August 16, 2012

Zacks Small-Cap Research

Brian Marckx, CFA
bmarckx@zacks.com
Ph (312) 265-9474

scr.zacks.com 111 North Canal Street Chicago, IL 60606

Interleukin Genetics (ILIU-OTC)

ILIU: Q2 Results / PST Data / Financing

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	03/28/2011
Current Price (08/06/12)	$0.50
Target Price	**$1.30**

OUTLOOK

Top-line data of the key UofM PST (periodontal disease) test study was announced on August 6th and looks very positive. This follows other encouraging news that Delta Dental injected $3MM in new financing into ILIU, a clear indication (in our opinion) of confidence in ILIU's PST test.

The next steps leading up to roll out of the high-potential PST test are publication of the full data and reimbursement by Renaissance Health/Delta Dental. We remain highly positive on ILIU and are maintaining our Outperform rating and $1.30 price target.

SUMMARY DATA

52-Week High	**$0.55**
52-Week Low	**$0.17**
One-Year Return (%)	**21.62**
Beta	**1.85**
Average Daily Volume (sh)	**23,911**
Shares Outstanding (mil)	**37**
Market Capitalization ($mil)	**$18**
Short Interest Ratio (days)	**3.49**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**1**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**-33.2**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**N/A**
P/E using 2012 Estimate	**N/A**
P/E using 2013 Estimate	**N/A**
Zacks Rank	**N/A**

Risk Level	**High,**
Type of Stock	**N/A**
Industry	**Med-Biomed/Gene**

ZACKS ESTIMATES

Revenue
(in '000s of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2011	719 A	797 A	765 A	575 A	2,857 A
2012	677 A	799 A	757 E	689 E	2,944 E
2013					7,464 E
2014					21,744 E

Earnings per Share

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2011	-$0.03 A	-$0.04 A	-$0.03 A	-$0.04 A	-$0.14 A
2012	-$0.04 A	-$0.03 A	-$0.04 E	-$0.03 E	-$0.13 E
2013					-$0.05 E
2014					$0.03 E

Zacks Projected EPS Growth Rate - Next 5 Years % **N/A**

© Copyright 2012, Zacks Investment Research. All Rights Reserved.

Q2 2012 RESULTS

Interleukin reported financial results for the second quarter ending June 30, 2012 on August 14th. Top and bottom line results were very much in-line with our numbers, with revenue coming in a hair below our estimate but net income beating on better gross margin and lower than modeled operating expenses.

On the operational side, the big news, which came just days prior to the earnings release, is that top-line data from the PST study is positive. The next step, which is being driven by U of M, is to have the full data published. In the meantime, Interleukin will work with their commercialization partner Delta Dental to finalize their business relationship and plan relative to commercialization and reimbursement of the PST test. Management noted on the call that Delta is very excited about the possibilities for the PST test and remains very much behind it. As a reminder, Delta injected $3 million of capital into ILIU in late June, which we think is an obvious vote of confidence for the opportunity that the PST test holds.

Q2 Results

Revenue
Q2 revenue of $799k was flat yoy and just missed our $829k estimate. We had previously modeled genetic testing revenue to grow sequentially throughout the remainder of 2012 based on the assumption that ILIU continues to see tangible traction in scoring corporate customers for its weight management test. We now think that's less likely and have trimmed our revenue estimates for Q3 and Q4. Management noted on the call that without additional clinical data to support a robust manuscript, a peer-reviewed publication of WM test data is not likely to happen - which, as noted in the past, was expected to help drive additional interest in the test from corporate customers (i.e. - weight loss clinics). With ILIU's attention now clearly focused on the PST test (which is slated as the long-term driver of revenue), the WM test is now back-burner. Nonetheless, we still model single-digit revenue growth in 2012 and a much steeper ramp in 2013 when we think the PST test could launch.

GM / Operating Expenses / EPS
GM was 50.8% versus our 47% estimate. We continue to model full-year GM of about 50%. Management continues to do a good job with managing expenses. Operating expenses were just $1.49 million, down $89k sequentially (despite an 18% increase in sales from Q1) and well below our $1.61 million estimate. Net loss and EPS were $1.23 million and ($0.03) compared to our $1.35 million and ($0.03) estimates.

Cash
The other big news, aside from the PST test results, was that ILIU raised $3 million (gross, $2.7 million net) in financing in late June from the sale of convertible preferred stock (see our Investor Note below) to Delta Dental and extended the maturity of the Pyxis credit line from June 30, 2012 to November 30, 2012.

Cash used in operations in Q2 was $1.2 million, up from $999k in Q1. Cash balance at the end of Q2 was $3.8 million, which includes the $3 million net from the preferred sale and the final $1.3 million draw on the Pyxis credit line. ILIU notes that they believe they have enough cash to fund operations until January 2013 assuming they can continue to extend the maturity date of Pyxis line. ILIU has been successful in extending the maturity date several times since the original maturity in August 2008.

OUTLOOK / RECOMMENDATION

Other than the above noted updates to revenue in the second half of 2012, our model remains largely unchanged following Q2 results. We continue to model only modest revenue growth until after substantial commercialization of the PST test. We look for revenue and EPS of $2.94 million / ($0.13) and $7.46 million / ($0.05) in 2012 and 2013, respectively. We are maintaining our $1.30 price target and Outperform rating.

Positive PST Study Top-Line Data (*per our 8/6/12 investor note*)

This morning (8/6/2012) Interleukin announced that the University of Michigan revealed top-line results of the eagerly awaited PST test study. The top-line data is positive, in favor of Interleukin's PST study showing efficacy on the primary endpoint, change in tooth loss based on patient risk category.

The study, officially titled *Periodontal Disease Prevention Study: A Retrospective Cohort Study to Assess the Effect of Genetics and Dental Preventive Care on Periodontal Disease* is funded by Renaissance Health Service/Delta Dental and conducted by the University of Michigan. It examined 16 years worth of data from over 5,000 patients taken from a large dental claims database. It is the pivotal study which is expected to show that certain risk factors, including a positive result on ILIU's PST genotyping test, can help predict periodontal disease and determine the optimal number of dental cleanings per year, which will provide support to reimburse for the PST from dental insurance providers.

Top-line data from the study showed exactly what Interleukin hoped, that high risk patients are likely to benefit from more than one cleaning per year while low risk patients are not. Specifically the data showed that there was no significant difference between two dental cleanings and one dental cleaning in reducing the number of tooth extractions in the low-risk patient population (13.8% vs. 16.4%, p=0.092). By contrast there was a significant difference between two dental cleanings and one dental cleaning in reducing the number of tooth extractions in the high-risk patient population (16.9% vs. 22.1%, p=0.002).

Per the trial protocol, patients were categorized as low risk of tooth loss if they were non-smokers, did not have diabetes and were PST test negative. High risk were smokers, diabetic and PST test positive. Of particular interest is that the top-line data also shows a highly significant ($p<0.001$) correlation between the number of positive risk factors and extractions - implying that all risk factors (i.e. - including PST) are indicative of risk of tooth loss.

The full data set is expected to be submitted for publication by the UofM. Following publication, we expect that Interleukin's game plan will continue to be to roll out their PST test supported with dental insurance reimbursement from Renaissance Health/Delta Dental which touches as many as 54 million covered lives.

This top-line data, along with the early July news that Delta Dental injected $3 million in new financing to ILIU provides what we view as substantial support for the potential of ILIU's PST test.

ILIU Scores $3MM In New Financing, Extends Note Maturity (*per our 7/2/12 investor note*)

In an 8K filing this morning (7/2/2012) Interleukin announced that they've secured $3 million (~$2.7MM net) in new financing via the sale of 500k shares (@ $6.00/share) of their Series B convertible preferred stock and extended the maturity of the credit facility from Pyxis (from June 30, 2012) to November 30, 2012. These are huge positives as it eliminates (or at least postpones) the impending liquidity crunch that the company faced as a result of the company's dwindling cash balance and maturity of the credit line.

Subsequent to Q1 2012, Interleukin drew down the remaining $1.3 million available under the $14.3 million Pyxis credit facility. The loan was set to mature on June 30, 2012 which, along with a nearly negligible cash balance, raised obvious concerns. This morning's 8K notes that Interleukin successfully amended certain terms of the debt, including extending the maturity to November 30, 2012.

Delta Dental Plan of Michigan, part of the Renaissance Health Service network, purchased the Series B convertible preferred stock and will get a seat on ILIU's board. Each Series B preferred share is convertible at the option of the holder into 21.86 shares of common stock ($0.2745 conversion price) and, at the discretion of the board, is eligible to receive an 8% (non-cumulative) dividend.

The investment by Delta Dental is, in our opinion, a meaningful show of confidence in the potential for Interleukin's PST (periodontal disease) test. Renaissance / Delta is funding Interleukin's large PST test study which is being conducted by the University of Michigan.

FINANCIAL MODEL

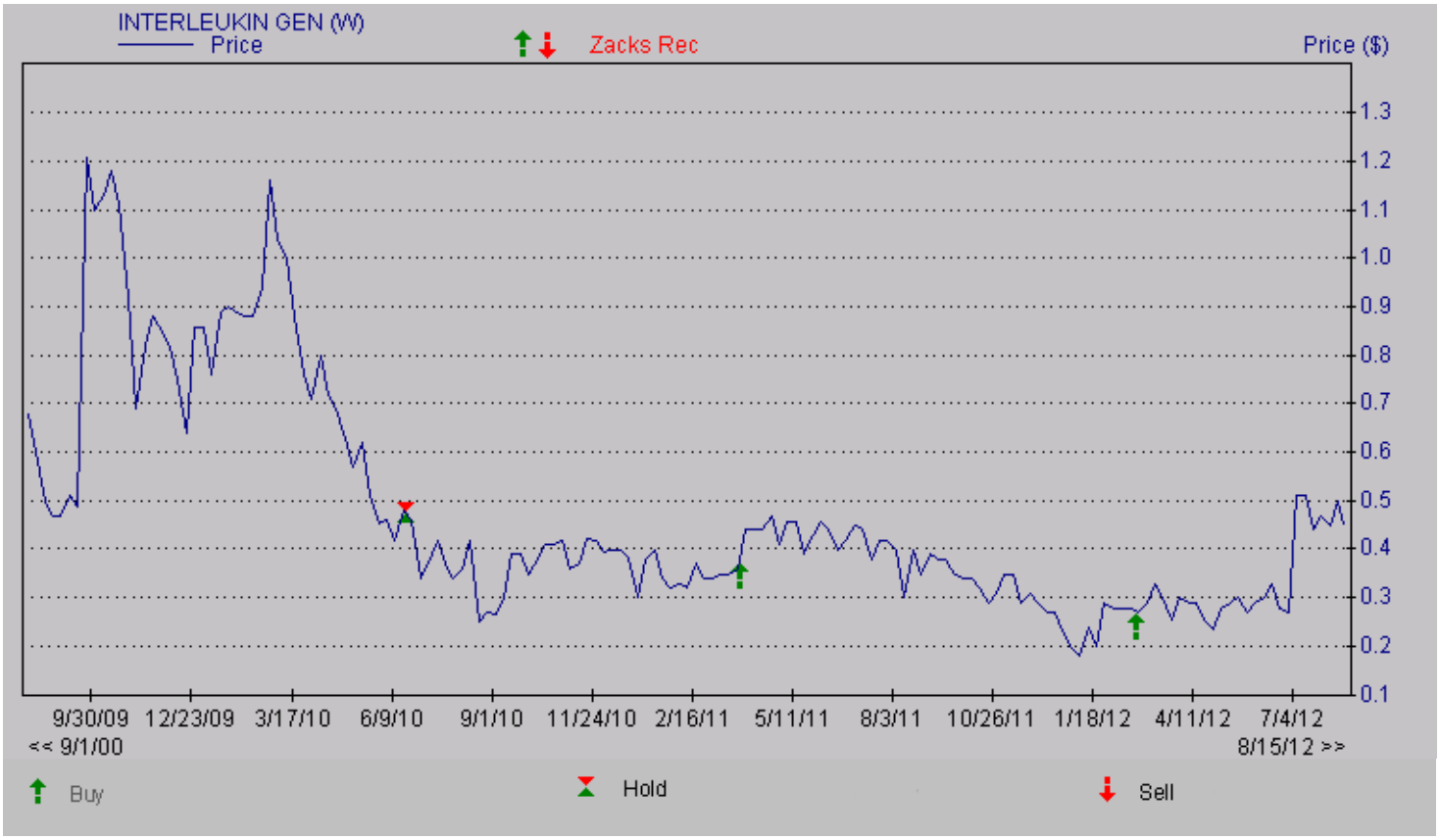
Interleukin Genetics, Inc.

	2011 A	Q1A	Q2A	Q3E	Q4E	2012 E	2013 E	2014 E	2015 E
Genetic testing	$2,757.4	$677.2	$777.5	$735.0	$669.0	$2,858.7	$7,247.0	$21,111.0	$40,457.0
YOY Growth	*42.1%*	*-5.9%*	*-0.2%*	*0.5%*	*26.8%*	*3.7%*	*153.5%*	*191.3%*	*91.6%*
Other	$99.7	$0.7	$21.9	$22.1	$20.1	$85.8	$217.4	$633.3	$1,213.7
Total Revenues	$2,857.1	$677.9	$799.4	$757.1	$689.1	$2,944.5	$7,464.4	$21,744.3	$41,670.7
YOY Growth	*43.1%*	*-5.8%*	*0.3%*	*-1.1%*	*19.8%*	*3.1%*	*153.5%*	*191.3%*	*91.6%*
Cost of Revenues	$1,527.2	$376.2	$393.1	$363.4	$351.4	$1,484.1	$3,508.3	$9,350.1	$16,668.3
Gross Income	$1,329.9	$301.7	$406.3	$393.7	$337.6	$1,460.3	$3,956.1	$12,394.3	$25,002.4
Gross Margin	*46.5%*	*44.5%*	*47.0%*	*52.0%*	*49.0%*	*49.6%*	*53.0%*	*57.0%*	*60.0%*
R&D	$1,376.4	$446.3	$317.4	$385.0	$410.0	$1,558.7	$2,254.0	$2,450.0	$3,144.0
% R&D	*48.2%*	*65.8%*	*39.7%*	*50.9%*	*59.5%*	*52.9%*	*30.2%*	*11.3%*	*7.5%*
R&D QTDP Grant	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
SG&A	$4,665.4	$1,136.6	$1,176.1	$1,168.0	$1,191.0	$4,671.8	$5,673.0	$6,958.2	$9,167.6
% SG&A	*163.3%*	*167.7%*	*147.1%*	*154.3%*	*172.8%*	*158.7%*	*76.0%*	*32.0%*	*22.0%*
Amortization	$115.4	$28.9	$28.9	$28.9	$28.9	$115.6	$140.0	$155.0	$180.0
Operating Income	($4,827.3)	($1,310.1)	($1,116.1)	($1,188.2)	($1,292.3)	($4,885.7)	($4,110.8)	$2,831.1	$12,510.9
Operating Margin	*-169.0%*	*-193.3%*	*-139.6%*	*-157.0%*	*-187.5%*	*-165.9%*	*-55.1%*	*13.0%*	*30.0%*
Total Other income	($356.2)	($104.6)	($113.7)	($130.0)	($130.0)	($469.7)	($480.0)	$0.0	$50.0
Pre-Tax Income	($5,183.5)	($1,414.7)	($1,229.9)	($1,318.2)	($1,422.3)	($5,355.4)	($4,590.8)	$2,831.1	$12,560.9
Taxes	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Tax Rate	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*
Net Income	($5,183.5)	($1,414.7)	($1,229.9)	($1,318.2)	($1,422.3)	($5,385.1)	($4,590.8)	$2,831.1	$12,560.9
YOY Growth	*-19.9%*	*12.7%*	*-10.3%*	*16.2%*	*0.0%*	*3.9%*	*-14.7%*	*-161.7%*	*343.7%*
Net Margin	*-181.4%*	*-208.7%*	*-153.8%*	*-174.1%*	*-206.4%*	*-182.9%*	*-61.5%*	*13.0%*	*30.1%*
EPS (continuing ops)	($0.14)	($0.04)	($0.03)	($0.04)	($0.03)	($0.13)	($0.05)	$0.03	$0.15
YOY Growth	*-22.0%*					*-5.4%*	*-59.6%*	*-161.7%*	*343.7%*
Diluted Shares O/S	36,661	36,748	36,757	36,760	50,800	40,266	85,000	85,000	85,000

Brian Marckx, CFA

© Copyright 2012, Zacks Investment Research. All Rights Reserved.

HISTORICAL ZACKS RECOMMENDATIONS



DISCLOSURES

The following disclosures relate to relationships between Zacks Investment Research ("ZIR") and Zacks Small-Cap Research ("Zacks SCR") and the issuers covered by the Zacks SCR analysts in the Small-Cap Universe.

ZIR or Zacks SCR Analysts do not hold or trade securities in the issuers which they cover. Each analyst has full discretion on the rating and price target based on their own due diligence. Analysts are paid in part based on the overall profitability of Zacks SCR. Such profitability is derived from a variety of sources and includes payments received from issuers of securities covered by Zacks SCR for non-investment banking services. No part of analyst compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in any report or blog.

ZIR and Zacks SCR do not make a market in any security nor do they act as dealers in securities. Zacks SCR has never received compensation for investment banking services on the small-cap universe. Zacks SCR does not expect received compensation for investment banking services on the small-cap universe. Zacks SCR has received compensation for non-investment banking services on the small-cap universe, and expects to receive additional compensation for non-investment banking services on the small-cap universe, paid by issuers of securities covered by Zacks SCR. Non-investment banking services include investor relations services and software, financial database analysis, advertising services, brokerage services, advisory services, investment research, and investment management.

Additional information is available upon request. Zacks SCR reports are based on data obtained from sources we believe to be reliable, but is not guaranteed as to accuracy and does not purport to be complete. Because of individual objectives, the report should not be construed as advice designed to meet the particular investment needs of any investor. Any opinions expressed by Zacks SCR Analysts are subject to change. Reports are not to be construed as an offer or the solicitation of an offer to buy or sell the securities herein mentioned. Zacks SCR uses the following rating system for the securities it covers. Buy/Outperform: The analyst expects that the subject company will outperform the broader U.S. equity market over the next one to two quarters. Hold/Neutral: The analyst expects that the company will perform in line with the broader U.S. equity market over the next one to two quarters. Sell/Underperform: The analyst expects the company will underperform the broader U.S. Equity market over the next one to two quarters.

The current distribution of Zacks Ratings is as follows on the 1036 companies covered: Buy/Outperform- 15.8%, Hold/Neutral- 76.4%, Sell/Underperform – 7.1%. Data is as of midnight on the business day immediately prior to this publication.

© Copyright 2012, Zacks Investment Research. All Rights Reserved.