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Zacks Small-Cap Research

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Verisante Technology Inc. (V.VRS)

V.VRS: Q3 Update / New Core Data

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	02/04/2011
Current Price (12/03/12)	$0.56
Target Price	**$2.50**

OUTLOOK

VRS took delivery of pre-production units in July. Final testing, then production and commercialization should happen in early 2013. Management continues to hit milestones and at the same time is driving awareness of Aura. Distributor in place for Canada and parts of Europe. Agreement for Australia expected next.

Comprehensive analysis of the 1,000-lesion study were accepted for publication by *Cancer Research*, a peer-reviewed journal of the American Association of Cancer Research and the most widely cited cancer journal in the world.

Aura continues to be recognized as one of the leading novel medical technologies throughout the world.

SUMMARY DATA

52-Week High	**$0.78**
52-Week Low	**$0.45**
One-Year Return (%)	**N/A**
Beta	**N/A**
Average Daily Volume (sh)	**100,010**
Shares Outstanding (mil)	**65**
Market Capitalization ($mil)	**35**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**N/A**
Insider Ownership (%)	**N/A**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**N/A**
5-Yr. Historical Growth Rates	
Sales (%)	**N/A**
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	**N/A**
Type of Stock	**N/A**
Industry	**Med/Dental-Supp**

ZACKS ESTIMATES

Revenue
(in '000 of $)

	Q1 (Sep)	Q2 (Dec)	Q3 (Mar)	Q4 (Jun)	Year (Jun)
2011	0 A	0 A	0 E	2 A	0 A
2012					0 E
2013					5,262 E
2014					21,516 E

Earnings per Share

	Q1 (Sep)	Q2 (Dec)	Q3 (Mar)	Q4 (Jun)	Year (Jun)
2011	-$0.02 A	-$0.01 A	-$0.02 A	-$0.02 A	-$0.06 A
2012					-$0.05 E
2013					-$0.04 E
2014					$0.05 E

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

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Q3 Financials

Verisante filed their Q3 2012 financials for the period ending 9/30/2012. Operating expenses of $688k remained in-line with the first two quarters of the year and were well below our $1.2 million estimate due to lower than modeled stock-based compensation. Net loss and EPS were $700k and ($0.01), also in-line with the first two quarters of 2012 and compared favorably to our $1.2 million (loss) and ($0.02) estimates.

Cash burn (including capitalized R&D) was $1.3 million and $3.8 million for the three and nine months ending 9/30/2012 - which was right within our expectations. VRS exited Q3 with $2.8 million in cash and liquid investments.

Operational Update

- **Aura:** VRS is now field testing Aura at five leading dermatology clinics throughout Canada, including in Vancouver, Edmonton, Oakville, Montreal and Markham. The expectation is that this will provide feedback in order to make any necessary refinements to usability and the software. Once completed, this should lead into the commercial roll-out - which is now anticipated in early 2013. This is a slight delay from prior expectations which had Aura on the commercial market in late 2012. Nonetheless, VRS expects to have Aura generating revenue in Canada, Europe and Australia during the early part of 2013. Management notes that they continue to receive positive feedback from the medical community relative to Aura's functionality, utility and viability as a tool for early detection of skin cancer in clinical practice.

  We note that while we've slightly pushed back our assumptions for the anticipated initial commercial roll-out of Aura (from late 2012 to early 2013), perhaps more important is that we continue to believe that (as we first detailed in our initiation report on VRS in Feb 2011) VRS can be highly successful over the long term based on the combination of the technology incorporated into Aura (and related competitive advantages) as well as VRS's business/revenue model. As we've explained in the past, we think Aura can be more competitive than MELA Science's Melafind device from a clinical perspective (for a number of reasons including superior accuracy, menu of indicated uses/label, speed of scans, probe size).

  And using the initial Melafind commercial roll-out as a yardstick to measure potential early interest in Aura, we think VRS's device could be very well received upon launch. MELA is about 6 months into their U.S. (and Germany) roll-out and noted that to-date they've placed (or have agreements to place) about 125 units. Note that VRS/Aura-to-MELA/Melafind isn't an apples-to-apples comparison for a variety of reasons, not the least of which is Melafind is approved for sale in the U.S. while Aura is not (Aura is approved for sale and will initially launch in Europe, Australia and Canada - the U.S. market could be 2+ years away). There's also differences in the revenue models, selling/proposed selling prices, consumables pricing, etc. Despite these differences, the Melafind roll-out does provide at least some insight into interest from physicians as well as the willingness of patients to pay out of pocket. MELA noted on their Q3 2012 earnings call that feedback and interest from dermatologists has been positive and that some practices using Melafind are successfully charging upwards of $225 per exam (despite no third-party reimbursement). Utilization, MELA noted, is currently at approximately one use per installed unit per day.

  We think all of this suggests that Aura could be very well received upon launch (particularly given potentially significant advantages of Aura over Melafind) and begins to answer the question about whether lack of reimbursement will be a deal-killer (it appears it will not be) for physicians/clinics/hospitals to buy (or lease) the device and for patients to pay out-of-pocket for an exam. And as a reminder, while VRS's Europe/Canada/Australia launch will likely initially target dermatologists, Aura is not restricted to use only by dermatologists which opens the door for VRS to detail to other health care providers including general physicians, skin care clinics, oncology practices, and imaging centers.

- **Distribution:** In September VRS announced that they signed an agreement with BO-Pharma to be the exclusive distributor of Aura in the Benelux (Belgium, Netherlands, Luxembourg) countries. BO-Pharma is the largest independent medical device distributor in the Benelux areas and has a particular focus on dermatological products.

Clarion Medical, VRS's Canadian distributor who will also be responsible for servicing Aura, recently completed technical training on Aura. In preparation for the commercial roll-out, Verisante is now putting together marketing materials and working with BO-Pharma and Clarion in training their sales reps. Distribution in Australia has yet to be announced but we presume this will be a near-term event.

- **New Core Data:** New study data using Verisante's exclusively licensed technology which is expected to be incorporated into a lung cancer detection device called Core, affirmed positive results from an earlier pilot study. The studies used VRS's Raman spectral analysis combined with autofluorescence to detect cancer. The recent data comes from a larger sample size (267 samples) compared to the smaller (129 samples) pilot study and also used the latest generation Raman system technology. The result was an improvement in the already impressive 91% specificity seen in the pilot study with only a slight reduction in sensitivity (which was 96% in the pilot study) in the ability to differentiate localized high grade dysplasia and carcinoma from benign lesions. The new study results will be presented by BC Cancer Agency researchers in a poster entitled Characterization of Pre-Neoplastic and Neoplastic Bronchial Lesions Using Laser Raman Spectroscopy at the BC Cancer Agency Annual Conference (Nov 29 - Dec 1) and at SPIE Photonics West 2013 (Feb 2 - 7, 2013). Verisante will also be in attendance at SPIE Photonics West, which is billed as the world's largest and most influential photonics and optics event with over 1,500 companies exhibiting and 20,000 attendees. VRS's Aura, as noted below, is a finalist for a SPIE Prism Award.

  As a reminder, results of the small (129 samples from 26 patients) pilot study which used Verisante's Raman system technology, combined with white light and fluorescence bronchoscopy (technology which Verisante acquired in June 2011) for the early detection of lung cancer were published in the July 2012 issue of the *Journal of Thoracic Oncology*. Results showed that when Verisante's Core lung cancer detection device (using Raman technology) is combined with the ClearVu and ClearVu Elite endoscopy system (which Verisante acquired) the number of false positives were reduced by over 75% compared to traditional endoscopic methods.

  As we've noted in the past that while the results of these studies are encouraging, as is Verisante's continued efforts to move their lung cancer detection program forward, we feel it is still too early to reasonably judge the potential for approvability of the device. In addition, management's current major focus is with getting Aura commercialized. As a result, we feel it is appropriate to continue to not incorporate a contribution from Core in our model until there is more information to comfortably judge the probability of regulatory approval and gauge launch timelines. If and when that happens, we will update our model accordingly – also as we noted in the past, this could potentially add significant upside to our current revenue and earnings estimates (especially given the relatively large size of the lung cancer diagnostics market).

- **Award Nomination:** Verisante's Aura has gained significant recognition and racked up an impressive number of awards related to novel, high-potential medical device technologies over the past 18 months. This streak could be extended and include a SPIE Prism Award, which Aura has been named as a finalist for. The winner of the award, which honors the best new photonic products on the market and is selected from entries throughout the world, will be named at the 2013 Prism Awards banquet on February 6th in San Francisco. Aura is in good company as one of three finalists in the Life Sciences and Biophotonics category - the other two finalists include a microscope objective from imaging giant Olympus and an ultrafast laser from Femtolasers.

Valuation

We now model an initial launch of Aura in Q1 2013 and approximate 140 unit placements by the end of 2013. We continue to model an assumed U.S. launch in mid-to-late 2015 (slightly more conservative than management's recent late-2014 guidance, which provides some cushion for further delays).

As commercialization (ex-U.S.) is now expected to be a near-term event, we are now using DCF as our valuation methodology. Key inputs to our 10-year DCF model include a 10% discount rate and 2% terminal growth rate. Our DCF model values VRS at about $2.50/share.

FINANCIAL STATEMENTS

INCOME STATEMENT (CDN $)

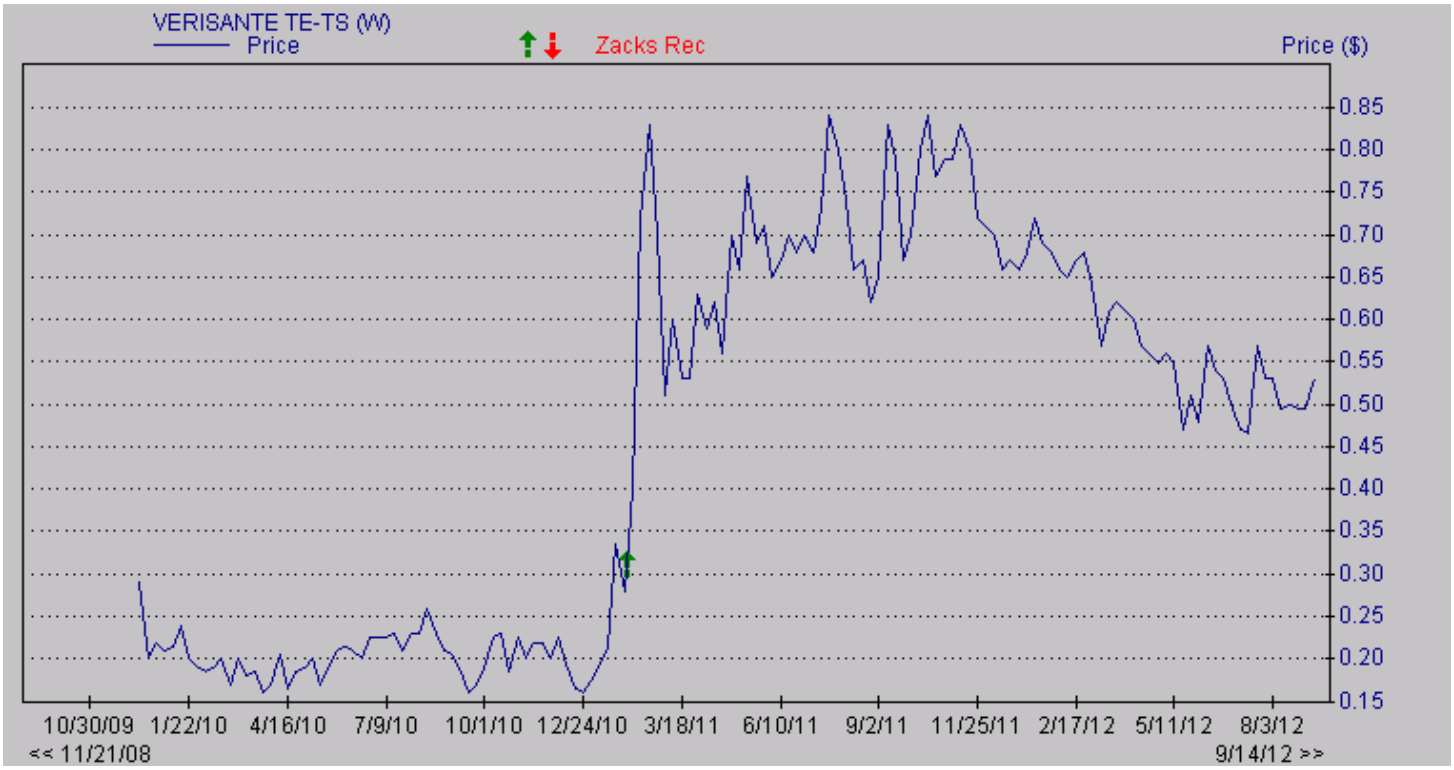
Verisante Technology

	2010 A	2011 A	2012 E	2013 E	2014 E	2015 E
Device sales	$0	$0	$0	$4,631	$17,325	$38,115
% total sales	-	-	-	*88.0%*	*80.5%*	*78.4%*
Cap sales	$0	$0	$0	$631	$4,191	$10,499
% total sales	-	-	-	*12.0%*	*19.5%*	*21.6%*
Revenue	$11	$2	$0	$5,262	$21,516	$48,614
YOY Growth	*-62.5%*	-	-	*#DIV/0!*	*308.9%*	*125.9%*
Cost of sales	$8	$0	$0	$2,347	$8,872	$19,582
Gross Income	$3	$2	$0	$2,915	$12,644	$29,031
Gross Margin	*26.0%*	-	*#DIV/0!*	*55.4%*	*58.8%*	*59.7%*
SG&A	$1,435	$3,435	$3,132	$5,752	$7,115	$12,265
% SG&A	-	-	*#DIV/0!*	*109.3%*	*33.1%*	*25.2%*
R&D	$215	$7	$0	$0	$0	$0
% R&D	-	-	*#DIV/0!*	*0.0%*	*0.0%*	*0.0%*
Interest expense (income), net	$0.4	($41.0)	($34.3)	$0.0	($5.0)	($50.0)
Operating Income	($1,648)	($3,399)	($3,098)	($2,837)	$5,534	$16,816
Operating Margin	-	-	-	*-53.9%*	*25.7%*	*34.6%*
Total Other Income	$163	($153)	($79)	($316)	($1,291)	($2,917)
Pre-Tax Income	($1,485)	($3,551)	($3,177)	($3,153)	$4,243	$13,899
Taxes (benefit)	$0.0	$0.0	$0.0	$0.0	$0.0	$2,501.9
Tax Rate	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*18.0%*
Net Income	($1,485)	($3,551)	($3,177)	($3,153)	$4,243	$11,397
Net Margin	-	-	-	*-59.9%*	*19.7%*	*23.4%*
EPS	($0.04)	($0.06)	($0.05)	($0.04)	$0.05	$0.13
YOY Growth	*30.4%*	*54.3%*	*-24.9%*	*-15.0%*	*-226.3%*	*156.0%*
Diluted Shares O/S	35,159	54,651	65,104	76,000	81,000	85,000

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HISTORICAL ZACKS RECOMMENDATIONS



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