July 25, 2012

Zacks Small-Cap Research

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Verisante Technology Inc. (V.VRS)

V.VRS: On-Track For 2012 Launch

OUTLOOK

VRS took delivery of pre-production units in July. Final testing, then production and commercialization should happen by year-end. Management continues to hit milestones and at the same time is driving awareness of Aura. Distributor in place for Canada. Agreements for Europe and 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.

Maintaining Outperform rating and $2.60/price target.

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	02/04/2011
Current Price (07/25/12)	$0.50
Target Price	**$2.60**

SUMMARY DATA

52-Week High	**$1.13**
52-Week Low	**$0.45**
One-Year Return (%)	**N/A**
Beta	**N/A**
Average Daily Volume (sh)	**89,888**
Shares Outstanding (mil)	**65**
Market Capitalization ($mil)	**33**
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					678 E
2013					12,606 E
2014					37,275 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					-$0.08 E
2013					-$0.01 E
2014					$0.10 E

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

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PRE-PRODUCTION UNITS DELIVERED, COMMERCIALIZATION ON-TRACK FOR 2012

In early May Verisante announced completion of the beta version of Aura, two of which were used by Starfish Medical, Verisante's development partner, to develop the commercial version of the device. This morning (7/25/2012) Verisante announced that they received back from Starfish two pre-production units which will now go through final testing prior to commencement of commercial production, which is still expected to happen by year-end. Verisante also recently released pictures of the pre-production units (below).

Verisante notes that they are still on track to hit expected milestones and continues to report that feedback from their interactions with industry professionals has been overwhelmingly positive - even noting that a recent anonymous survey conducted at a meeting of skin specialists indicated strong interest in Aura. Clarion, Verisante's Canadian distributor also notes that their preliminary market research is "showing great interest in Aura."

We continue to remain highly positive on Verisante and Aura and note that the news flow and progress towards commercialization have been very encouraging. We continue to model a launch in late 2012 with insignificant revenue in the current year but showing a steep ramp throughout 2013.

Aura Pre-Production Units



Near-to-Mid Term Milestones (*not necessarily in chronological order*)

- Final testing of pro-production units
- Commence commercial production
- Distribution agreements for Europe and Australia (agreement already in place for Canada with Clarion Medical Technologies
- Commercialization in Canada, Europe, Australia
- Publication of 1,000 lesion study in *Cancer Research*. The study was already published in the on-line version of the journal in late March (see below from our last update on VRS on April 5th)
- Feedback from FDA regarding U.S. regulatory approval pathway for Aura
- Registration to sell Aura in Mexico and Brazil
- Completion and data analysis of clinical study of Core for lung cancer being conducted at the Lung Tumor Center at Vancouver General Hospital
- Regulatory approval of Core in Europe, Canada, Australia

Valuation

We continue to value VRS using 25x our long-dated (2015) EPS estimate discounted back at 20%/year. We model 2015 EPS of $0.21 which affirms valuation at approximately $2.60/share. We are maintaining our Outperform rating.

Aura Study Results Published (*from our 4/5/12 update*)

Comprehensive analysis of the 1,000-lesion study were accepted for publication by *Cancer Research*, a peer-reviewd journal of the American Association of Cancer Research and the most widely cited cancer journal in the world. The manuscript, titled "Real-time Raman Spectroscopy for In Vivo Skin Cancer Diagnosis", was first published in the online version of the journal in late March.

As a reminder, Verisante announced the preliminary statistical analysis earlier this year which were presented by Dr. Haishan Zeng at the SPIE (international society for optics and photonics) conference in San Francisco. Data was acquired on over 1,000 lesions from 848 patients. The study analysis focused on only those classes of lesions that are considered to be associated with concern of skin cancer - which resulted in a final dataset of 518 lesions from 453 patients. Specifically, the classes of skin lesions included in the analysis were those diagnosed as malignant or premalignant (i.e. - malignant melanoma, squamous cell carcinoma, basal cell carcinoma, and actinic keratosis - in aggregate, these represent essentially 100% of skin cancers) and benign conditions that look like skin cancer (i.e. - seborrheic keratosis, atypical nevi, malanocytic nevi, compound nevi, and intradermal and blue nevi).

The study focused on three distinct categories, specifically Aura's ability to differentiate; 1) skin cancers and pre-cancers from benign skin lesions, 2) melanomas from non-melanoma pigmented lesions, and 3) melanomas from seborrheic keratoses. Statistical analysis was done using two methods; principal component with general discriminant analysis (GDA) and partial least squares. With sensitivities between 95% and 99%, Aura demonstrated specificities in these three tasks between 15% and 54% with GDA (in most instances using partial least squares resulted in higher specificities) - which resulted in a biopsy ratio (the number of non-melanoma lesions that undergo biopsy for each confirmed case of melanoma) of between 0.77:1 to 5.56:1. Specifically (see Table 3 from the study below) the GDA analysis showed, in differentiating 1) skin cancers and pre-cancers from benign skin lesions, specificity was 17% at 99% sensitivity and 41% at 95% sensitivity (partial least squares showed specificity of 24% at 99% and 52% at 95%) 2) melanomas from non-melanoma pigmented lesions was 15% at 99% sensitivity and 38% at 95% sensitivity, and 3) melanomas from seborrheic keratoses was 25% at 99% sensitivity and 54% at 95% sensitivity. The study authors concluded that, " Raman spectroscopy can distinguish (1) malignant and premalignant lesions from benign disorders, (2) melanomas from benign pigmented skin lesions, and (3) melanomas from seborrheic keratoses."

The biopsy ratio is a metric which helps gauge the accuracy of melanoma diagnosis - the lower the ratio, the more accurate the diagnosis. Misdiagnosis of skin cancer is rampant, often resulting in unnecessary biopsies. Biopsies can be costly, uncomfortable, and result in scarring. If Aura can improve the accuracy of diagnosis (which we believe it can), there should be substantial commercial demand for the device. Relative to the biopsy ratio, for reference the manuscript cites a retrospective study of ~5,000 pigmented skin lesions evaluated by ~500 general practitioners which resulted in a biopsy ratio between 58:1 and 21:1 (i.e. - 21 non-melanoma lesions biopsied for every confirmed case of melanoma). Other unrelated studies have indicated biopsy ratios in clinical practice may be even significantly higher than these figures. Although it's not necessarily fair (as there could be significant differences in the make-up of the various studies) to make a direct comparison of the biopsy ratios in the Aura study (which appear comparably very strong) with these other studies, at least on the face of it, the Aura data looks potentially persuasive.

As we noted in our most recent update, the Aura data does look to be very compelling relative to clinical trial data from MELA Sciences Melafind device which showed a sensitivity of 98% and specificity of about 10% in the detection of melanoma. Aura's biopsy ratio appears similarly relatively strong. Also noteworthy is that MELA opted to use a statistical method different than either GDA or partial least squares, both of which are considered conservative. As such, it's possible that Aura's specificities may have been relatively even stronger than Melafind's had the statistical methods used for both devices' studies been the same. Also as we've previously explained, Aura has other advantages to Melafind including a significant speed advantage (allowing for full body scans) and the ability to detect of all types of skin cancer whereas Melafind is used for only melanoma.

Table 3. Summary of Raman spectroscopy diagnostic parameters derived from ROCs according to various levels of sensitivity.

Diagnosis classification task	Sensitivity level (95% CI)	Principal component analysis (GDA[a])				Partial least squares			
		Specificity (95% CI)	PPV [b]	NPV [c]	Biopsy ratio	Specificity (95% CI)	PPV	NPV	Biopsy ratio
Skin cancers + Actinic keratosis *vs* Benign lesions	0.99 (0.98-1.00)	0.17 (0.13-0.21)	0.49	0.95	1.03:1	0.24 (0.19-0.29)	0.51	0.97	0.95:1
	0.95 (0.92-0.99)	0.41 (0.35-0.48)	0.57	0.91	0.77:1	0.52 (0.48-0.58)	0.62	0.93	0.62:1
	0.90 (0.86-0.94)	0.64 (0.58-0.70)	0.67	0.89	0.49:1	0.66 (0.61-0.71)	0.68	0.89	0.47:1
Melanoma *vs* Benign pigmented lesions	0.99 (0.96-1.00)	0.15 (0.11-0.19)	0.15	0.99	5.58:1	0.14 (0.10-0.18)	0.15	0.99	5.65:1
	0.95 (0.89-1.00)	0.38 (0.32-0.44)	0.19	0.98	4.24:1	0.44 (0.38-0.50)	0.21	0.98	3.83:1
	0.90 (0.81-0.99)	0.68 (0.63-0.73)	0.30	0.98	2.31:1	0.63 (0.57-0.69)	0.27	0.98	2.67:1
Melanoma *vs* Seborrheic keratosis	0.99 (0.96-1.00)	0.25 (0.17-0.33)	0.34	0.98	1.96:1	0.46 (0.37-0.55)	0.41	0.99	1.41:1
	0.95 (0.89-1.00)	0.54 (0.45-0.63)	0.44	0.97	1.25:1	0.52 (0.43-0.61)	0.43	0.96	1.31:1
	0.90 (0.81-0.99)	0.68 (0.59-0.77)	0.52	0.95	0.92:1	0.66 (0.57-0.75)	0.51	0.94	0.98:1

[a] GDA: general discriminant analysis.

[b] PPV: positive predictive value, the ratio of true positives to the total of true positives and false positives.

[c] NPV: negative predictive value, the ratio of true negative to the total of true negatives and false negatives.

FINANCIAL STATEMENTS

INCOME STATEMENT (CDN $)

Verisante Technology

	2010 A	2011 A	2012 E	2013 E	2014 E	2015 E
Device sales	$0	$0	$630	$10,710	$29,295	$52,920
% total sales	-	-	*92.9%*	*85.0%*	*78.6%*	*74.9%*
Cap sales	$0	$0	$48	$1,896	$7,980	$17,779
% total sales	-	-	*7.1%*	*15.0%*	*21.4%*	*25.1%*
Revenue	$11	$2	$678	$12,606	$37,275	$70,699
YOY Growth	*-62.5%*	-	-	*1759.3%*	*195.7%*	*89.7%*
Cost of sales	$8	$0	$317	$5,450	$15,047	$27,349
Gross Income	$3	$2	$361	$7,156	$22,229	$43,350
Gross Margin	*26.0%*	-	*53.2%*	*56.8%*	*59.6%*	*61.3%*
SG&A	$1,435	$3,435	$4,720	$5,290	$6,845	$11,100
% SG&A	-	-	*696.2%*	*42.0%*	*18.4%*	*15.7%*
R&D	$215	$7	$1,160	$1,950	$1,622	$2,015
% R&D	-	-	*171.1%*	*15.5%*	*4.4%*	*2.9%*
Interest expense (income), net	$0.4	($41.0)	$0.0	$0.0	($15.0)	($75.0)
Operating Income	($1,648)	($3,399)	($5,519)	($84)	$13,777	$30,310
Operating Margin	-	-	-	*-0.7%*	*37.0%*	*42.9%*
Total Other Income	$163	($153)	($60)	($756)	($2,237)	($4,242)
Pre-Tax Income	($1,485)	($3,551)	($5,579)	($840)	$11,540	$26,069
Taxes (benefit)	$0.0	$0.0	$0.0	($210.0)	$3,115.8	$7,820.6
Tax Rate	*0.0%*	*0.0%*	*0.0%*	*25.0%*	*27.0%*	*30.0%*
Net Income	($1,485)	($3,551)	($5,579)	($630)	$8,424	$18,248
Net Margin	-	-	-	*-5.0%*	*22.6%*	*25.8%*
EPS	($0.04)	($0.06)	($0.08)	($0.01)	$0.10	$0.21
YOY Growth	*30.4%*	*54.3%*	*19.2%*	*-89.3%*	*-1354.4%*	*106.4%*
Diluted Shares O/S	35,159	54,651	72,000	76,000	81,000	85,000

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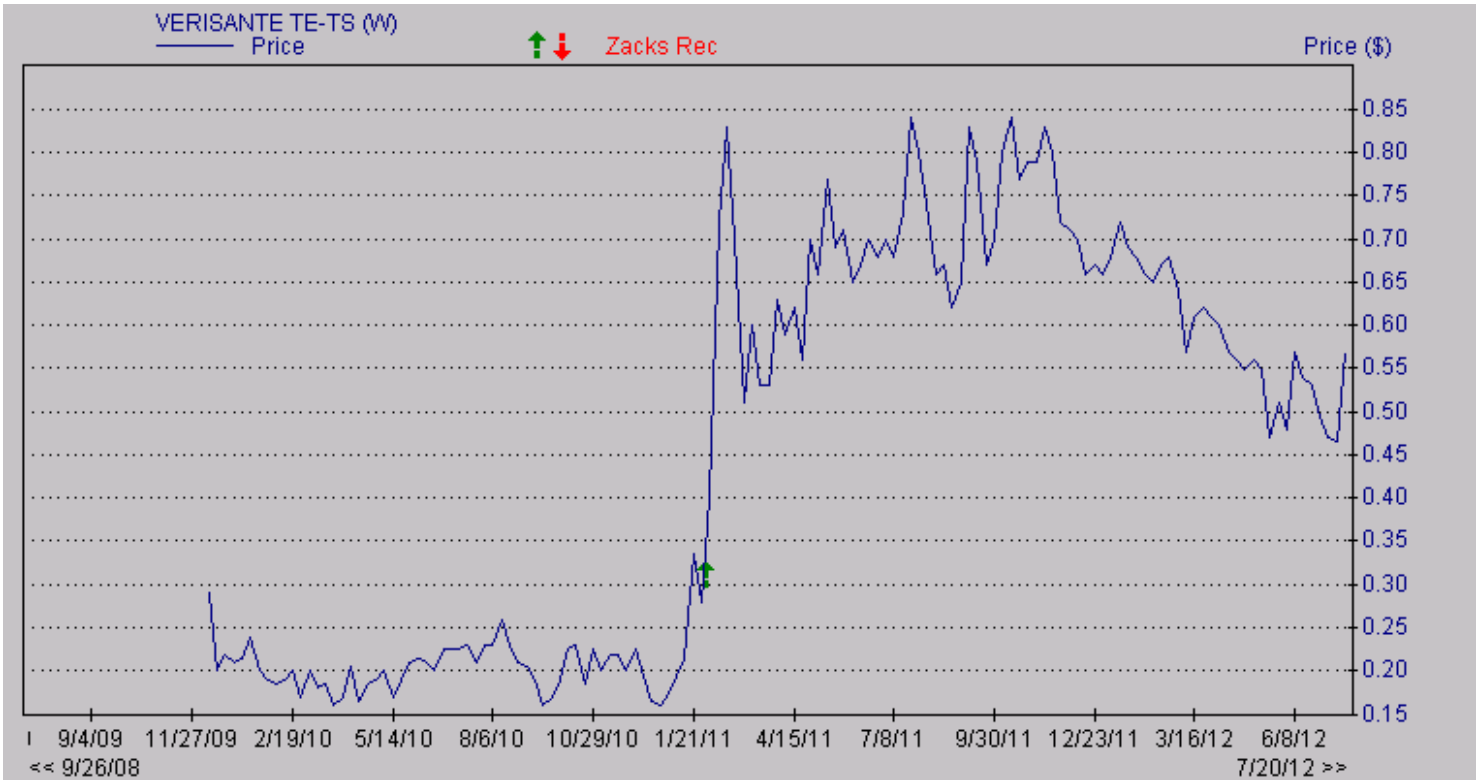

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