Zacks Equity Research

February 4, 2011

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Verisante Technology Inc. (V.VRS)

V.VRS: New Gold Standard for Melanoma Screening? Initiating At Outperform.

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	02/04/2011
Current Price (02/04/11)	$0.39
Six- Month Target Price	**$2.10**

OUTLOOK

Based on preliminary trial data, high throughput and other advantages, Verisante's Aura could eventually become the new gold-standard for skin cancer diagnosis. We look for Aura to launch in Europe/Canada/Australia by early 2012 and in the U.S. in late 2013. The size and high incidence of skin cancer in these markets, combined with Verisante's razor / razor blade business model and low cost base means revenue and earnings could ramp very quickly.

Full analyses of a large clinical trial is expected by May 2011, at which time probability of approval and launch timelines should be more clear. We are initiating on Verisante Technology, Inc. with an Outperform rating and $2.10 price target.

SUMMARY DATA

52-Week High	**$0.40**
52-Week Low	**$0.00**
One-Year Return (%)	**N/A**
Beta	**N/A**
Average Daily Volume (sh)	**116,482**
Shares Outstanding (mil)	**41.9**
Market Capitalization ($mil)	**16.3**
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 2011 Estimate	**N/A**
P/E using 2012 Estimate	**N/A**
Zacks Rank	**N/A**

Risk Level	**N/A,**
Type of Stock	**N/A**
Industry	**Med/Dental-Supp**
Zacks Rank in Industry	**N/A**

ZACKS ESTIMATES

Revenue
(in '000 of $)

	Q1 (Sep)	Q2 (Dec)	Q3 (Mar)	Q4 (Jun)	Year (Jun)
2010	5 A	6 A	0 A	0 E	11 E
2011					0 E
2012					3,810 E
2013					15,567 E

Earnings per Share

	Q1 (Sep)	Q2 (Dec)	Q3 (Mar)	Q4 (Jun)	Year (Jun)
2010	-$0.01 A	-$0.01 A	-$0.01 A	-$0.01 E	-$0.04 E
2011					-$0.04 E
2012					-$0.05 E
2013					$0.07 E

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

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INITIATING COVERAGE

We are initiating coverage of Verisante Technology, Inc. with an Outperform rating and a $2.10 near-term price target.

Verisante's Aura appears to be more accurate and faster than the current gold-standard in the diagnosis of skin cancer, an annual market that could eventually be worth billions of dollars. Verisante expects to introduce the device in markets with some of the highest prevalence of skin cancer which, along with a razor / razor blade business model, could result in sales and earnings ramping very rapidly.

While several significant milestones must be met before Aura will launch, based on our conversations with management we feel comfortable that sufficient progress is being made and believe it is reasonable the device could launch in Canada, Europe and Australia by early 2012. Clinical trials in support of FDA approval could also begin in 2012. If all goes to plan Aura could enter the U.S. market in late 2013.

In the meantime Verisante will need to continue to raise financing. They have been successful at raising add-on financing since going public in late 2009 and management has indicated that they believe they can continue to do so based on continued strong investor interest.

KEY POINTS

- Skin cancer is the most common form of cancer in the U.S. Almost 70% of Australians and 15% of Canadians will be diagnosed with skin cancer at some point in their lifetimes. Melanoma, the most deadly form of the disease, kills about 50k people worldwide every year.
- Melanoma is a progressive disease and gets worse over time. While the disease, in its later stages is often a death sentence, when it is diagnosed early it has an almost 100% survivability rate.
- The current gold-standard for melanoma diagnosis is antiquated, unsophisticated, slow and highly susceptible to error. Misdiagnosis not only increases the risk that malignant lesions are left to progress, it also results in unnecessary biopsies. The current method is also not practical on individuals with numerous moles.
- Verisante's Aura uses patented technology to analyze the molecular composition of a mole. The technology was configured for high sensitivity, specificity and throughput. Aura was developed by highly-acclaimed physicians at the British Columbia Cancer Agency.
- Preliminary clinical trial data has shown Aura to be more accurate than the gold-standard in the diagnosis of melanoma. The full data set analysis is expected to be available by May 2011.
- Aura scans each lesion in under 1 second, allowing for full-body scans.
- The worldwide market for a more effective melanoma diagnostic is tremendous and largely untapped.
- Verisante will incorporate the razor-razor blade business model. Revenue and earnings could ramp very quickly following launch.
- Commercial prototype currently under development and expected to be completed later in 2011. Current timelines put launch in Europe, Canada and Australia in 2012. U.S. launch could come in late 2013.
- Follow-on products for the detection of cancers of the lung, colon and cervix are also being considered.

BUSINESS

Verisante Technology, Inc was incorporated in March 2006 and in late 2009 raised $1.5 million (7.5 million shares @ $0.20/share) through an initial public offering. The shares began trading on the Canadian TSX Venture Exchange in December 2009. The company was known as T-Ray Science, Inc. until adopting the Verisante name in January 2011, which management believes is more indicative of the company's focus and better aligns the Verisante brand with their products.

In July 2010 Verisante entered a licensing agreement with British Columbia's BC Cancer Agency for use of their cancer detection technology in order to accelerate development of their cancer detection device program. Initial commercialization of the device will focus on the detection of skin cancer, with extensions of the product expected to follow for the detection of other cancers, including lung, gastro-intestinal and cervical. Verisante's current timeline expects a commercial prototype for Aura, for the detection of skin cancer, completed by April 2011. If all goes well management believes the device could launch in Canada, Australia and parts of Europe in the third quarter 2011.

Skin cancer is a relatively common disease, the incidence of which is on the rise. Since melanoma is progressive and usually fatal in later stages, early detection and removal of cancerous skin lesions is critical to improve patient outcomes. Verisante's patented Aura device is being designed to do just that.

Preliminary trial data has shown the Aura to be substantially more accurate than current standard practice in the diagnosis of skin cancer. Aura also appears to have other significant advantages over the standard method of skin cancer diagnosis including; being less time consuming, is non-invasive, can be performed by technicians, is less costly, results are immediate, and can scan numerous lesions very rapidly. Aura is expected to be used as an adjunct to current standard practice by physicians in the diagnosis of skin cancer.

Aura Roll-Out
Verisante hopes to have Aura on the market in Europe, Canada and Australia later this year and in the U.S. by 2013. Their plan is to initially target "early adopters" (i.e. – dermatologists), physicians that quickly identify with the benefits of the technology. This not only represents the "low hanging fruit", it will also hopefully drive acceptance and adoption of the technology by general practitioners, which represent a significantly larger target market. Gaining traction in Europe, Canada and Australia could also benefit roll-out in the U.S. The enormous size of the combined markets which Verisante is targeting means only low-single digit penetration could be a highly significant for the company's relatively meager size.

Using rough estimates, we put the combined number of dermatologists in Canada, Europe and Australia at about 21k (about 1k in Canada and Australia), roughly twice the number as the U.S. There are approximately 350k primary care physicians in the U.S., Canada and Australia both have about 30k each and we estimate the E.U. has about 560k.

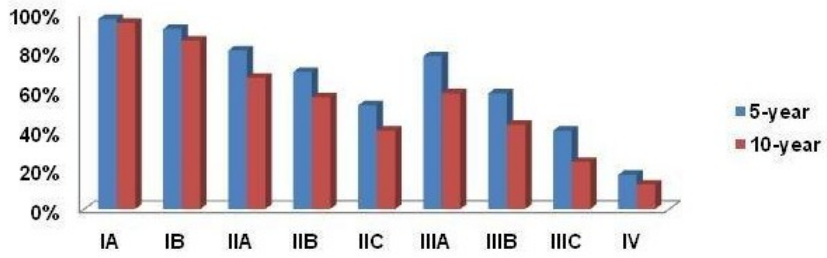
MARKETS

Skin Cancer
Basal cell carcinoma (BCC), squamous cell carcinoma (SCC), and melanoma encompass the vast majority of skin cancer cases. BCC accounts for about 80% of skin cancer diagnoses. BCC develops in the lowest layer of the skin, tends to grow slowly and only rarely spreads to other parts of the body. SCC accounts for about 16% of skin cancer cases. SCC develops in the upper layer of the skin and tends to afflict fair-skinned people and the elderly with long-term sun exposure. SCC can metastatize (spread) if left undiagnosed and untreated. Melanoma is the most deadly form of skin cancer and accounts for about 4% of all skin cancer cases. It develops in the pigment cells within the skin. Melanoma can be lethal, especially if it penetrates the lowest skin layer and enters the lymph system. While Verisante's Aura is expected to be useful in the diagnosis of all skin cancer types, melanoma screening is where we believe the majority of the opportunity for the device is.

While statistics show that five-year survivability in the U.S. is as high as 97% if melanoma is diagnosed and treated at its earliest stage (i.e. - IA), this drops precipitously as the disease progresses. Worldwide there are approximately 200k new cases of melanoma diagnosed every year and about 50k deaths from the disease. And despite the relatively low incidence of melanoma compared to non-melanoma skin cancers, due to its lethality

(causes 75% of skin cancer deaths) and progressive nature, screening for it commands a disproportionate amount of time, money and resources. And while melanoma represents a relatively small percent of all skin cancer cases, its incidence is dramatically rising (see graph on next page). We believe all this provides a significant opportunity for Verisante to exploit the antiquated nature of current screening techniques and at the same time, improve patient outcomes and reduce overall costs associated with melanoma diagnosis.

U.S. Melanoma Survivability by Disease Stage



Source: American Cancer Society

Skin Cancer in Canada Statistics

- Most common of all cancers in Canada
  - 1 in 7 Canadians will develop some form of skin cancer in their lifetime
  - Skin cancer represents 1/3 of all new cancer cases in Canada
- Non-melanoma (BCC and SCC): ~75k people diagnosed each year, ~300 people die each year
- Melanoma: ~5k people diagnosed each year, ~1k people die each year

Skin Cancer in UK Statistics

- Non-melanoma: ~85k – 100k new cases each year, ~1k deaths each year
- Melanoma: ~11k new cases each year, ~3k deaths each year
  - ~85% 5-year survivability
  - Incidence of malignant melanoma has more than quadrupled over the last 30 years
  - Malignant melanoma rates have increased more than any other cancer over last 25 years
  - At current run-rate, in 15 years UK will have ~16k new cases of malignant melanoma per year

Skin Cancer in Australia Statistics

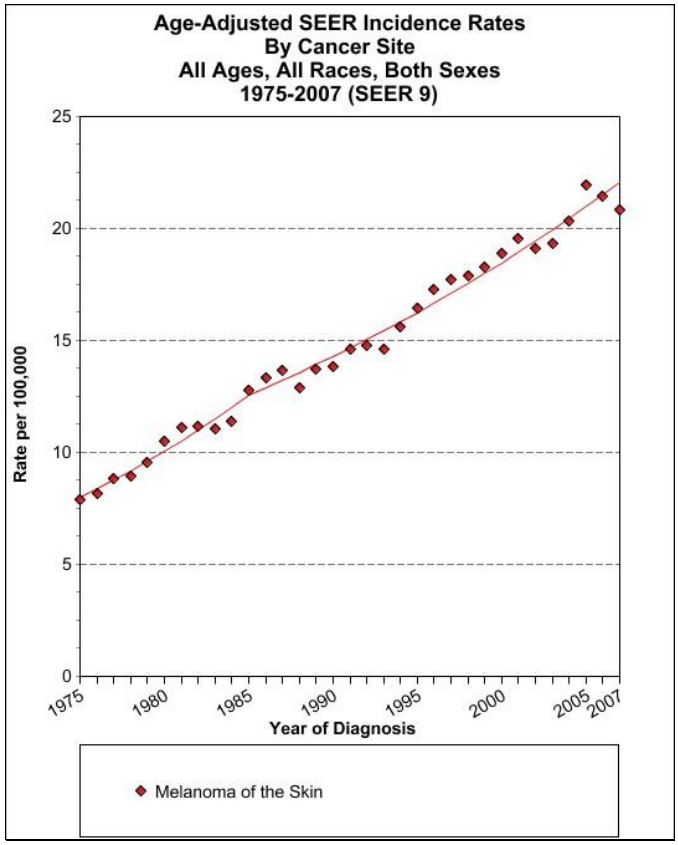
- Australia has the highest rate of melanoma of all countries
  - Skin cancer accounts for 80% of all newly diagnosed cancers
  - 2 of 3 Australians will be diagnosed with skin cancer in their lifetime
- Non-melanoma: ~450k new cases each year, ~400 deaths each year
- Melanoma: ~10k new cases each year, ~2k deaths each year
- General physicians in Australia have over 1 million patient consultations for skin cancer each year

Skin Cancer in U.S. Statistics

- Skin cancer accounts for about ½ of all cancers in the U.S.
- 1 in 5 Americans will be diagnosed with skin cancer in their lifetime
- Non-melanoma: ~1+ million new cases diagnosed each year, ~3k deaths each year
- Melanoma: ~60k new cases diagnosed each year, ~9k deaths each year
  - Melanoma accounts for about 3% of skin cancer but causes 75% of skin cancer deaths
  - Five-year survivability is ~97% if diagnosed early, this drops to ~15% for late-stage melanoma

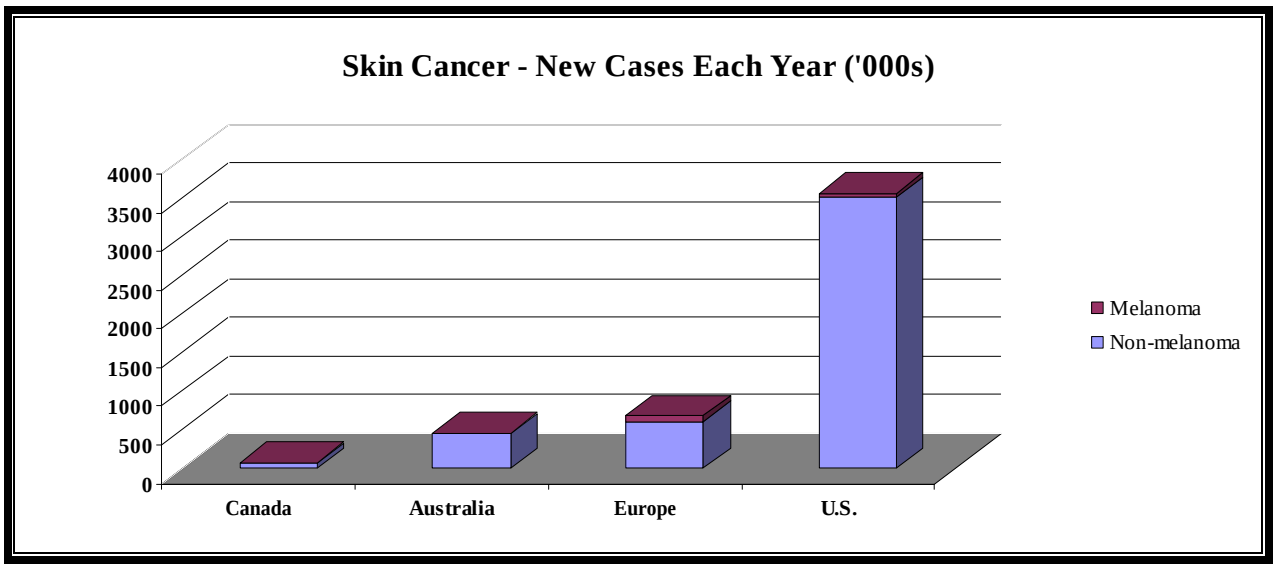
Dramatically Escalating Incidence of Melanoma

Incidence of Melanoma in U.S.

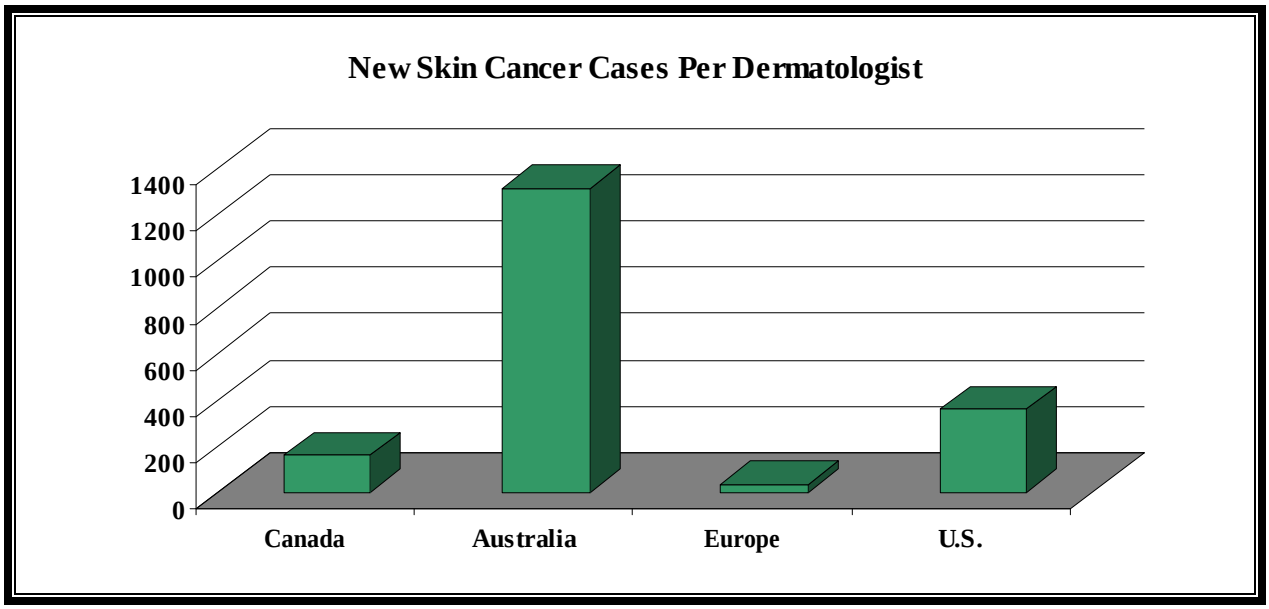


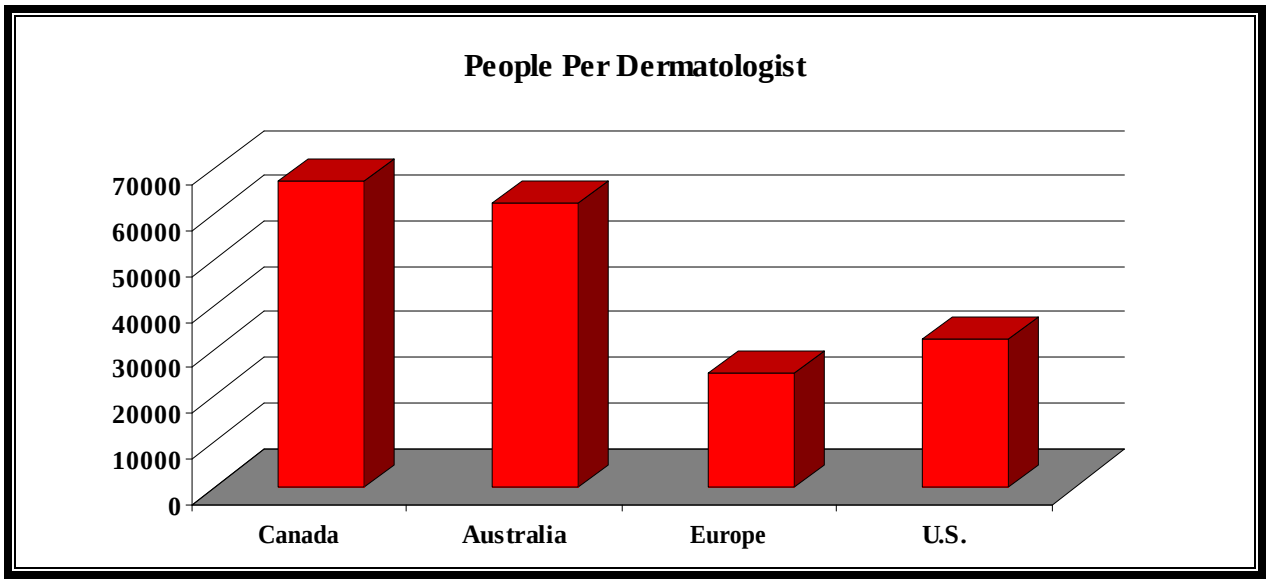
Source: SEER

Large size of the U.S. and European populations and high incidence of skin cancer could be a boon for Verisante.



With relatively few dermatologists and high incidence of skin cancer, Australia and Canada represent very attractive markets for skin cancer diagnosis. A small number of dermatologists can mean long lead times for patients seeking appointments and melanoma gets more lethal over time. The dearth of dermatologists in Australia has resulted in GPs commonly staffing skin care clinics. GPs are less experienced than dermatologists at spotting skin cancer which increases the risk of misdiagnosis.



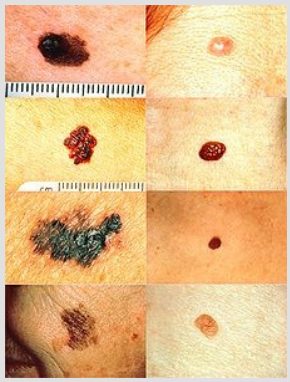


CURRENT MELANOMA SCREENING METHOD

The current standard screening for melanoma typically involves a general physician or dermatologist visually examining a patient's skin for lesions. Physicians use what's termed the "ABCD" method to determine whether a lesion should be biopsied.

(**A**)symmetry :	skin cancers usually grow in an irregular, uneven way.
(**B**)order :	moles with jagged or blurry edges may signal that the cancer is growing
(**C**)olor:	melanoma is often multicolored (tan, brown, black)
(**D**)iameter:	larger than 6 millimeters can be worrisome

"ABCD" Method



ABCD rule illustration. On the left side from top to bottom: melanomas showing (A) Asymmetry, (B) a border that is uneven, ragged, or notched, (C) coloring of different shades of brown, black, or tan and (D) diameter that had changed in size. The normal moles on the right side do not have abnormal characteristics (no asymmetry, even border, even color, no change in diameter).

Source: Wikipedia

Despite "ABCD" being the standard screening method for melanoma since the 1980s, well-documented studies have shown its sensitivity (i.e. – identifying all melanoma lesions) among dermatologists falls anywhere between only 65% - 85%. In other words, the "ABCD" method when used by dermatologists typically fails to identify 15% - 35% of melanomas. While sensitivity of "ABCD" is generally relatively high when used on moles of 6 millimeters or larger, it suffers when used on smaller moles. Since melanoma increases in size as it progresses, "ABCD" may fail to catch a significant portion of malignant melanomas at its earliest stage. As highlighted by the chart in the beginning of this report, early diagnosis of melanoma is critical as survivability of the disease plummets over time.

Specificity (i.e. – lack of false positives) among dermatologists using "ABCD" varies widely depending on the study cited and has ranged from as low as 4% (as seen in MELA Sciences ~1,400 lesion study) to as high as 96% in other large trials. In other words use of "ABCD" can result in a significant number of lesions being diagnosed as melanoma and unnecessarily biopsied. Skin biopsies are not only costly (~$1,000 each), they are invasive, uncomfortable and can cause scarring.

Preliminary results of a six-year study have shown Verisante's Aura device had 100% specificity and 70% sensitivity in the diagnosis of melanoma. Statistical analysis of the full trial data is expected to be available by May 2011.

Sensitivity and specificity of the "ABCD" method when used by general practitioners appears to be significantly worse (in general) than with dermatologists (as might be expected). Verisante cites data from a study published in the British Journal of Dermatology which showed sensitivity and specificity at only 33% and 34%, respectively. The

study, conducted in Australia, examined 8,694 skin excisions taken over a three year period, mostly from general practitioners (202 GPs and 42 specialists, including only 1 dermatologist).

This study highlights an issue in Australia, a country which Verisante believes offers significant opportunity for Aura. Despite having the highest incidence of skin cancer, Australia has relatively few dermatologists. As a result, Australian skin cancer clinics are primarily staffed by GPs, which according to this study, may diagnose melanoma with a relatively low level of sensitivity.

Recommended Screening

The American Cancer Society recommends individuals get regular skin-cancer screenings beginning at age 20. People with a history of melanoma and at higher risk of the disease should have a full-body exam at least once per year.

People with numerous moles are considered at high risk of developing melanoma. This provides a significant challenge for a physician using the "ABCD" method (and the reality is, physicians do not have the time or resources to perform detailed full body scans using "ABCD"). Visually inspecting each individual mole is highly time consuming and more prone to error. As a result, "ABCD" is not practical for these patients. Verisante expects its commercialized Aura device to be able to perform a full-body scan within minutes (½ second per lesion) and significantly faster than a physician using "ABCD" or the competing technologies currently on the market.

At High Risk of Melanoma



Aura may be able to significantly reduce the number of unnecessary skin biopsies. Skin biopsies are not only costly (~$1,000 each), they are invasive, uncomfortable and can cause scarring.



Source: Dermaimaging

Lung Cancer
Lung cancer is the most common cause of cancer deaths worldwide with more than 1.2 million people dying from the disease every year. The overall 5-year survival is only 16%, although when lung cancer is diagnosed and treated in the pre-invasive and early invasive stage, the 5-year survival dramatically improves (~70 - 90%). As a result, early detection is key to improving patient outcomes. Verisante's Core device has been used in a small clinical trial for the detection of lung cancer with "excellent results" (data was not published). Verisante believes Core can reduce the number of unnecessary biopsies due to incorrect diagnoses of benign tumors as malignant. Core has been developed to non-invasively determine whether a lung lesion is malignant and as a result, has the potential to reduce invasive biopsies as well as lower overall health care costs.

Verisante expects to move Core into larger clinical trials for lung cancer (and potentially for colon and cervical cancer). Based on the lack of information on Core and or any data from the small study we have little to judge the potential for approvability of the product. As a result, we currently do not incorporate a contribution from Core in our model. If and when there is more information to comfortably judge the probability of regulatory approval and gauge launch timelines, we will update our model – 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).

PRODUCTS

Technology
Verisante's devices use what is called the Raman effect to determine the chemical composition of skin lesions. The original technology is named after one of its discoverers, C.V. Raman, who won the Nobel Prize in Physics in 1930. Raman spectroscopy uses a laser to excite the energy in a particular sample. The scattered energy is then collected and analyzed to determine its molecular make-up.

By using a near-infrared (NIR) laser, which is low intensity, to excite the energy, Raman spectroscopy can be used to collect data on biochemical markers directly from the skin. However, the drawback of the higher wavelengths of NIR lasers has been long collection times (up to half an hour per sample). The devices are also bulky and not practical in a clinical setting.

Through the use of fiber optic light delivery and collection, compact diode lasers, and high efficiency spectrograph-detector combinations, newer prototypes have been successful in shortening the collection and measurement times (to minutes or less). The BC Cancer Agency has improved on this technology, reduced the total size and designed a probe which makes the signal collection more efficient. The small size of the probe allows for diagnosis of more difficult to access areas of the body (behind the ear, around the neck) and more efficient signal collection allows for sub-second collection times per sample. This is the technology that is incorporated into Aura.

HIGHLY-ACCLAIMED DEVELOPMENT and ADVISORY TEAMS

-- PRODUCT DEVELOPMENT TEAM --

Dr. Branko Palcic, Ph.D
Dr. Branko Palcic holds a Ph.D. in Biophysics from McMaster University. He is currently both an Honorary Professor for the Department of Pathology an d Laboratory Medicine, and was an Adjunct Professor for the Department of Physics, at the University of British Columbia. He was the founder and Senior Scientist of the Cancer Imaging Department, as well as the Director of Technology Development, with the BC Cancer Agency. Dr. Palcic's research interests include the development of methods for detection, diagnosis, and prognosis of early cancer and precancerous lesions.

Dr. Haishan Zeng, Ph.D
Dr. Haishan Zeng holds a Ph.D. in Biophysics from the University of British Columbia. He is currently a Senior Scientist in the Integrative Oncology Department (Imaging Unit) at the BC Cancer Agency and also an Associate Professor of Dermatology and Skin Science at the University of British Columbia. Dr. Zeng's research focus is on the optical properties of biological tissues and light -tissue interaction and their applications in medical diagnosis and therapy and is named on numerous patents, including the patents that Verisante Technology has licensed from the BC Cancer Agency.

-- CLINICAL ADVISORY BOARD --

Dr. Harvey Lui, MD, FRCPC
Dr. Harvey Lui is a Professor in the Faculty of Medicine at the University of British Columbia, Medical Director of the Skin Cancer Centre, the Lions Laser Skin Centre and the Psoriasis & Phototherapy Clinic as well as the head of the Department of Dermatology and Skin Science at the University of British Columbia. In addition, Dr. Lui was a former Clinical Fellow, Massachusetts General Hospital at Harvard Medical School. He was awarded the Universit y Killam Prize in 2001 and is a co -inventor of the Veris?nte™ technology.

Dr. David McLean, MD, FRCPC
Dr. David McLean is a Professor in the Faculty of Medicine at the University of British Columbia, President of the Cancer Prevention Institute of Canada and former President of the Canadian Dermatology Association. Dr. McLean is also a co-inventor of the Veris?nte™ technology.

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Aura
Verisante's Aura device was developed jointly by the BC Cancer Agency and the University of British Columbia Faculty of Medicine. Aura was developed by a team of award winning physicians and engineers with decades of combined experience in the field of cancer imaging. Verisante has an exclusive license to the technology, which includes the rights to develop, commercialize and sell follow-on devices for the detection of other types of cancer. Terms of the license include Verisante paying the BC Cancer Agency a 6% royalty on sales.

Aura scans for 21 different cancer biomarkers in less than one second. In then compares the "signature" of the scanned mole to a database to determine whether it should be biopsied. In contrast to the traditional method of waiting for biopsy results (which can take weeks), the Aura provides immediate results. The device has been developed to be simple to operate, allowing use by trained technicians and physician assistants. This not only frees up physicians to treat more patients, it also reduces the examination costs. Aura can scan numerous moles within minutes and, unlike the traditional "ABCD" method, makes full-body scans practical.

Verisante Aura



Source: Verisante

The device was used in a six-year study on over 1,000 lesions. Results were confirmed with a biopsy. Preliminary results on 274 lesions showed Aura correctly identified 100% of all malignant melanomas (and 90% of all cancerous and precancerous lesions) with only 30% false positives (25% false positives of all cancerous and precancerous lesions). In January 2011 Verisante entered an agreement with the Skin Care Centre at Vancouver General Hospital/Department of Dermatology and Skin Science, UBC for the statistical analysis of this study. Results of the analysis are expected to be available by May 2011.

Core

Following the expected launch of Aura, Verisante expects to introduce Core, for the detection of lung, gastrointestinal and cervical cancers. Initial focus will be on lung cancer. Core was also developed by the BC Cancer Agency and is built on the Aura platform. Verisante will work with Vancouver General Hospital's (VGH) Lung Centre on development of a commercial Core prototype. VGA's Dr. Stephen Lam will be directly involved in the project. Dr. Lam credentials include professor of medicine at the University of BC, chair of the Lung Tumour Group and leader of the Lung Cancer Prevention Program at the BC Cancer Agency. He is also co-inventor of LIFE-Lung, a device used to detect pre-invasive lung cancers which is being used in more than 150 major medical centers worldwide

Removal of a suspected cancerous lesion in the lung is highly invasive. Accurate diagnosis prior to the biopsy is therefore important in order to optimize patient care. Better diagnosis also maximizes health care resources and reduces overall costs. Verisante has publicized relatively little information about Core although they do note on their website that, "the Verisante Core™ device determines with exceptional accuracy if a lesion is malignant or benign. Through this quick and non-invasive verification process, the Verisante Core™ device prevents unnecessary biopsies and the resulting stress and health-care risks and costs that accompany the biopsy procedure."

The BC Cancer Agency and VGA's Lung Centre completed a small pilot study with 50 patients, which Verisante's November 16, 2010 press release, notes showed "excellent results." Verisante expects to move Core into large clinical studies in the detection of cancers of the lung, colon and cervix. These studies would likely not commence prior to the completion of a commercial prototype (~Q4 2011). As noted previously, given very limited visibility on the trial data to-date and potential protocol and timing of larger studies we have no way to judge the probability of eventual approval or opportunity for the device. When we know more we will update our model to include a contribution from Core, if appropriate – which could potentially add significant upside to our current revenue and earnings estimates (especially given the relatively large size of the lung cancer diagnostics market).

End Caps

Verisante will also manufacture and sell proprietary end caps for Aura. The single-use, sterile caps will ensure patient safety. This will also provide the company will an ongoing revenue stream which is expected to eventually comprise a significant portion of total sales.

MANUFACTURING

Verisante will manufacture the device in-house and recently signed consulting agreements with two doctors from the BC Cancer Agency to manage the project to build the devices to be used in regulatory clinical trials. Dr. Branko Palcic, formerly of the BC Cancer Agency (founder of its imaging department) and a member of Verisante's scientific advisory board will manage the project. Dr. Haishan Zeng, Senior Scientist in the Integrative Oncology Department (Imaging Unit) of the BC Cancer Agency and one of the inventors of Aura's skin cancer technology (Zeng built the current prototype that was used in the 1,000+ lesion trial) will be the lead scientific advisor to Verisante on the project. A team of engineers and scientists with requisite expertise and knowledge has been hired to build the clinical prototypes.

In January 2011 Verisante announced that they signed a building lease where they will build the device. Verisante has also begun the process of obtaining ISO 13485:2003 certification, a requirement for medical device manufacturing in Canada and the EU. Aura has been classified as a Class II device by Health Canada. Verisante expects to have their final commercial prototype available by the third quarter 2011.

FINANCIAL CONDITION

Verisante had CDN $568k in cash as of September 30, 2010. Operating cash burn was CDN $297k and CDN $793k in the three and nine months ending September 30, 2010. Verisante also used CDN $107k and CDN $234k in investing activities over the same periods – this is almost entirely related to capitalized costs related to product development.

Verisante has been successful in raising capital on a regular basis and raised another $1,250k in total through private placements in November 2010 and January 2011. The company will likely need to continue to raise money likely at least through 2012. We expect cash burn to increase in 2011 as a result of prototype development, upfront (and near-term) licensing fees and milestones to BC Cancer Agency and, later, pre-launch preparedness for the Canadian, European and Australian markets.

We currently look for U.S. clinical trials to commence in early 2012. We expect this to be largely financed through raising outside capital and potentially from a modest contribution from sales of Aura in Canada, Europe and Australia.

In our discussions with management they indicated substantial interest from potential investors and feel very comfortable in their ability to continue to raise financing (piecemeal or otherwise) for the foreseeable future.

KEY ASSUMPTIONS

Sales Channel
Verisante has yet to disclose their plans relative to marketing although we expect this will most likely be handled through distributors outside of Canada. With roughly only ~500 dermatologists in Canada it is possible Verisante can handle sales there in-house.

Physician Interest
Despite the fact that Aura appears to be a significant improvement to the current method for the diagnosis of melanoma, physician interest will be virtually non-existent if the economics do not work. Third-party reimbursement is not available for skin cancer imaging so cost of a scan will be borne 100% by the patient.

In our discussions with Verisante's management they noted that they have had conversations with numerous dermatology practices in Canada that supported use of Aura. The general consensus was that patients would be willing to pay for scans out-of-pocket and that there was enough financial incentive for the physician. We assume that this also translates to the other markets where Verisante expects to enter.

Assuming physicians purchase Aura for $30k, charge $100 per scan, average four scans per business day and variable cost per scan (technician pay, cost of cap, etc) runs $60/scan, time to payback would be less than one year. These are rough estimates and may actually be conservative (especially the number of scans/day given the potential for high utilization as a result of Aura's fast scan time) – but we think this illustrates that it is reasonable that physicians would find that the economics work.

Regulatory Approval / Launch
Verisante must gain regulatory approval in Canada first before they can sell their products outside their home country – the biggest hurdle to this is gaining ISO certification. Once Verisante has a finished a commercial prototype (expected Q3 2011), they expect to submit data from the 1,000+ lesion study (after statistical analysis has been completed ~May 2011) in support of their ISO certification application. Turnaround time for ISO applications can be as quickly as 15 days after submission. Once Verisante has ISO certification, management believes CE Marking will come in short order and they can commence launch of their products in Canada, Europe and Australia.

Assuming management can hit their current timelines, Aura will launch later this year in Canada, Europe and Australia. Based on the interim data set from the 1,000+ lesion study management appears to be confident in gaining regulatory clearance on the first pass – the full statistical study is expected to be available early in the third quarter, at which time there should be significantly greater visibility on probability of approval and timeline for launch. We currently model Aura to launch in early 2012 (slightly more conservative than management).

Verisante hopes to launch Aura in the U.S. in 2013. FDA approval would likely come through PMA and would likely require additional trial data (additional to the 1,000+ lesion study). However, until we see the full data set from the 1,000+ lesion study, it is difficult to determine how much additional data the FDA might require. We do note that in MELA Sciences quest for FDA approval of its skin imaging device, the FDA set 95% sensitivity (statistical at 95% conf interval) as one of the endpoints for the ~1,400 patient clinical trial used to support their PMA application.

The interim data set from Verisante's 1,000+ lesion study showed 100% sensitivity. Although the full analysis may indicate lower sensitivity, Verisante can adjust their device to increase sensitivity. This would compromise specificity somewhat, although likely not nearly anywhere near as low as the 9.5% specificity logged with MELA's device in their ~1,400 patient trial (an FDA advisory panel voted by a narrow margin that MELA's device was effective despite the 9.5% sensitivity). In our discussions with Verisante management, they indicated that their current expectations are that they will run a small U.S.-based trial (~150 patients at each of 3 sites) to supplement the data from the 1,000+ lesion study. The combined data, they believe, may be sufficient support to gain FDA approval.

Assuming a finalized commercial prototype is available in Q3 2011, U.S. clinical trials would likely not commence much earlier than Q1 2012. Trials would take 6 – 12 months and a PMA submission could potentially happen in late-2012. Even if FDA designates expedited review, we think a reasonable guess is that turnaround time would likely not be much quicker than nine months (~Q2 or Q3 2013). Adding a little cushion for possible delays and pre-launch activities and we think Aura could launch in the U.S. in late 2013 or early 2014. We currently model the U.S. launch in Q4 2013.

Pricing / Margins
Verisante's investor presentation notes that they expect Aura and the end caps to retail for CDN $30k and CDN $10, respectively. These are likely best guesses as pricing will likely depend (at least partially) on Verisante's cost to manufacture the products – which will not be known until sometime after the commercial prototypes have been completed. Prices of competing devices could also affect Verisante's pricing strategy. Although due to different business models (mostly derivations of razor-razor blade) it is very difficult to make an apples-to-apples pricing comparison to competing devices. Efficacy will also likely be a bigger determinant than price in physicians' decision to purchase among the competing devices – which we believe will favor Aura and could potentially afford Verisante additional pricing power.

As it is now our assumptions incorporate Verisante's current pricing expectations. And assuming a 30% cut to distributors for the devices, we ballpark revenue to Verisante at CDN ~$21k per device.

We have very little information to base an estimate of unit cost other than discussions with company management and experience covering the medical device industry. We assume management's pricing is based on expectations of gross margins (assumes use of third-party distributors) of 50% on devices and 95% on caps. As caps revenue becomes significantly more meaningful and grows to a larger share of overall sales, total gross margin will expand.

Revenue
Using our estimates, there are approximately 21k dermatologists in Canada, Australia and Europe. The GP market in those territories, while likely significantly more difficult to penetrate, at approximately 560k is about 30x larger. The total U.S. market adds another 10k dermatologists and 350k GPs. We also assume that there are, on average, approximately two dermatologists per practice. This represents a total installed-base market of approximately 500k units.

Verisante's current plan of attack with Aura is to initially target dermatologists and then begin detailing to GPs in year two.

Assuming Verisante will have ample manufacturing capacity and distribution reach, we think it is not unreasonable that they can place 150 units (~1.5% penetration of dermatologist practices in Europe, Canada, Australia) during the first full year after launch. Year two we estimate an additional 535 in unit sales, aided by the introduction to GPs and the U.S. launch (we estimate Q4 2013). A bigger push into the (potentially tough to penetrate) GP segment could significantly accelerate system sales going into 2014. With the larger installed base Verisante would also begin to see meaningful dividends from recurring cap sales (razors in the razor-razor blade business model). We currently approximate 4 scans per unit every working day – this may be erring on the side of conservative (given that we assume 2 physicians per unit).

Using these assumptions we think Verisante could generate CDN $3.2 million in device sales in 2012 and CDN $11.2 million in 2013. With almost two full years on the market, 2014 could see a significantly greater rate of adoption by the sizable GP market. Greater traction in the GP segment combined with continued single digit share gains of the CE Marked countries' dermatology segments along with initial introduction into U.S. market could considerably accelerate sales in 2014. We model device sales of CDN $24.6 million and cap revenue of CDN $11.5 million in 2014.

COMPETITION

The majority of the near-term competitive threat to Verisante is likely confined to MELA Sciences, Lucid Inc and SciBase Inc., all of which have products that use non-invasive technology in the diagnosis of skin cancer. While it appears both Lucid and SciBase have legitimate products that could present meaningful competition to Verisante, based on the significant size of the combined markets for melanoma diagnosis that Verisante expects to enter (Canada, U.S., Europe and Australia) and Aura's rapid throughput and high accuracy, we believe Aura should be well received.

We also note that Verisante may be faced with competition from new highly accurate and fast throughout devices in the not so distant future. While we expect Verisante's Aura to be the first device utilizing Raman technology for the detection of skin cancer to reach commercialization, it may not be the last. Researchers at Harvard University have been investigating the use of Raman technology (specifically "stimulated Raman scattering") for a variety of applications, including the detection of skin cancer. A laser incorporating the technology is currently being developed at Michigan State University. We however, have no visibility at this time relative to if or when a product utilizing this technology could or would be commercialized.

MELA Sciences

MELA's MelaFind skin imaging device operates by taking a picture of a mole and comparing its characteristics to a database of 10k biopsied melanomas to determine whether the mole is melanoma. The device is not powered to analyze other forms of skin cancer such as BCC or SCC.

MELA filed for FDA approval in June 2009. In clinical trials MelaFind was shown to have 98% sensitivity but only 9.5% specificity. Specificity was (statistically) significantly higher than that of dermatologists (3.7%) but the data did not impress well on regulators. In March 2010 the FDA returned with an approvable letter and later convened an advisory panel to weigh in on the decision whether to approve. After digging into the details of the data, the FDA concluded that MelaFind is actually less accurate than dermatologists in detecting melanoma. The agency characterized the benefit seen in the data as "clinically meaningless" as the device not only does not reduce the number of biopsies, it actually increases the number that doctors would need to perform.

Despite this, the FDA advisory panel actually voted 8 – 6 in favor that MelaFind is effective, 10 – 6 in favor that it is safe, and 8 – 7 in favor of approval based on the potential benefits outweighing the risks. The FDA, however, does not need to follow the advice of advisory panels and in this case, very well may not. Even analysts that have been bullish on MELA seem to be handicapping that the FDA will not grant approval without more trial data. If MELA needs to run additional trials it could be several years before FDA approval would again be considered. As it is now, based on the data to date and the FDA's comments we do not believe MelaFind poses much of a threat to Aura. And even if MelaFind does eventually gain FDA approval, it can not be used to detect SCC and BCC, which combined represent over 90% of all skin cancer cases

Lucid Inc.

Lucid's VivaScope incorporates confocal technology and uses a laser to look below the skin which provides detailed cellular images of the skin. The images are than sent electronically to a pathologist who renders a diagnosis.

VivaScope gained FDA 510(k) clearance in October 2008. VivaScope is currently in use in the U.S., Europe and Australia. Lucid generates revenue both through device sales and at every use. Lucid currently offers three different models of VivaScope, the latest a smaller device which can scan difficult to access areas of the body.

Unlike MelaFind, VivaScope appears to have some utility for dermatologists and also holds the first-to-market advantage. We believe Aura can be very competitive against VivaScope, however, based on Aura's faster scan times and quicker diagnosis turnaround (VivaScope requires a specialist to analyze the scan). As Lucid is a privately-held company, financial information and unit placement figures are not available.

SciBase Inc.

SciBase is a privately-held Swedish company which is developing a method called electrical impedance spectroscopy (EIS) to detect skin cancer. Damaged skin has different electrical properties compared to healthy skin. EIS measures the resistance of the skin after application of a weak electrical current. SciBase is developing a device that they believe will be able to help dermatologists determine which moles are cancerous.

In August 2010 SciBase announced that their device achieved 98% sensitivity and specificity 20% better than dermatologists in the detection of malignant melanoma in a 1,200 patient clinical trial. SciBase currently has their device in a clinical study that is expected to form the basis for their application for regulatory approval in the U.S. and Europe. An IDE (Investigational Device Exemption) approval has been granted for the study in the U.S. by the FDA. If approved, SciBase intends to launch the device in the U.S., Europe and Australia. SciBase said they hope to commence the launch sometime in 2011.

We again believe Aura can be competitive with SciBase's device based on speed of scan and, potentially, higher sensitivity/specificity.

INVESTMENT THESIS / VALUATION

Market Size
We estimate the combined "early adopter" (i.e. – low hanging fruit) markets in Europe, Canada and Australia could be worth over CDN $200 million in net device sales (~11k dermatologist practices x CDN $21k per device). The recurring revenue opportunity could conservatively be worth over CDN $100 million every year (this assumes only 4 scans per day for every 2-physician dermatology practice). Entry into the U.S., while likely years away, increases Verisante's total dermatology practice market by another 50% (in device sales and recurring revenue).

And while the GP segment will likely be significantly more difficult to penetrate, at almost 30x the size of the dermatology practice market, it represents a multi-billion dollar opportunity.

Unmet Need
The current "ABCD" technique, while still considered the gold-standard in the diagnosis of skin cancer, is antiquated, unsophisticated, slow and been proven through numerous clinical studies to be fraught with error (especially with early stage skin cancer). Aura looks to be significantly more accurate and exponentially faster in the diagnosis of melanoma and has the potential to save lives, reduce the number of unnecessary biopsies and lower overall healthcare costs.

Sparse Competition
Analysts were smitten with the opportunity for MelaFind, based mostly on the size of its potential market and a clear need for a better tool in the diagnosis of skin cancer. MelaFind's efficacy is now largely in doubt and even the most bullish of analysts seem to be hedging their bets.

Although there are other technologies that have either been recently introduced or are in late-stage development that would directly compete with Aura, the market still remains almost completely up for grabs. And based on the huge market size and what we expect to be certain competitive advantages (speed, versatility for all types of skin cancer, greater accuracy, smaller probe), we believe Aura will be very well received and expect sales to ramp very quickly following launch.

Technology
The basis for the technology incorporated into Aura was discovered by the winner of the 1930 Nobel Prize in Physics. An award-winning team from the BC Cancer Agency made improvements to the existing near-infrared Raman technology, making it feasible for incorporation into a portable device for the accurate and early detection of skin cancer. This patented technology is the backbone of Aura.

Business Behind The Technology
A great technology does not necessarily make a feasible business. We think Verisante has both. Verisante handles very little in-house and instead mostly in-licenses and outsources. This keeps fixed costs low, mitigates risk and maximizes expertise of major functions.

The company's low-cost base, razor / razor blade business model and the opportunity afforded by the ex-U.S. markets alone should allow Verisante to turn cash flow positive in relatively short order. We model Verisante to post positive earnings by 2013. And while U.S. clinical trials (expected in 2012) will require significant capital, we think this is manageable from a combination of operating cash flow from sales to ex-U.S. markets and external financing.

Entry into the U.S. market (we look for late-2013) could help push revenue up to CDN $36 million in 2014.

VALUATION
We value Verisante using the average of enterprise value and P/E.

MELA Sciences current market capitalization is $73 million. With approximately $30 million of cash on their balance sheet (had ~$37 MM as of 9/30/10 and burning ~ $5MM/quarter) and no debt, MELA's enterprise value is currently about $33 million. As it appears MelaFind's chances of receiving FDA approval in the absence of more clinical data are now less than 50% and even if eventually launched, the utility of the device is questionable at best, we believe an investment in Verisante offers significantly more upside without a commensurate increase in risk. As such, we

think Verisante should trade at a significant premium to MELA. Using an enterprise value of $66 million (twice MELA's $33 million), values Verisante at approximately $1.65 per share.

For P/E/ valuation, we apply a P/E multiple of 25x to our estimated year 2014 EPS of CDN $0.20 and discount this back at 20% per year to arrive at a valuation of $2.56 (current U.S.$ / CDN $ exchange rate is 1/1).

The average of the two methods results in a valuation for Verisante of $2.10 per share.

As the chances of ISO certification and CE Marking of Aura become more certain, we think this value could move significantly higher. Meaningful progress in the development and commercialization of Core could also prompt us to increase our price target.

As it is now, we value Verisante at $2.10 per share and are initiating on the company with an Outperform rating.

Risks to our recommendation include

- Commercial prototype fails to be feasible
- Fail to gain ISO certification / CE Marking
- Insufficient physician or patient interest
- Full clinical data analysis shows underperformance relative to expectations
- Financing dries up

MANAGEMENT / BOARD OF DIRECTORS

Thomas Braun BA, JD, LLM
Chief Executive Officer

Prior to founding the company, Thomas Braun practiced corporate securities law at Braun and Co., specializing in representing small high tech public companies. Mr. Braun is experienced in the management of public companies and has conducted dozens of mergers and acquisitions and going public transactions.
Mr. Braun earned a BA degree from the University of Western Ontario, a Juris Doctor (JD) degree from the University of British Columbia, and a Master of Laws (LLM) degree from the University of San Francisco specializing in International Business Transactions. He is a member of the State Bar of California, and the American Bar Association; and is also a member of the Law Society of British Columbia and the Canadian Bar Association. He is also admitted to practice before the Federal Court for the Northern District of California and the Ninth Circuit Court Appeals.

Anna Trinh, B.Comm, LLB
CFO
Vice President of Administration
Corporate Counsel

Anna Trinh obtained a Bachelor of Commerce (Finance) and a Bachelor of Laws degree from the University of British Columbia and was admitted to the British Columbia Bar in August 2007. During the past five years Ms. Trinh has had experience in advising start-up Companies regarding regulatory and other compliance filings, general corporate finance and corporate management matters. Ms. Trinh is a member of the Law Society of British Columbia, the Canadian Bar Association (BC) and the Canadian Corporate Counsel Association.

Joe Biegel, B.S., M.S.

Mr. Biegel is the Vice President of Product Management and Marketing for the Medical Imaging Division of McKesson Provider Technologies. He joined McKesson in 2004 and is responsible for developing product strategy and plans for the growing family of diagnostic imaging IT solutions from the McKesson Imaging Group.
Mr. Biegel has been working in digital imaging for over 27 years, and in diagnostic imaging for 19 years. Prior to joining McKesson, he served as Vice President of Business Development for Agfa Healthcare. Before joining Agfa, he had senior roles in diagnostic imaging product development and marketing at Hewlett-Packard's Medical Products Group, Polaroid Medical Imaging Systems and the DuPont Merck Pharmaceutical Company. Mr. Biegel also was on the faculty of the Rochester Institute of Technology's Center for Imaging Science where he taught courses in imaging and computing and was involved in contract research programs for NASA and other US Government organizations.

Karen Boodram, B.Sc., MBA

Karen Boodram comes to us from PI Financial Corp. where she served as a Life Sciences Analyst and has over 18 years of life sciences industry experience including Director of External Affairs for Novartis Pharmaceuticals and several senior management positions (including Manager of Health Economics) for Ciba-Geigy Pharmaceuticals, spanning both the Canadian and European marketplace. Prior to joining PI Financial Corp., Karen led BioManna Consulting where she spearheaded and managed projects for the National Research Council as well as biotechnology, pharmaceutical and medical device companies in North America. Karen is a graduate of the University of Alberta with Bachelor of Science Degrees in Biochemistry and Pharmacy as well as an MBA. She is also a member of the Alberta Pharmaceutical Association.

Chris Dennis, MBA

Chris Dennis is currently CEO of Comcare Ltd., a 4,000 employee health services Company. Prior to joining Comcare, Mr. Dennis was formerly Senior Vice President Global Commercial Operations for Angiotech Pharmaceuticals and Global President OrthoNeutrogena: Pharma and Medical Devices (a Johnson & Johnson company). Mr. Dennis was with J&J for a total of 18 years in senior marketing executive roles. He has managed large sales and marketing departments and generated millions of dollars in sales for the various organizations that he has managed. Mr. Dennis holds an MBA from Athabasca University.

Dr. Jake Thiessen, Ph.D.

Dr. Jake J. Thiessen is the founder of the Hallman, School of Pharmacy, and Director, Health Sciences Campus, University of Waterloo. Jake is a former professor and associate dean at the Leslie Dan Faculty of Pharmacy, University of Toronto. He earned his B.Sc. (Pharm) degree from the University of Manitoba, and went on to complete a M.Sc. at Manitoba and a Ph.D. at the University of California, San Francisco. Jake's area of specialization is pharmacokinetics. His research interests include new approaches in cancer treatment and new molecules to treat patients with iron overload. He has broadened his experience and shared his expertise through work with the Drug Quality and Therapeutics Committee of the Ontario Ministry of Health, Health Canada's Scientific Advisory Committee on Bioavailability and Bioequivalence, and the Canadian Council for Accreditation of Pharmacy Programs.

FINANCIAL STATEMENTS

INCOME STATEMENT (CDN $)

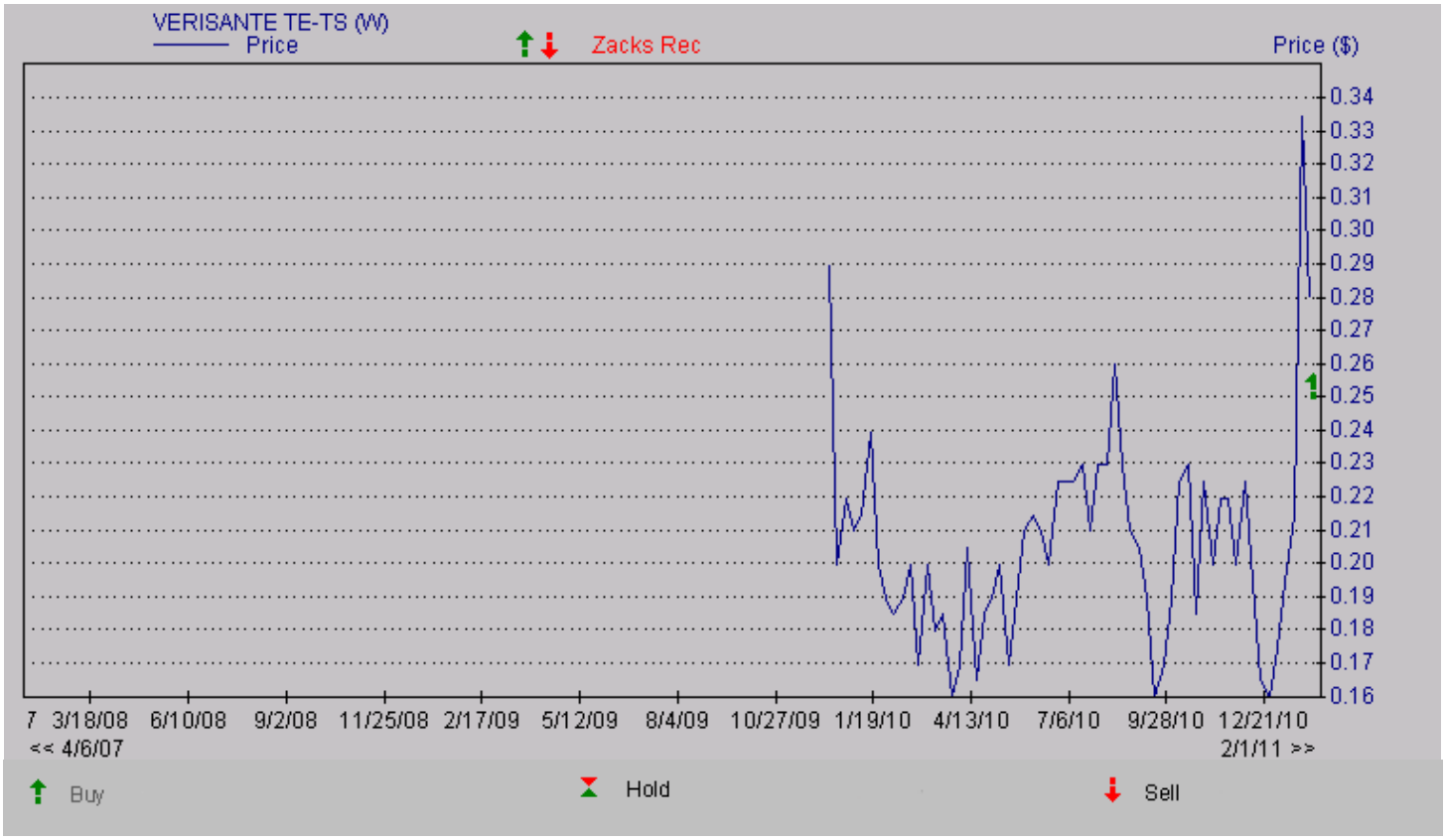
Verisante Technology

	2009 A	Q1A	Q2A	Q3A	Q4E	2010 E	2011 E	2012 E	2013 E	2014 E
Device sales	$0	$0	$0	$0	$0	$0	$0	$3,150	$11,235	$24,570
% total sales	-	-	-	-	-	-	-	*82.7%*	*72.2%*	*68.2%*
Cap sales	$0	$0	$0	$0	$0	$0	$0	$660	$4,332	$11,448
% total sales	-	-	-	-	-	-	-	*17.3%*	*27.8%*	*31.8%*
Revenue	$30	$5	$6	$0	$0	$11	$0	$3,810	$15,567	$36,018
YOY Growth	-	-	*335.5%*	-	-	*-62.5%*	-	-	*308.6%*	*131.4%*
Device COGS	$0	$0	$0	$0	$0	$0	$0	$1,575	$5,618	$12,285
Cap COGS	$0	$0	$0	$0	$0	$0	$0	$33	$217	$572
Cost of sales	$7	$1	$3	$4	$0	$8	$0	$1,608	$5,834	$12,857
Gross Income	$23	$4	$3	($4)	$0	$3	$0	$2,202	$9,733	$23,161
Gross Margin	*76.1%*	*84.4%*	*47.8%*	-	-	*26.0%*	-	*57.8%*	*62.5%*	*64.3%*
SG&A	$827	$284	$349	$320	$345	$1,298	$1,481	$1,820	$2,420	$2,775
% SG&A	*2714.5%*	-	-	-	-	-	-	*47.8%*	*15.5%*	*7.7%*
R&D	$285	$67	$38	$57	$65	$226	$550	$2,720	$1,055	$1,010
% R&D	*937.2%*	-	-	-	-	-	-	*71.4%*	*6.8%*	*2.8%*
Interest expense (income), net	$3.7	$0.4	$0.0	$0.0	$0.0	$0.4	$0.0	$0.0	$0.0	$0.0
Operating Income	($1,093)	($348)	($383)	($381)	($410)	($1,522)	($2,031)	($2,338)	$6,258	$19,376
Operating Margin	-	-	-	-	-	-	-	-	*40.2%*	*53.8%*
Government grants	$268	$31	$31	($1)	$10	$71	$88	$50	$50	$50
Royalty payments	($33)	$0	$0	$0	$0	$0	$0	($229)	($934)	($2,161)
FX gain (loss)	($4)	($1)	$0	$1	$0	$0	$0	$0	$0	$0
Total Other Income	$231	$31	$31	$0	$10	$71	$88	($179)	($884)	($2,111)
Pre-Tax Income	($862)	($317)	($352)	($381)	($400)	($1,451)	($1,943)	($2,517)	$5,374	$17,265
Taxes (benefit)	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$1,343.5	$4,661.4
Tax Rate	*N/A*	*N/A*	*N/A*	*N/A*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*25.0%*	*27.0%*
Net Income	($862)	($317)	($352)	($381)	($400)	($1,451)	($1,943)	($2,517)	$4,030	$12,603
Net Margin	-	-	-	-	-	-	-	-	*25.9%*	*35.0%*
EPS	($0.03)	($0.01)	($0.01)	($0.01)	($0.01)	($0.04)	($0.04)	($0.05)	$0.07	$0.20
YOY Growth	-	*-6.2%*	*4.6%*	*34.8%*	*73.4%*	*23.7%*	*1.4%*	*16.0%*	*-246.6%*	*188.1%*
Diluted Shares O/S	26,692	33,083	33,087	36,608	43,000	36,445	47,963	53,550	58,500	63,500

Source: Zacks Investment Research *Brian Marckx, CFA*

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