



# Biotech Sector - 2008

**Matthijs Smith**

+61 3 9200 7050

[m.smith@lodgepartners.com.au](mailto:m.smith@lodgepartners.com.au)

## Year of *Rattus norvegicus*

### Top 5 Biotech Stocks for 2008

<b>MSB</b>	<b>Mesoblast</b>	<b>\$0.95</b>	<b>\$113.3m</b>
<b>PAB</b>	<b>Patrys</b>	<b>\$0.43</b>	<b>\$65.7m</b>
<b>CXS</b>	<b>ChemGenex</b>	<b>\$0.79</b>	<b>\$147.8m</b>
<b>ACR</b>	<b>Acrux</b>	<b>\$1.05</b>	<b>\$167.2m</b>
<b>CYT</b>	<b>Cytobia</b>	<b>\$0.40</b>	<b>\$33.8m</b>

### Biotech Stocks To Watch in 2008

<b>PXS</b>	<b>Pharmaxis</b>	<b>\$2.95</b>	<b>\$573.74m</b>
<b>ACL</b>	<b>Alchemia</b>	<b>\$0.51</b>	<b>\$81.5m</b>
<b>NAN</b>	<b>Nanosonics</b>	<b>\$0.42</b>	<b>\$81.9m</b>
<b>AVX</b>	<b>Avexa</b>	<b>\$0.38</b>	<b>\$154.3m</b>
<b>PLI</b>	<b>Peplin</b>	<b>\$0.61</b>	<b>\$103.6m</b>

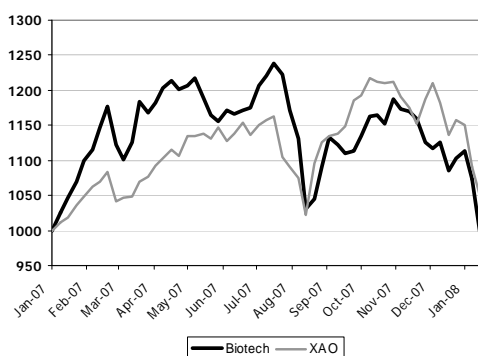
### Companies In Brief

<b>AAH</b>	<b>Arana</b>	<b>\$0.94</b>	<b>\$219.7m</b>
<b>CST</b>	<b>Cellestis</b>	<b>\$2.38</b>	<b>\$228.5m</b>
<b>NEU</b>	<b>Neuren</b>	<b>\$0.17</b>	<b>\$24.6m</b>
<b>SPL</b>	<b>Starpharma</b>	<b>\$0.33</b>	<b>\$58.4m</b>
<b>SRX</b>	<b>Sirtex</b>	<b>\$3.49</b>	<b>\$194.6m</b>

### Sector Snapshot

<b>Number of Listed Companies</b>	<b>119</b>
<b>Capitalisation of Sector</b>	<b>\$5.4 B</b>
<b>Annual Turnover</b>	<b>\$3.2 B</b>
<b>Capitalisation of Largest 20</b>	<b>59%</b>
<b>Turnover of Largest 20</b>	<b>54%</b>

**Lodge Biotech Index v All Ordinaries**



### Outlook For 2008

According to the Chinese Zodiac, the Rat year is one of plenty, bringing opportunity and good prospects. While things prosper, it is supposed to be a time to make long term investments. However, those who speculate indiscriminately will come to a sad reckoning.

With the year opening with fallout from the sub-prime mortgages and a major meltdown across the entire stock market, the biotech sector will be needing all the support it can get from long term investors, at least to help get through what looks to be a challenging first half of the year.

The biotech sector was starting to get reasonable support in the first half of 2007, despite strong competition for investor dollars from the booming resource sector and some spectacular nosedives by Metabolic (MBP), Progen (PGL), Clinical Cell (CCE) and Chemeq (CMQ). However, since August 2007, support for biotech stocks has been generally lacklustre. Despite this, a number of companies did raise additional capital in the second half of 2007 including significant raisings by Pharmaxis (\$61.7m) and Universal Biosensors (\$34.2m).

With many investors taking a defensive approach to their portfolios by minimising their exposure to smaller, volatile, illiquid stocks, we expect that access to new capital will be a significant challenge, at least for the first half of 2008. What this means is companies who do not have good cash reserves in hand (12+ months) are likely to come under significant pressure. Furthermore, while there are a number of companies with aspirations to list in 2008, we anticipate that only those companies which offer outstanding investment propositions will succeed, at least in the near term.

On a more positive note, several companies are set to hit major and significant milestones during 2008, particularly in relation to late-stage clinical trials. With many stocks trading at a significant discount, we believe this offers investors the opportunity to get into the sector at very attractive prices.

Our top 5 stocks (**MSB, PAB, CXS, ACR** and **CYT**) are ones that we believe are best positioned to provide good returns during 2008. All of these companies have sound cash positions, good technology and are on track to achieve significant milestones during the year. At their current prices, we believe these companies offer very attractive risk/return profiles for investors in the sector.

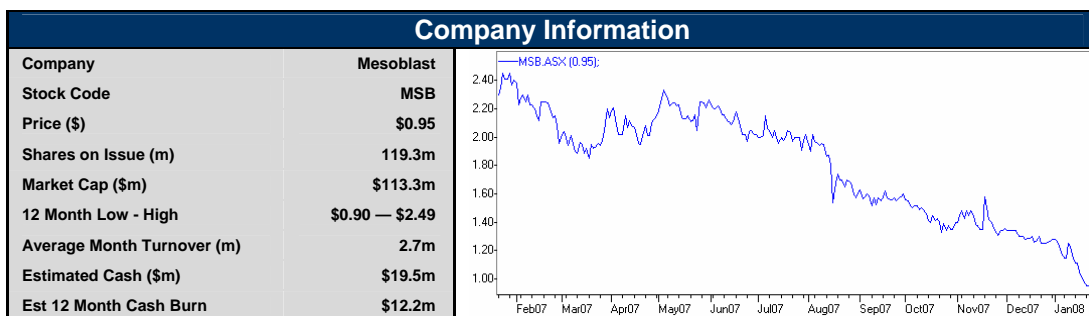
We also have comment on 5 stocks (**PXS, ACL, NAN, AVX** and **PLI**) that we believe are worth keeping an eye on. These are all high quality companies that could make significant progress during the year which may lead to good share price growth.

Finally, we briefly cover 5 additional stocks (**AAH, CST, NEU, SPL** and **SRX**) that may deliver share price upside during the year but have some qualities that make them a little more speculative in nature.

We have little doubt, in the near term at least, market conditions will be very challenging for the biotechnology sector in 2008. However, we believe investors should not lose sight of good products underpinned by good technologies and sufficient cash. While not for the faint-hearted, the current conditions do provide an opportunity to make significant returns by astutely investing in high quality companies with clear value-infection points ahead of them.

## Braveheart's Top 5 Biotech Stocks For 2008

### Mesoblast (MSB) – Growth From Growth



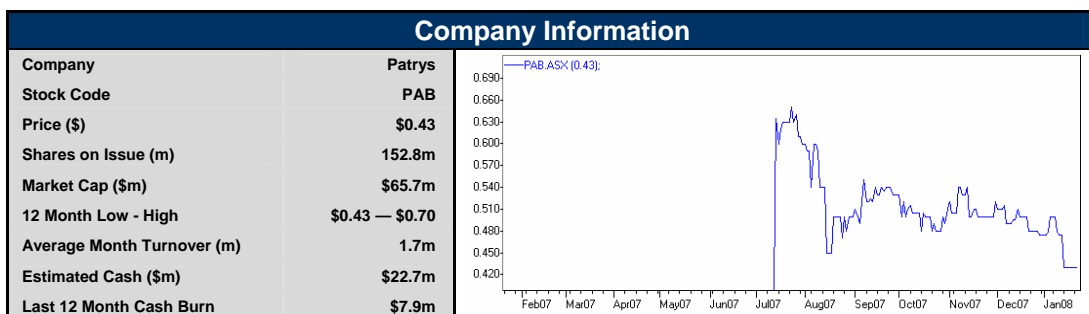
Despite the commencement of two Phase-II trials using adult stem cells (spinal fusion by MSB and heart failure by Angioblast in which MSB has 39.2% equity stake) MSB's price has declined significantly since the market correction in August 2007.

The company has very strong news flow for 2008 which we expect could rapidly return MSB's price to its pre-correction levels of above \$2.00:

- Initial results from two Phase-II clinical trials using allogeneic adult stems cells
- US listing or other financing of Angioblast providing external valuation point
- Potential licensing or co-development deal around an application for adult stem cells

Lodge has a current valuation for MSB of **\$2.35**. However, if the current Phase-II trials confirm the safety and efficacy of MSB's adult stems cells, we believe this will validate the company's business model for high-margin, high-volume, off-the-shelf cell therapies and would support a price target of **\$3.20**. However, we see good near-term potential returns for investors from strong news flow that should take the stock back to its pre-August levels.

### Patrys (PAB) – Man To Man



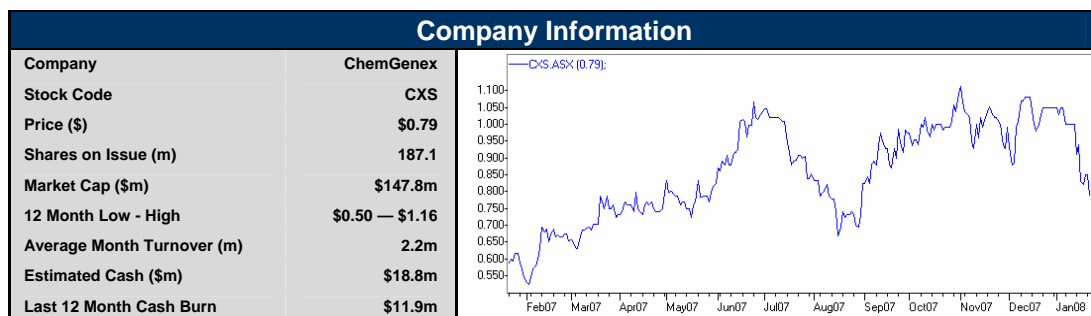
PAB listed in July 2007 raising \$25m to fund the development of at least 2 of its unique natural human anti-cancer antibodies to the end of Phase I/IIa clinical testing. In addition, the company has 7 antibodies being developed by major pharma partners.

PAB has proprietary technology that can immortalise antibody producing cells isolated from the human body. PAB has generated >40,000 antibody-producing cell lines and screened them to identify 275 cell lines which produce antibodies that react with cancer tissue but ignores normal, healthy tissue. What make these antibodies unique is they have been generated within the human body and seem to react with novel, cancer-specific targets.

The antibody space has continued to be one of the hottest areas in biotech with big pharma paying significant prices to access different antibody technologies and assets. In December 2007, GSK entered into a US\$1.4B deal with OncoMed to access that company's pipeline of preclinical antibodies and the novel targets they identify.

During the first half of 2008, PAB will complete scale-up production of its candidate antibodies allowing the final preclinical studies to be undertaken that will enable human clinical trials to start in 2H. Once scale-up production is complete, PAB will be in a good position to consider licensing deals for these candidates. We also anticipate good news flow from the partnered programs particularly with Takeda having a defined period to undertake evaluation of 5 antibodies and exercise its license option. Lodge has a price target for PAB of **\$1.00**

## ChemGenex (CXS) – Hard To Resist



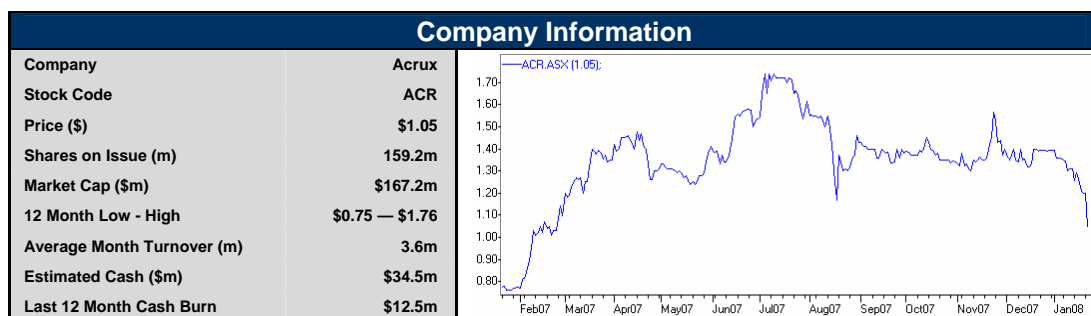
Last year, CXS continued to report excellent clinical data from its pivotal Phase-II/III trial using omacetaxine to treat Gleevec-resistant chronic myeloid leukaemia (CML) patients with the T315I mutation. Furthermore, the company announced results from preclinical studies showing that, unlike other CML drugs which are currently in the market, omacetaxine is able to kill the stem cells in the bone marrow which generate the leukaemic cells in the blood.

We are expecting the clinical data package from this trial to be completed around mid-2008, pending the FDA's requirements under CXS's adaptive trial design. With fast-track status awarded by the FDA, this could result in marketing approval by late-2008 or early-2009. In addition to the T315I trial, CXS is also conducting trials using omacetaxine to treat patients who have developed resistance to two or more tyrosine kinase inhibitors (TKIs).

A further advance is that CXS has established that omacetaxine works by reducing the levels of a protein called Mcl-1 which protects cancer cells from cell death. As the levels of this protein are often elevated in other leukaemia's and cancers, this has the potential significantly expand the commercial and therapeutic opportunities for omacetaxine.

In addition to ongoing results from pivotal clinical trials, CXS is likely to be filing for marketing approval sometime in mid-2008. We believe that, with the only drug to treat T315I CML patients potentially 12-months away from market entry, CXS is a ripe acquisition target for overseas players who would pay a premium. Lodge has a price target of **\$1.85** for CXS.

## Acrux (ACR) – Fuelled By Testosterone



ACR had a strong year in 2007, expanding its product pipeline and partnerships and also seeing the value of its delivery technology validated in a US\$150m deal between Vivus and KV Pharmaceuticals. While the stock has come off of its mid-2007 high of \$1.76, we believe this is primarily due to concern of significant stock overhang. Once this is addressed, the stock has potential for a significant upwards re-rating.

In July 2007, ACR raised \$23.0m to fund the Phase-III development of spray on testosterone to treat men with low levels of the hormone. While this is currently a relatively small market (2006 global sales US\$570m) and single product called Androgel accounted for over 60% of sales. We believe that the convenience of ACR's testosterone product format will put it in a very competitive position to secure significant marketshare. As we believe the sales potential of testosterone is greater than ACR's Evamist product, which KV Pharmaceuticals paid US\$150m for the US rights, ACR should be able secure an attractive deal for this product.

In addition to male testosterone, ACR will be receiving the first royalty payments from sales of Evamist during 2008. Although we are not expecting the initial payments to be substantial, they could reach \$10m-\$15m within 3 years. The company should also deliver news on its contraceptive program with Organon (now Schering-Plough) and other products in its extensive pipeline. Lodge has a price target of **\$2.55** for ACR.

## Cytopia (CYT) – Lets Get Clinical

Company Information	
Company	Cytopia
Stock Code	CYT
Price (\$)	\$0.40
Shares on Issue (m)	84.6m
Market Cap (\$m)	\$33.8m
12 Month Low - High	\$0.40 — \$0.74
Average Month Turnover (m)	1.1m
Estimated Cash (\$m)	\$14.5m
Last 12 Month Net Cash Burn	\$9.6m

CYT will undergo a significant transformation during 2008 as its most advanced drug called CYT997, a new class of anti-cancer drugs called Vascular Disrupting Agents, progresses through an extensive program of Phase-II clinical trials. CYT's VDA is unique in that it is the only one we are aware of that can be given orally (ie: as a pill) which has the potential to extend cancer treatments to outside the hospital setting. This drug has shown an excellent safety profile and was able to halt tumour growth in late-stage cancer patients who had failed to respond to standard cancer therapies.

CYT commenced the first of its Phase-II trials in December 2007 for multiple myeloma. Interim results from this trial are expected in 3Q 2008. However the company is planning to commence 2-3 other Phase-II trials using the drug to treat other cancer types (brain cancer, melanoma and stomach cancer).

The company has a partnership in place with Novartis for developing drugs that target an enzyme called JAK3 to prevent the rejection of organs following surgical transplantation. This is the largest deal established providing \$13m in upfront and R&D payments over 3 years and up to \$274m in milestone payments. The company is expected to receive the first of these milestone payments during 2008.

CYT also has two programs developing highly potent and specific inhibitors for two validated drug targets called JAK2 and FMS, both of which belong to an established family of enzyme drug targets called kinases. Preclinical work for both these programs should near completion during 2008 allowing these drugs to enter clinical development in late-2008 or early 2009.

We believe CYT's current valuation of \$40.6m (enterprise value of ~\$26m) does not reflect the quality of its programs, products and partnerships. We see an opportunity for investors to make initial returns from a re-rating of CYT to reflect the underlying value of its assets and further gains from the anticipated strong news flow. Lodge has a price target of **\$1.00** for CYT.

### Lodge Biotechnology Index

Lodge has established a Biotechnology Index (see front page) to monitor the performance of the sector as a whole. The Index is based on 117 listed stocks that are involved in the development of new therapeutics, diagnostics, medical devices or biotechnology-based industrial and agricultural products.

The Index has been constructed using the Volume Weighted Average Price (VWAP) traded for each stock each week. A 1000 point base has been established for each stock using the VWAP for the week that ended on Friday 5 January 2007. For stocks that listed during 2007, the offer price of the issue has been used as the base. The contribution of each stock to the Index has been weighted according to their market capitalisation on Wednesday 11th January 2008.

Going forward, we will be also track separate indices for companies that started the year with a market capitalisation >\$100m (22 companies) and those with market capitalisation <\$100m (95 companies). We will review the composition of all three indices at the beginning of each calendar year to take into account new listings and major movements.

## Stocks To Watch

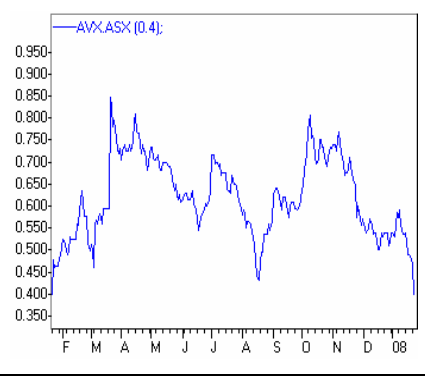
Pharmaxis (PXS) \$2.95		Market Cap \$573.7m
<ul style="list-style-type: none"> <li>• PXS has undoubtedly been the best performing stock in the biotechnology sector to date.</li> <li>• In August 2007, PXS reported positive initial data from its Phase-III trial using Bronchitol to assist patients with bronchiectasis with mucus clearance.</li> <li>• 12-month safety data from this trial is expected in mid-2008 which will form the basis for the first marketing approval application for Bronchitol.</li> <li>• During 2008, PXS will be undertaking Phase-III trials using Bronchitol for Cystic Fibrosis (CF) and bronchiectasis in the US and for CF in Europe.</li> <li>• Expect continued good performance from PXS, with its quality management and news from clinical trials. However the strong performance of PXS (until recently) may cap the extent of upside.</li> </ul>		
12 Month Low - High	\$2.95 — \$4.53	
Average Month Turnover (m)	11.2m	
Estimated Cash (\$m)	\$121.3m	
Last 12 Month Net Cash Burn	\$31.2m	

Alchemia (ACL) \$0.51		Market Cap \$81.5m
<ul style="list-style-type: none"> <li>• In April 2007, ACL announced a marketing and manufacturing partnership for its fondaparinux product with leading generics company Dr Reddy's</li> <li>• While the new deal terms are more favourable than ACL's previous partnership with Abraxis (up to 60% profit share), and sales of Arixtra (GSK's fondaparinux) continue to grow, ACL's price has declined significantly over the last 8 months.</li> <li>• We are expecting Dr Reddy's to file an ANDA application with the FDA during 1Q 2008 which should allow US sales to commence by 1Q 2009.</li> <li>• ACL's oncology assets are expected to progress and provide partnership opportunities during 2008.</li> <li>• With a product potentially 12-months from market entry, ACL is ripe for an upward re-rating in 2008.</li> </ul>		
12 Month Low - High	\$0.51 — \$1.28	
Average Month Turnover (m)	5.9m	
Estimated Cash (\$m)	\$19.5m	
Last 12 Month Net Cash Burn	\$8.9m	

Nanosonics (NAN) \$0.42		Market Cap \$81.9m
<ul style="list-style-type: none"> <li>• NAN is on track to commence sales of its first product, an ultrasound probe disinfectant, in FY08. NAN filed a CE Mark application in November 2007 which we expect to be granted in 1Q 2008.</li> <li>• NAN is developing products for low-cost, safe sterilisation of high-end medical equipment. The partnerships that NAN has established with major OEMs such as GE, Siemens and Philips reinforces the market need for these products.</li> <li>• We believe NAN has a compelling business model underpinned by good products with a significant market opportunity.</li> <li>• However, the surprise resignation of the CEO in December 2007 has put some uncertainty in the stock which may result in some price weakness until a new appointment is made.</li> </ul>		
12 Month Low - High	\$0.42 — \$0.90	
Average Month Turnover (m)	3.9m	
Estimated Cash (\$m)	\$25.3m	
Last 12 Month Net Cash Burn	\$24.4m	

**Avexa (AVX) \$0.38**

**Market Cap \$154.3m**

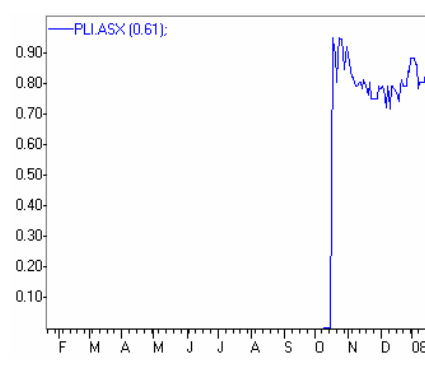


12 Month Low - High	\$0.33 — \$0.99
Average Month Turnover (m)	21.3m
Estimated Cash (\$m)	\$63.5m
Last 12 Month Net Cash Burn	\$29.2m

- In September 2007, AVX reported 24-weeks data showing 80% of AIDS patients in its Phase-IIb trial with ATC had undetectable blood levels of HIV.
- 48-week data from this trial is expected in 1Q 2008 and should reinforce the potential role of 3TC for patients who have developed resistance to the existing NRTI's that are part of HAART therapy.
- AVX initiated its first Phase-III trial in January 2008. However at its AGM, the company flagged that the full Phase-III program would require additional funding or the support of a partner.
- With greater focus of combination therapies, 3TC is likely to be of significant value to partners who could incorporate it into multiple products. We believe a partnership or co-development deal has the greatest potential to drive AVX's price in 2008.

**Peplin (PLI) \$0.61**

**Market Cap \$103.6m**



12 Month Low - High	\$0.61 — \$0.88
Average Month Turnover (m)	0.5m
Estimated Cash (\$m)	\$23.0m
Last 12 Month Net Cash Burn	\$27.5m

- In December 2007, PLI's the final results from their Phase-IIa trial using PEP005 for showed that it was safe and that a 2-3 day treatment was able to clear actinic keratosis (AK) lesions.
- PLI anticipates initiating the first Phase-III trial for this drug in 1Q 2008 and is also developing the drug for superficial basal cell carcinoma (BCC).
- In October 2007, Peplin (ASX:PEP) completed a restructure that moved the assets into an US-vehicle (Peplin Inc.) and converted the Australian shares into CHES Depository Interests (CDIs).
- The intention is raise money in the US market and to list Peplin Inc on NASDAQ. As there is no precedent for this in the Australian biotech sector, it is worth following to see if this strategy unlocks additional value for PLI shareholders.

**Other Companies In Brief**

**Arana (AAH) \$0.94**

**Market Cap \$219.7m**



- Despite having significantly enhanced its technology assets through the acquisition of Evogenix in August last year, AAH continues to trade at a value that primarily reflects only its cash.
- Following the sale of its equity in UK-based Domantis, AAH had \$169.0m in cash at 30 Sept 2007. AAH has since received the final \$17.7m from GSK and until 2010 should receive \$25m-\$35m/yr in royalty payments for its TNF $\alpha$  IP.
- With so little value being ascribed to its technology and significant cash assets, AAH is ripe for either a re-rating or becoming an acquisition target.

<b>Cellestis (CST) \$2.38</b>	<b>Market Cap \$228.5m</b>
<p>CST.ASX (2.39)</p>	<ul style="list-style-type: none"> <li>• In October 2007, CST finally received approval from the FDA for its in-tube TB-diagnostic test.</li> <li>• While the company's TB-test is clearly more sensitive and specific than anything else available and there is a clear market (prisons, healthcare workers, military and immigration), the sales have been slower than expected to materialise.</li> <li>• Potentially one of the factors that has contributed to slow sales growth has been anticipation of the more convenient single-tube format.</li> <li>• With this now approved in the US, we hope to see the sales potential of Quantiferon become reality.</li> </ul>

<b>Neuren (NEU) \$0.17</b>	<b>Market Cap \$24.6m</b>
<p>NEU.ASX (0.17)</p>	<ul style="list-style-type: none"> <li>• From a pipeline perspective, NEU has never looked better with its neuroprotectant, Glypromate, in Phase-III for CABG, the oral and more potent form (NNZ-2566) going into Phase-II, and the acquisition of Hamilton Pharmaceuticals bringing a Phase-II drug for post-stroke depression.</li> <li>• However, having done several small raisings over the last few years, NEU has always been under pressure in anticipation of the next capital raising.</li> <li>• NEU is in the process of undertaking a \$10.1m rights issue which would provide 12-months cash that will allow it clinical programs to progress</li> </ul>

<b>Starpharma (SPL) \$0.33</b>	<b>Market Cap \$58.4m</b>
<p>SPL.ASX (0.325)</p>	<ul style="list-style-type: none"> <li>• With the acquisition of DNT in 2006, SPL secured a significant patent estate around an entire class of synthetic nanoparticles called dendrimers.</li> <li>• While its lead product, VivaGel (a topical microbicide for the prevention of infection by HIV and HSV2) still requires 2-3 years of field testing, the company has secured deals around the use of dendrimers as condom coatings, siRNA delivery, water purification and dermal drug delivery.</li> <li>• SPL's technology has attracted industry awards and funding from NIH. Further deals may lead to greater support in the market during 2008.</li> </ul>

<b>Sirtex (SRX) \$3.49</b>	<b>Market Cap \$194.6m</b>
<p>SRX.ASX (3.55)</p>	<ul style="list-style-type: none"> <li>• Sales of SRX's Sir-Spheres for the treatment of liver cancer have continued to grow with \$34.8m in FY07 and \$9.1m in 1Q FY08.</li> <li>• The company is focused on driving sales growth and is expanding its sales forces in US and Europe and also undertaking additional clinical trials to increase the markets for its product.</li> <li>• Unfortunately the impact of this growth is dampened by the company being embroiled in a legal battle involving a former employee and the University of Western Australia which incurred \$3.9m in legal expenses in FY07.</li> </ul>

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Expected total Return is measured as (capital gain (or loss) + dividend)/purchase price

We have divided our recommendations into three main categories:

**Buy:** Expected Total Return in excess of 15% over a 1 year period.

**Hold:** Expected Total Return between 0% and 15% over a 1 year period.

**Sell:** Expected Total Return less than 0% over a 1 year period.

**Analyst Verification****The analyst holds shares in PAB and MSB**

I verify that I Matthijs Smith, have prepared this research report accurately and that any financial forecasts and recommendations that are expressed are solely my own personal opinions. In addition, I certify that no part of my compensation is or will be directly or indirectly tied to the specific recommendation or financial forecasts expressed in this report.

**Contact Lodge Partners:**Melbourne

Level 5, 60 Collins St  
Melbourne Vic, 3000

Phone: +61 3 9200 7000

Fax: +61 3 9200 7077

[www.lodgepartners.com.au](http://www.lodgepartners.com.au)

Sydney

Level 9, 30 Castlereagh St  
Sydney NSW 2000

Phone: +61 2 8224 5000

Fax: +61 2 8224 5055

Disclosure

*Lodge Corporate Services has provided corporate advice and services to Mesoblast Limited including acting as Lead Manager and Underwriter for an Initial Public Offering that raised \$21.0m at \$0.50 per share in December 2004 and Lead Manager for an Institutional Placement raised \$15.0m at \$1.25 per share in August 2006, and Lead Manager for an Institutional Placement that raised \$13.4m at \$1.28 per share in December 2007. Lodge Corporate Services received fees for these services.*

*Lodge Corporate Services has provided corporate advice and services to Patrys Limited including Lead Manager and Underwriter for an Initial Public Offering that raised \$25m at \$0.40 per share in July 2007.*

*Lodge Corporate Services has provided corporate advice and services to Cytopia Limited including acting as Lead Manager for an Institutional Placement raised \$5.1m at \$0.46 per share in December 2007. Lodge Corporate Services received fees for these services.*

*Lodge Corporate Services has provided corporate advice and services to Cellestis Ltd including acting as Lead Manager for and Institutional Placement that raised \$11.0m at \$2.40 in December 2004. Lodge Corporate Services received fees for these services.*