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Zacks Small-Cap Research

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Interleukin Genetics (ILIU-OTC)

ILIU: Excited About PST Test Opportunity

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	03/28/2011
Current Price (11/16/12)	$0.32
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	**$0.17**
One-Year Return (%)	**-2.86**
Beta	**1.84**
Average Daily Volume (sh)	**12,224**
Shares Outstanding (mil)	**37**
Market Capitalization ($mil)	**$13**
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 (%)	**-32.2**
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	420 A	689 E	2,582 E
2013					2,707 E
2014					12,611 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	-$0.03 A	-$0.04 E	-$0.15 E
2013					-$0.07 E
2014					-$0.00 E

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

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Q3 2012 RESULTS

Interleukin reported financial results for the third quarter ending September 30, 2012 on November 14th. Results on both the top and bottom lines came in significantly lighter than our estimates which we think relates to a combination of typical quarterly variability as well as lessened high-profile media exposure of the weight management test over the recent past. As a reminder, ILIU's revenue has been largely driven by retail (i.e. - individual via Amway) demand for their weight management test, interest and demand for which has been catalyzed by media attention, which isn't always a regular event.

On the operational side, management remains very positive on the PST test as well as to their ongoing discussions and commercialization plan with their partner Delta Dental/Renaissance Health. As a reminder, positive top-line clinical trial data of their PST test, which is expected to be the next major catalyst to ILIU's revenue, was released in early August (see our Investor Note below). A manuscript is in process and the expectation is that this will be submitted and published in a respected journal in the near-term. The next step will be to finalize reimbursement through Renaissance/Delta Dental plans which is envisioned to cover the PST test and to reimburse for one cleaning per year as standard or two cleanings if the PST test determines the patient is at high risk of periodontal disease. If all goes well, the Delta Dental plans incorporating the PST test will be finalized and plan participants will be notified by mid-to-late next year for those policies that renew in early 2014. At that point ILIU hopes to have their reimbursable PST test on the commercial market. In aggregate, Delta Dental plans cover 58 million lives in the U.S.

In addition, ILIU is also looking seriously at opportunities in companion diagnostics, a relatively new and rapidly growing field which focuses on personalizing medicine to an individual's make-up in contrast to the one-sized fits all approach which has been practiced for centuries. A big part of personalized medicine involves the use of a diagnostic test to help pharmaceutical companies in drug development (for example, in clinical trial enrollment to select individuals most likely to respond to a particular therapy) or physicians in making prescribing decisions. ILIU has recently noted (and again mentioned on the earnings call) that they are pursuing potential opportunities in companion diagnostics which may include partnering with pharma companies (discussions have already been initiated). As an example, ILIU's osteoarthritis test (which we detailed in our 3/29/2011 initiation report on ILIU) could be an attractive companion diagnostic for drug developers given that there is currently no method for selecting these high risk patients which has resulted in drug companies having extreme difficulty in fulfilling enrollment protocol for OA drug development (only 8% - 20% of OA trial participants actually progress in three-year trials, requiring very large initial patient enrollments).

Q3 Results

Revenue
Q3 revenue of $420k was down 45% yoy, down 47% sequentially and about 45% less than our $757k estimate. As noted, we would not read much into the significant revenue drop given the inherent variability in demand and, in particular, that the long-term driver of ILIU resides in their PST test and other pipeline products, not in their current suite of tests.

GM / Operating Expenses / EPS
GM was 35.4% versus our 52% estimate. We model full-year GM of about 46%. Management continues to do a good job with managing expenses. Operating expenses continue to come in lower than our estimates and were just $1.32 million, down $204k sequentially (despite an 18% increase in sales from Q1) and well below our $1.58 million estimate. Net loss and EPS were $1.29 million and ($0.03) which is actually better than our $1.32 million and ($0.04) estimates despite the lower than estimates revenue.

Cash
As a reminder, ILIU raised $3 million (gross, $2.7 million net) in financing in late June from the sale of convertible preferred stock to Delta Dental and extended the maturity of the Pyxis credit line from June 30, 2012 to November 30, 2012. ILIU hopes to further extend the maturity - given their success in the past (since the original maturity in August 2008) to do so, we assume that happens again.

Cash used in operations in Q3 was $1.1 million, down slightly from $1.2 million in Q2. Cash balance at the end of Q3 was $2.5 million, down from $3.8 million at the end of Q2. ILIU notes that they believe they have enough cash to fund operations until March 31, 2013 (assuming maturity of the Pyxis line is extended).

OUTLOOK / RECOMMENDATION

ILIU has been and continues to look to grow sales of their weight management test which includes broader penetration of the institutional channel, specifically weight loss clinics and programs. Tapping this market would likely significantly increase sales as well as provide a more stable, less variable source of revenue but has been slow to materialize.

We think it's likely that ILIU's suite of currently commercialized products will experience only flat to moderately positive sales growth, which is unchanged from our recent previous assumptions and that the major future growth driver of the company lies with its PST test (and potentially other pipeline tests including their osteoarthritis test).

We continue to model only modest revenue growth until after substantial commercialization of the reimbursable PST test (we model to start in 2014). We look for revenue and EPS of $2.7 million / ($0.07) and $12.6 million / ($0.00) in 2013 and 2014, 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.

FINANCIAL MODEL

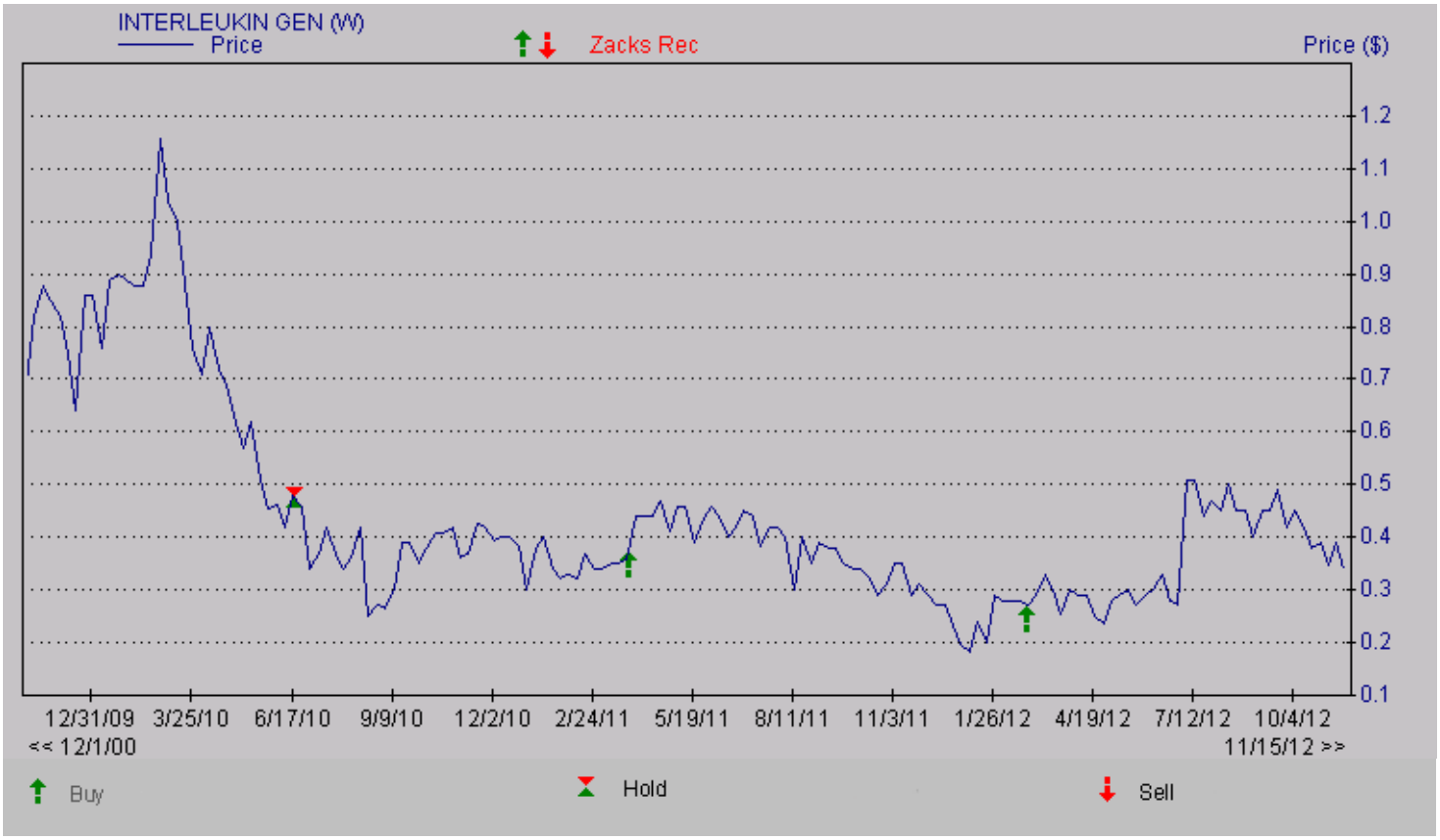
Interleukin Genetics, Inc.

	2011 A	Q1A	Q2A	Q3A	Q4E	2012 E	2013 E	2014 E	2015 E
Genetic testing	$2,757.4	$677.2	$777.5	$383.0	$669.0	$2,506.7	$2,628.0	$12,244.0	$30,012.0
YOY Growth	*42.1%*	*-5.9%*	*-0.2%*	*-47.6%*	*26.8%*	*-9.1%*	*4.8%*	*365.9%*	*145.1%*
Other	$99.7	$0.7	$21.9	$36.9	$20.1	$75.2	$78.8	$367.3	$900.4
Total Revenues	$2,857.1	$677.9	$799.4	$419.9	$689.1	$2,581.9	$2,706.8	$12,611.3	$30,912.4
YOY Growth	*43.1%*	*-5.8%*	*0.3%*	*-45.1%*	*19.8%*	*-9.6%*	*4.8%*	*365.9%*	*145.1%*
Cost of Revenues	$1,527.2	$376.2	$393.1	$271.4	$351.4	$1,392.2	$1,272.2	$5,422.9	$12,364.9
Gross Income	$1,329.9	$301.7	$406.3	$148.5	$337.6	$1,189.7	$1,434.6	$7,188.5	$18,547.4
Gross Margin	*46.5%*	*44.5%*	*50.8%*	*35.4%*	*49.0%*	*46.1%*	*53.0%*	*57.0%*	*60.0%*
R&D	$1,376.4	$446.3	$317.4	$245.7	$410.0	$1,419.5	$2,254.0	$2,450.0	$3,144.0
% R&D	*48.2%*	*65.8%*	*39.7%*	*58.5%*	*59.5%*	*55.0%*	*83.3%*	*19.4%*	*10.2%*
R&D QTDP Grant	$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	$1,044.6	$1,191.0	$4,548.3	$4,615.0	$4,821.0	$8,408.2
% SG&A	*163.3%*	*167.7%*	*147.1%*	*248.7%*	*172.8%*	*176.2%*	*170.5%*	*38.2%*	*27.2%*
Amortization	$115.4	$28.9	$28.9	$28.9	$28.9	$115.5	$140.0	$155.0	$180.0
Operating Income	($4,827.3)	($1,310.1)	($1,116.1)	($1,170.6)	($1,292.3)	($4,893.6)	($5,574.4)	($237.5)	$6,815.3
Operating Margin	*-169.0%*	*-193.3%*	*-139.6%*	*-278.8%*	*-187.5%*	*-189.5%*	*-205.9%*	*-1.9%*	*22.0%*
Interest income, net	($360.5)	($96.0)	($113.7)	($115.6)	($130.0)	($455.4)	($480.0)	$0.0	$50.0
Gain on asset sale	$4.3	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Other expense	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Total Other income	($356.2)	($104.6)	($113.7)	($115.6)	($130.0)	($455.4)	($480.0)	$0.0	$50.0
Pre-Tax Income	($5,183.5)	($1,414.7)	($1,229.9)	($1,286.3)	($1,422.3)	($5,348.9)	($6,054.4)	($237.5)	$6,865.3
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)	($1,286.3)	($1,422.3)	($5,353.1)	($6,054.4)	($237.5)	$6,865.3
YOY Growth	*-19.9%*	*12.7%*	*-10.3%*	*13.4%*	*0.0%*	*3.3%*	*13.1%*	*-96.1%*	*-2990.1%*
Net Margin	*-181.4%*	*-208.7%*	*-153.8%*	*-306.3%*	*-206.4%*	*-207.3%*	*-223.7%*	*-1.9%*	*22.2%*
EPS (continuing ops)	($0.14)	($0.04)	($0.03)	($0.03)	($0.04)	($0.15)	($0.07)	($0.00)	$0.08
YOY Growth	*-22.0%*					*3.0%*	*-51.1%*	*-96.1%*	*-2990.1%*
Diluted Shares O/S	36,661	36,748	36,757	36,757	36,757	36,755	85,000	85,000	85,000

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