pipeline would easily justify a multiple of the current market capitalisation and a catalyst for a re-rating is likely to be a licensing deal. However, in the absence of this, Sareum will need to issue equity this year, a fact that is probably depressing the shares. The company also remains attractive as a potential trade sale candidate.

Price	0.7p
Market Cap	£4m

Share price graph



Share details

Code	SAR
Listing	AIM
Sector	Pharmaceuticals & Biotechnology
Shares in issue	598.7m

Business

Sareum is a UK company with a discovery-stage oncology pipeline and a profitable fee-for-service business providing structure-based drug discovery.

Bull

- Six internal small molecule drug discovery programmes, focused on 'best in class' therapeutics for cancer.
- Early stage out-licensing deals would provide significant upside at current valuation.
- Profitable service business with long-term contracts with Roche, J&J, Schering-Plough, Plramed and Almirall and repeat business with Lundbeck and Genentech.

Bear

- Fee-for-service business has seen disruption from M&A activities among clients.
- Lack of negotiating capital. Licensing deal terms could be compromised by low market valuation.
- Requirement to raise additional equity in the short term, although licensing deals may provide sufficient funding in the longer term.

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Company description

Sareum was formed in August 2003 through a management buy-out of the UK operations of Millennium Pharmaceuticals. Its management team pre-dates the 2003 buyout, having been formed at Cambridge Discovery Chemistry, a UK firm which was acquired by Millennium in 2000. The company started out as a provider of structure-based drug discovery research services but since 2005 has evolved into an early-stage drug discovery company focused on oncology. The company listed on AIM in 2004 and has raised a total of £5.4m in equity and generated revenues of £5.4m since inception.

Sareum selects novel but well-validated drug targets and improve on the drug candidates already in trials. Exhibit 1 summarises the R&D pipeline.

Exhibit 1: R&D programme summary

Programme	Status	IP	Notes
CHK1 (checkpoint 1 kinase)	Approaching candidate nomination. Efficacy established in cancer cells models, including synergistic activity with chemotherapeutics.	4 patents filed	CHK1 is a kinase involved in regulating cell cycle checkpoint signals that are activated in response to DNA damage and errors in DNA caused by defective replication. Therefore CHK1 inhibitors should prevent DNA repair in cells damaged by chemotherapy/ radiotherapy and could be used as a cytotoxic potentiator in solid tumours (eg colon/ovarian). Joint venture with the Institute of Cancer Research/Cancer Research Technology. Compounds with same mechanism include: Exelixis's XL844, Lilly's LY2603618, AstraZeneca's AZD7762 and Pfizer's PF477736 (all Phase I).
FLT4	Effectiveness established in cell models, in vivo ADME properties.	IP filed	FLT4 is a kinase that controls the mobilisation of cancer cells, a key process involved in metastasis. Therefore an FLT4 inhibitor should prevent tumour spread and could be suitable for use with tumours that are identified at metastatic stage (eg pancreatic) and be used with existing therapy. Believed to be the leading FLT4 specific inhibitor, although there are a number of multi-kinase inhibitors with FLT4 activity both approved (sorafenib, sunitinib) and in development (AstraZeneca's Recentin (cediranib), Amgen's AMG 706/motesanib).
Aurora Kinase	Effectiveness in cell-based models. Established orally bioavailable.	2 patent filed	Aurora kinases A and B are required for cells to both enter and proceed through mitosis and are over-expressed in a variety of cancers (pancreatic, ovarian, colon, breast, liver, lung, thyroid and bladder). Sareum has compound series with different specificities to the A & B subtypes, so can select the best profile based on the success of competitors. Competing products with the same method of action include: Merck/Vertex's VX-689, Millennium's MLN8054 and MLN8237, Merck Serono/Rigel's AS703569/R763 and AstraZeneca's AZD1152 (all in Phase I).
PLK-1 (polo-like kinase1)	Five novel series currently in chemistry.	N/A	Higher levels of PLK-1 are present in many solid tumours and tend to correlate with a poor disease prognosis. Key competitors: Boehringer Ingelheim's BI 2536 (Phase I/II), GSK 461364 (Phase I), Cyclacel's CYC800 series (preclinical).
B-RAF Kinase	Hit discovery.	N/A	Many cancers have mutations in the B-RAF gene which cause a large increase in B-RAF protein kinase activity. These mutations have been observed in >60% of malignant melanoma as well as colorectal, thyroid, and lung cancers and glioblastoma. Key competitors: Roche/Plexxikon's PLX4032; Deciphera (various, preclinical), ArQule's ARQ-350RP (preclinical).
Fatty Acid Synthetase (FASN)	Novel chemical series, active against cancer cells.	Patent filed	FASN is over-expressed in common cancer cells. Blocking FASN expression or activity results in apoptosis of tumour cells and reduction of tumour volumes in cancer models.

Source: Edison Investment Research

Investment summary

Sareum's investment proposition now rests on its ability to secure a partner(s) for one or more of its lead programmes, especially CHK1, FLT4, and Aurora kinase. If it can do so, the economic terms would likely provide sufficient resources to advance the development of other programmes. The company continues to offer drug discovery services and has long-term contracts with Roche, J&J, Organon (Schering-Plough), PIramed and Almirall and repeat business with Lundbeck and Genentech. The fee-for-service business has suffered from some lumpy contract awards in the past year, compounded by delays in placing orders as a result of client M&A activity.

Recent licensing activity suggests that major pharmaceutical companies are (or at least have been) prepared to pay very substantial sums to acquire early-stage programmes in cancer. Exhibit 2 lists some recent early-stage cancer licensing deals to illustrate the potential value.

Exhibit 2: Selected early-stage licensing deals in cancer

Companies /date	Compound/stage	Financial terms /notes
Celgene/Array (Sept 2007)	Preclinical. Cancer and inflammation.	$40m upfront plus for each drug potential milestone payments of approximately $200m and $300m on commercial milestones and royalties on sales.
Bristol-Myers Squibb/Exelixis (Dec 2006)	Preclinical. Various compounds.	$60m upfront and $20m for each of up to three different drug candidates selected at IND stage. US development costs, profits and co-promotion responsibilities shared. Royalty payable on ex-US sales.
Roche/ Plexxikon (Oct 2006)	PLX4032 (IND stage) and follow on compounds targeting other B-RAF kinase mutations.	$40m upfront, $6m in guaranteed research funding over the two years and milestones of up to c $660m.
Genentech/CGI (Jun 2006)	Undisclosed multiple kinase inhibitors (preclinical).	$25m upfront (including equity) and $500m in milestones, plus royalties on sales.
Novartis/Infinity Pharmaceuticals (May 2006)	Preclinical. BCl-2 inhibitors.	$30m upfront, equity and research fees, up to $370m in milestones.
Novartis/SGX Pharmaceuticals (Mar 2006)	BCR-ABL inhibitors for the treatment of drug-resistant CML.	$25m upfront and equity, $490m in milestones.
AstraZeneca/ Astex (Jul 2005)	Preclinical. Novel small molecule inhibitors of Protein Kinase B (PKB; also known as Akt).	$5m upfront, research funding and milestone payments of up to $270m and double-digit royalties on sales.
Genentech/ PIramed (Nov 2005)	Preclinical. Drugs targeting PI 3-kinase.	Undisclosed upfront and milestones up to an aggregate of $230m. Royalties on sales.
Astex/Novartis (Dec 2005)	AT9311 (pre-IND) and option on AT7519 (Phase I).	Upfront and deferred equity payments of $25m with a potential of up to $520m in fees and equity payments, option payments and milestones, plus royalties on global product sales.
Merck Serono/ Rigel (Oct 2005)	Preclinical. Aurora kinase inhibitor programme, including R763.	$10m upfront, $15m equity purchase, development and sales-based milestone payments up to $135m, plus royalties on sales.
Merck & Co/ Vertex (Jun 2004)	Aurora kinase inhibitor VX-680 (Phase I)	$20m upfront and $14m in R&D funding over two years, and up to $350m in milestones ($130m for the successful development in the first oncology indication), and royalties on sales.
AstraZeneca/ Array (Dec 2003)	ARRY-1886 (now AZD6244), a selective MEK inhibitor.	$10m upfront, undisclosed research funding development milestone and royalties on sales.

Source: Edison Investment Research

Financials

Sareum reported revenues of £1.1m for the six months to 30 December, of which £222,000 arose from success-based payments. Revenues relate largely to specific ongoing drug discovery projects, although some agreements provide for downstream payments as compounds move through preclinical and clinical development, which represents a source of hidden value.

Overall revenues were slightly down (c 10%) on the comparative and immediately preceding six month periods. This decline reflects the tough trading conditions in this space, with client companies reluctant to initiate new R&D programmes given the current economic uncertainty, compounded by delays in contract awards as a result of M&A activity within its customer group.

We have assumed Sareum achieves revenues of around £2m for the financial year to 30 June 2008, which grows modestly in FY2009 and 2010. We believe these are low base case figures and the model deliberately does not anticipate any revenues from potential licensing deals or downstream milestones from compounds covered by prior fee-for-service agreements, so as to represent a worst-case scenario.

Sareum held cash of £0.9m on 30 December and has indicated that it will need to seek further funding before the end of June 2008. We estimate that Sareum will spend around £1.2m on internal R&D this year (this is included in cost of sales). Internal R&D is to some extent discretionary and Sareum intends to use upfront funding from licensing agreements to fund development of its pipeline. Nevertheless, assuming a c 20% year-on-year growth in R&D expenditure and in the absence of a licensing deal, our model suggests its funding requirement of just over £1.2m in the financial year to June 2009 and £3m to June 2010 (this is included in long-term debt).

Edison's model is shown overleaf in Figure 3.

Exhibit 3: Financial results and forecasts.

£'000 Year end 30 June	2006 IFRS	2007e IFRS	2008e IFRS	2009e IFRS	2010e IFRS
PROFIT & LOSS					
Revenue	**1,476**	**2,471**	**2,020**	**2,200**	**2,600**
Cost of Sales	(1,080)	(1,853)	(2,010)	(2,340)	(2,808)
Gross Profit	396	618	10	(140)	(208)
EBITDA	**(512)**	**(463)**	**(1,202)**	**(1,523)**	**(1,777)**
Operating Profit (before GW and except.)	**(750)**	**(734)**	**(1,452)**	**(1,748)**	**(1,977)**
Intangible Amortisation	0	0	0	0	0
Exceptionals	0	0	0	0	0
Other	0	0	0	0	0
Operating Profit	**(750)**	**(734)**	**(1,452)**	**(1,748)**	**(1,977)**
Net Interest	(2)	12	10	0	0
Profit Before Tax (norm)	**(753)**	**(723)**	**(1,442)**	**(1,748)**	**(1,977)**
Profit Before Tax (FRS 3)	**(753)**	**(723)**	**(1,442)**	**(1,748)**	**(1,977)**
Tax	128	195	241	281	337
Profit After Tax (norm)	**(625)**	**(527)**	**(1,201)**	**(1,467)**	**(1,640)**
Profit After Tax (FRS 3)	**(625)**	**(527)**	**(1,201)**	**(1,467)**	**(1,640)**
Average Number of Shares Outstanding (m)	359.4	431.6	529.3	598.7	598.7
EPS - normalised (p)	(0.2)	(0.1)	(0.2)	(0.2)	(0.3)
EPS - FRS 3 (p)	(0.2)	(0.1)	(0.2)	(0.2)	(0.3)
Dividend per share (p)	0.0	0.0	0.0	0.0	0.0
BALANCE SHEET					
Fixed Assets	**810**	**1,046**	**965**	**900**	**860**
Intangible Assets	17	31	32	32	32
Tangible Assets	792	1,015	933	868	828
Investments	0	0	0	0	0
Current Assets	**965**	**1,498**	**1,066**	**743**	**1,041**
Stocks	0	0	0	0	0
Debtors	437	837	498	542	641
Cash	528	660	568	200	400
Current Liabilities	**(517)**	**(1,017)**	**(498)**	**(542)**	**(641)**
Creditors	(517)	(1,017)	(498)	(542)	(641)
Short term borrowings	0	0	0	0	0
Long Term Liabilities	**(63)**	**(160)**	**(165)**	**(1,200)**	**(3,000)**
Long term borrowings	(63)	(160)	(165)	(1,200)	(3,000)
Other long term liabilities	0	0	0	0	0
Net Assets	**1,195**	**1,366**	**1,367**	**(100)**	**(1,740)**
CASH FLOW					
Operating Cash Flow	**(363)**	**(370)**	**(1,382)**	**(1,523)**	**(1,777)**
Net Interest	(2)	12	10	0	0
Tax	120	128	241	281	337
Capex	(66)	(518)	(168)	(160)	(160)
Expenditure on intangibles		0	(1)	0	0
Acquisitions/disposals	0	0	0	0	0
Financing	398	880	1,203	0	0
Dividends	0	0	0	0	0
Net Cash Flow	87	132	(97)	(1,402)	(1,600)
Opening net debt/(cash)	**(348)**	**(466)**	**(500)**	**(403)**	**1,000**
HP finance leases initiated	0	0	0	0	0
Other	31	(98)	(1)	0	(0)
Closing net debt/(cash)	**(466)**	**(500)**	**(403)**	**1,000**	**2,600**

Source: Edison Investment Research