

Tuesday 16 May 2006

ChemGenex (CXS)**Shave for Leukaemia**

CXS's lead compound has completed a Phase 2 trial. The funds raised will enable a Phase 2/3 trial to be completed for a certain type of Leukaemia. Enrolment is expected to be completed in early 2007. We have set a price target of A\$0.91 and rate the stock a buy.

Table 1 : Milestone Table

Estimated Date	Milestone	Impact
2QCY06	Sign up hospitals to start Ceflatonin trial	Positive
3QCY06	Ongoing results from Quinamed Phase 2 trial	Positive
4QCY06	Update on Phase 3 Ceflatonin trial	Positive
1QCY07	Complete recruitment of Ceflatonin Phase 3 trial	Positive
2QCY07	Results of Ceflatonin Phase 3 trial	Major Positive

*Source ABN AMRO Morgans estimates***Introducing ChemGenex**

ChemGenex is one of Australia's leading biotech companies, specialising in genomic research and development with projects in the fields of cancer, diabetes and depression. The lead compound (Ceflatonin – for the treatment of Chronic Myeloid Leukaemia) is about to commence registration directed Phase 2/3 trials. The balance of the pipeline includes, another anti-cancer compound currently in Phase 2 trials, and a robust pre-clinical pipeline in cancer, inflammation and diabetes. Details of the pipeline are included overleaf.

Funding risk reduced

The recent A\$15m capital raising (34.8m shares at A\$0.43) plus an ability to raise an extra A\$5m through a Share Purchase Plan has significantly reduced one of the key risks underlying the company. The fact that major shareholder Merck Santé will contribute \$US3m (subject to shareholder approval) is strong validation of the science. The current funds are expected to see ChemGenex through to the end of calendar 2007 and registration of its lead compound Ceflatonin.

Key assumptions underlying valuation of A\$1.40

There are approximately 100,000 incidences in the developed world of CML with approximately 10,000 new cases each year. We have assumed a treatment cost of A\$30,000 per patient pa (below cost of current treatment), assumed a 70% probability of success and grow the market share from 5% in FY09 to 20% by 2014 and a royalty of 30%. Our DCF valuation is calculated at A\$1.40.

Outlook – Significantly undervalued, Buy

We initiate coverage with a Buy recommendation, set our price target at A\$0.91, a 35% discount to our DCF valuation, reflecting where we believe the stock will trade in 6 months upon the achieving recruitment milestone. We believe that when the Phase 2/3 clinical trial results for the lead compound for the treatment of CML are reported in 2007, the stock will be re-rated towards our valuation. We note that as ChemGenex reports successful clinical results we will increase our probability of success and therefore our valuation. Our DCF valuation excludes the potential of the earlier stage pipeline products.

Important disclosures regarding companies that are the subject of this report and an explanation of recommendations and volatility can be found at the end of this document.

Priced at close of business 12 May 2006. Use of ▲ ▼ indicates that the line item has changed by at least 10%.

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Buy

Important: The above recommendation has been made on a 12 month view and may not suit your investment needs or timeframe. The basis it is prepared on is summarised on the last page of this report. **PLEASE CONTACT YOUR ADVISER TO DISCUSS THIS GENERAL RECOMMENDATION BEFORE ACTING ON IT.**

N/A Volatility**Price**

A\$0.43

Market capitalisation

A\$57.0m

Price Target

A\$0.91

Reuters

CXS.AX

CXS60516

Analysts**Scott Power**

ABN AMRO Morgans
+61 7 3334 4884
scotp@abnamromorgans.com.au

Tanya Solomon

+61 7 3334 4521
tsolomon@abnamromorgans.com.au

www.abnamromorgans.com.au

Introducing ChemGenex

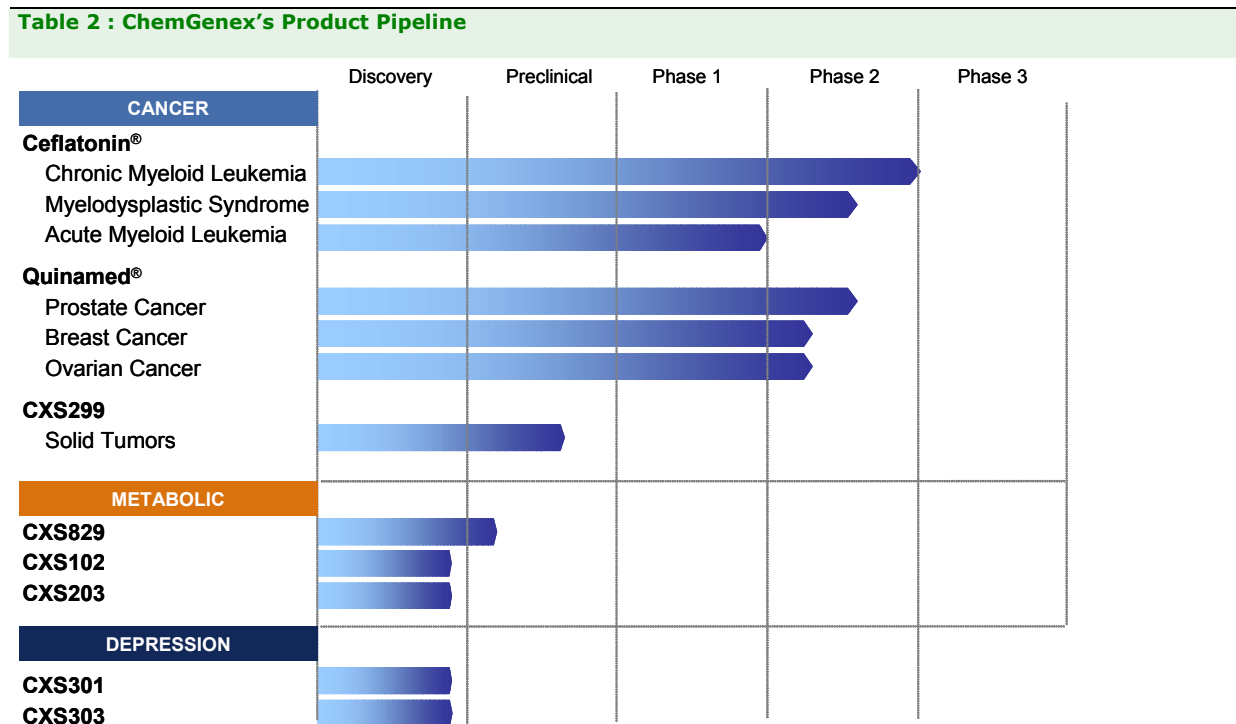
ChemGenex has flown under investor’s radars for some time. With a solid cash position and a registration directed clinical trial about to start, we expect this to change and rate the stock a Buy.

Investment view

ChemGenex Pharmaceuticals (CXS) is a pharmaceutical development company with projects in oncology, diabetes, obesity and depression. ChemGenex uses its understanding of the genetics of complex diseases to help develop individualised medicines. In addition to its Australian listing, ChemGenex is also listed on NASDAQ (CXSP).

CXS was established in 2004, following the scrip merger of ChemGenex Therapeutics (based in Menlo Park California) with AGT Biosciences (based in Melbourne). The merger combined AGT’s genomics driven platform and drug discovery technology (focused on anxiety, depression, obesity and diabetes) with ChemGenex Therapeutics’ advanced product pipeline, focused on cancer, and clinical development expertise. CXS also has a centre for Statistical Genomics in San Antonio, Texas.

The table below sets out the current state of CXS’ extensive pipeline.



Source: Company Data

Placement and SPP

CXS has recently completed a A\$15m (representing 30% of the issued capital) placement to overseas, domestic and sophisticated investors and a share purchase plan raising up to A\$5m. Given the size of the placement CXS intends to utilise these funds to fund a Phase 2/3 registration trial for its lead compound Ceflatonin. ABN AMRO Morgans was manager to the issue.

Key Strengths

- **Market launch of lead compound in FY09 with initial forecast revenue from royalties of A\$25m** – Based on conservative assumptions of 5% market share and expectations of market registration during calendar 2007.
- **Substantial market opportunity** –The current market for Gleevec is estimated at US\$2.6bn including US\$1.8bn in off label use. Gleevec resistance is a growing issue and Ceflatonin is targeting this resistance.
- **Balance of pipeline looks promising** – ChemGenex has a broad platform of additional compounds targeting other diseases, including Depression and Anxiety and Diabetes and Obesity. Components of these programs have been licensed to international pharmaceutical companies however ChemGenex retains other licensing opportunities.
- **Key personnel and Scientific Advisory Board have solid track record** – Dr Hagop Kantarjian of the MD Anderson Cancer Centre in Houston is one the world's leading authorities in leukaemia and is a member of ChemGenex's Scientific Advisory Board.

Key issues/ risks

- **Commercialisation risk** - Delays or lack of success in the clinical programs are an inherent risk for all biotechnology companies, in both development and registration of new compounds. In our modelling we have not attempted to value the other earlier programs. As the programs move through the clinical process we can place a value on them.
- **Inability to secure a marketing partner** – Assuming ChemGenex receives registration for Ceflatonin, it will be responsible for finding a marketing partner.
- **Intellectual property risk** – CXS' ultimate ability to commercialise its compounds is dependent on its ability to obtain patent protection for those compounds; and to sell those compounds without infringing the IP rights of third parties. No guarantee can be given that patents are ultimately granted or for existing patents that they will not be challenged in the courts.
- **Financial risks** - The capital requirements associated with CXS' other research programs may require further funding. All projects in the ChemGenex's portfolio will require funding to advance development to either the commercialisation or licensing stage. The current funds raised are considered sufficient to fund CXS through to the registration of Ceflatonin by the end 2007. Prior to the capital raising ChemGenex had cash reserves of A\$4.2m as at 31 Dec 05.

Anticipated News Flow

We have identified a number of near-term catalysts which if achieved we believe have the potential to drive the share price higher.

Table 3 : Our suggested future milestones to watch

Estimated Date	Milestone	Impact
2QCY06	Sign up hospitals to start Ceflatonin trial	Positive
3QCY06	Ongoing results from Quinamed Phase 2 trial	Positive
4QCY06	Update on Phase 2/3 Ceflatonin trial	Positive
1QCY07	Complete recruitment of Ceflatonin Phase 2/3 trial	Positive
2QCY07	Results of Ceflatonin Phase 2/3 trial	Major Positive

Source: ABN AMRO Morgans; Company data

Valuation

We have an A\$1.40 per share target price on the stock. Our price target has been set at a 35% discount to our valuation to reflect where we expect the stock will trade in six months assuming the patient recruitment timetable is achieved. Our key assumptions are detailed in Table 4. Key assumptions include A\$3.8b market. This is based on approximately 100,000 patients with CML, with an assumed sale price of A\$30,000 per annum. Ceflatonin sales are expected to commence in FY09 with an initial 5% market share being secured, growing to 20% thereafter. The royalty rate is assumed at 30%.

Sensitivity Analysis

We have conducted a sensitivity analysis on the Probability of Success which currently stands at 70%. Each 5% change in probability of success increases/decreases our valuation by \$0.07 per share.

Product pipeline

CXS is focused on developing and marketing compounds for the treatment of cancer and depression and metabolic conditions. It has three main development and discovery programs:

- (1) Cancer Therapeutics (Ceflatonin, Quinamed and CXS299)
- (2) Depression and Anxiety
- (3) Diabetes and Obesity

Ceflatonin

ChemGenex's lead compound is Ceflatonin (homoharringtonine or sHHT) which is a structurally unique, well-tolerated inducer of programmed cell death, originally identified from the National Cancer Institute natural product screening program. CXS is developing Ceflatonin to treat three types of blood cancer – Chronic Myeloid Leukaemia (CML), myelodysplastic syndrome (MDS) and acute myeloid leukaemia (AML).

Market Potential - There is significant market potential for Ceflatonin in CML. In the US there are approximately 5,000 new cases of CML, 12,000 new MDS cases and 10,000 new AML cases each year. Since the approval of Gleevec in 2001, the number of patients living with CML is increasing. However a growing number of these patients are developing resistance to Gleevec. While the incidence of CML is low, Gleevec generated sales of US\$630m for CML, and off-label use sales of US\$1.4b in 2004.

Table 4 : Market Potential for Ceflatonin

Indication	Worldwide Prevalence	Development Status
CML	100,000	Phase 2/ 3 pending
MDS	200,000	Phase 2 on-going
AML	100,000	Phase 2 in CY06

Source: ABN AMRO Morgans; Company data

CML is the lead program - Ceflatonin is now entering registration-directed Phase 2/3 clinical trials in CML for patients who have developed resistance to current treatments of Gleevec® and dasatinib.

Table 4: DCF Valuation

Assumptions	
WACC	16.1%
Beta	1.6
Equity risk premium	6.5%
Risk-free rate	5.75%
Long run growth rate	1.0%

Source: ABN AMRO Morgans estimates

CXS leverages its expertise in pharmacogenomics to develop cancer compounds that are no longer treatable with existing therapies.

Despite high response rates, many patients on Gleevec still have residual CML in their bone marrow stem cells and will gradually develop resistance (due to the emergence of abl-kinase point mutations). In 2004, 30% of CML patients were resistant to Gleevec, having been treated with Gleevec since its 2001 launch. Research indicates that the majority of CML patients will eventually become resistant to Gleevec, creating a demand for more broadly-acting drugs.

CML is a slow growing cancer of the white blood cells.

One of the most common point mutations, T315I, is associated with complete resistance to Gleevec, as well as the other experimental CML treatments (dasatinib and AMN107) under development. Patients with T315I point mutation account for 15-20% of Gleevec resistant CML patients.

ChemGenex has already completed a number of clinical trials for Ceflatonin, both as a monotherapy and in combination with Gleevec, with promising results:

- Phase 2 study - In chronic-phase CML patients resistant to Gleevec, 6 patients with 12 month follow-up, showed 100% complete hematologic response rate, showing that Ceflatonin is active in Gleevec resistant chronic phase CML;
- Phase 2 data - In 9 accelerated phase CML patients resistant to Gleevec, 88% of patients survived for 12 months, 80% of patients returned to chronic phase, and 67% showed complete hematologic response, showing that Ceflatonin is active in resistance CML; and
- Phase 1/2 data – In 9 patients who had achieved partial or complete response to Gleevec, 70% of patients showed a declining BCR-ABL transcripts, with two patients showing a complete cytogenetic response. This demonstrates that Ceflatonin is synergistic with Gleevec to eradicate minimal residual disease.

Registration directed clinical trials – CXS now plans to undertake two clinical trials directed for registration. The first will be in 40-85 patients in chronic, accelerated and blast phase CML with the T315I mutation. The second trial will be in 40-85 patients in chronic, accelerated and blast phase CML who are resistant to Gleevec and dasatinib (transkinase inhibitors). CXS will fund these trials itself. Then it has the option of taking the product to market itself with additional funding or has the option of seeking a partner to distribute and market the product.

Development plan – Orphan drug status has already been granted in both US and EU, giving it market exclusivity for 5-7 years in these markets Fast Track status will be applied for. CXS intends to initially seek approval for CML patients with the T315I mutation who have failed Gleevec and registration directed clinical trials are expected to commence imminently. We expect a marketing application will be filed with the FDA in CY07. We would expect that following this approval, similar to Gleevec, that as Phase 2 data is released for other indications off-label use of the product will increase. To this end, further studies in CML, MDS and AML are underway to broaden the near-term market potential of the drug.

Intellectual Property position - CXS has freedom to operate and there are no competing IP positions that it is aware of. CXS also has 'use' protection on 4 Ceflatonin patent families from 2000-2002, in addition to the exclusive license of 6 Ceflatonin families (use, purification, analogs) from Stragen Pharma.

Manufacturing – CXS has exclusively contracted Stragen Pharma to manufacture Ceflatonin. Commercial scale manufacturing has already been achieved to FDA, EMEA approval requirements. Under this agreement, Stragen Pharma will receive 51% of

profits in Europe, while CXS retains the rights for the Rest of World, including the key US market.

Competitors – There are currently no other compounds in clinical trials that target the T315I mutation, being targeted by CXS.

Other indications – Phase 2 clinical trials in MDS and AML are ongoing and planned.

Overall, Ceflatonin is well tolerated and shows promising activity in CML resistant Gleevec. We believe that given that there are no approved therapies for patients that have developed resistance to Gleevec, and given the good clinical results to date, Ceflatonin has a high probability of being approved by the FDA.

Quinamed

Quinamed (amonafile monohydrochloride) is a small molecule which inhibits Topoisomerase II, with confirmed anti-tumour activity in man. In initial clinical trials by the NCI, high response rates against tumours were shown (25% in advanced breast cancer and 12% in prostate cancer). However a number of unpredictable side effects were also found and the development was put on hold.

Quinamed's metabolism is affected by the patients genotype, and can therefore benefit from a personalised medicine approach.

Since then these toxicities have been linked to specific genetic differences between patients, which effects the way the compound is metabolized.

These genetic differences (that is whether or not patients are fast or slow metabolizers) can now be determined by testing the patients NAT-2 genotype. This then provides the ability to offer more precise dosing, possibly improving Quinamed's therapeutic potential, especially in relation to the side effect profile.

Market Potential – Table 5 outlines the market potential.

Table 5 : Market Potential for Quniamed

Indication	US Prevalence	Market US\$b	Development Status
Prostate	140,000	2.1	Phase 2 on-going
Breast	220,000	3.3	Phase 2 on-going
Colon	144,000	2.2	Phase 2 on-going

Source: ABN AMRO Morgans; Company data

Phase 2 clinical trial underway - Currently, Quinamed is in Phase 2a clinical trials with dosing based on NAT-2 genotype in prostate, breast and ovarian cancer who have failed chemotherapy. There is also an ongoing Phase 1/2 clinical trial, where investigators have already been able to achieve a higher overall dose intensity using a weekly schedule without observing unexpected side effects. A total of 32 patients have been enrolled and responses were observed in a number of patients.

Development plan – We expect that CXS will seek a licensing partner for Quinamed, following the completion of the Phase 2 clinical trials. At this stage, we have not incorporated a value for this in our valuation, providing upside to our target price. We would expect a typical licensing deal to include up-front and milestone payments and a royalty stream.

Intellectual Property - CXS has one issued patent and have filed eight additional patent applications covering the composition of matter for both organic and inorganic salts of amonafile, formulations, synthesis and uses.

CXS299

CXS is a novel targeted therapy for resistant solid tumours, which CXS has in-licensed from the leading MD Anderson Cancer Centre in Houston. It is a platinum (IV) anti-cancer compound which overcomes resistance to existing platinum (II) therapies, e.g. cisplatin and carboplatin.

CXS299 has activity CXS299 is currently in pre-clinical trials and is expected to progress to clinical trials in 12-18 months.

Diabetes and Obesity

CXS utilises its extensive human DNA sample collection (approximately 44,000 samples) together with animal and cell models and screening of chemical libraries to discover and validate novel small molecule therapeutics and biological targets for obesity and type 2 diabetes.

ChemGenex boasts a long term partnership with Merck Santé (a subsidiary of Merck KgaA) in diabetes and obesity. To date, CXS has received greater than A\$40m in research funding, milestone payments and equity purchase from Merck Santé. Merck Santé's continued support was demonstrated by their participation in the recent placement. Head of Merck's Pharmaceuticals business Elmar Schnee also sits on the CXS board. In January 2006 ChemGenex and Merck signed a new three year alliance agreement for CXS to provide pre-clinical support in the fields of diabetes, insulin resistance and complications through December 31, 2008.

Over the past year the company has developed new programs outside of its focussed collaborative program with Merck and is developing a substantial suite of unencumbered intellectual property in the areas of diabetes and obesity which we believe will be partnered with an international pharmaceutical company at some stage. These new programs offer potential significant revenue streams that may be realized in the medium term.

Examples of novel targets identified by CXS are PSARL and SGIP1.

PSARL (CXS-203) is a novel mitochondrial protein associated with insulin resistance. Genetic variation in PSARL is associated with insulin resistance in human populations. PSARL is being developed as a target for intervention in the treatment of diabetes and insulin resistance.

SGIP1 (CXS-102) is a novel protein found exclusively in the brain, and specifically is located in the regions of the brain known to regulate appetite. Genetic variation in the human SGIP1 gene is associated with both body weight and the amount of body fat. SGIP1 is being developed as a new target for the regulation of food intake and body weight.

Depression and Anxiety

CXS is utilising its genomic sample collections to identify and characterize novel targets for the treatment of depression and anxiety. CXS has partnered its depression and anxiety programs with Vernalis, a UK based biotechnology company. Vernalis provides research funding and short-term milestone payments. We believe that the revenues received from Vernalis exceed A\$1 million since the partnership commenced, and that these revenues make this program cash flow positive.

CXS currently has ten potential new targets under development, including proteins involved in neuronal signal transduction, homeostasis and biogenesis.

Intellectual Property Position

ChemGenex has a broad portfolio of patents and intellectual property covering composition of matter, semi-synthetic manufacturing processes, uses, formulations and novel genes and targets.

Peer Group Comparison

Compared with other Australian listed companies with later stage clinical programs ChemGenex is not expensive.

Table 5 : Comparative companies

Australian Companies	Mkt Cap (A\$m)	Comment
Alchemia (ACL)	170	Developed a synthetic version of heparin, expecting to enter market in early 2008.
Progen (PGL)	139	Currently undertaking a series of Phase 2 trials in a range of cancer indications.
Avexa (AVX)	56	Developing a HIV compound which is undertaking a Phase 2b trial results expected in the 2HCY06.
Pharmaxis (PXS)	427	Recently has received product approval for respiratory diagnostic product in Europe and Australia. About to start Phase 3 trial for Cystic Fibrosis product.
ChemGenex (CXS)	57	Phase 2 cancer complete with Phase 3 trials about to start
Cytopia (CYT)	76	Early stage program in inflammatory diseases which is likely to be licensed out and a cancer program undertaking Phase 1 trial
Peplin (PEP)	105	Undertaking Phase 2 trials in sun spots and certain types of skin cancer

Source :ABN AMRO Morgans

Share holders and Board

ChemGenex has compiled an outstanding Scientific Advisory Board which includes Dr Hagop Kantarjian who is affiliated with the MD Anderson Cancer Centre in Huston and is Chairman of the Leukemia Department. Others include Prof Paul Zimmet, Prof Ian Gust, Dr John Hughes, Prof David James and Dr John Blangero.

Table 6 : Company details

Major shareholders:		Board:
Charter Pacific	20.5%	Brett Heading, Chairman
QIC	9.2%	Dr Greg Collier (MD)
Merck Santé	8.5%	Dr Denis Brown
		Mr Elmar Schnee
		Mr Kevin Dart
		Mr Roger Byne
		Mr Patrick Burns
		Mr Peter Bradfield

NB: The top 6 shareholders hold 62%

Source: Company data as at 20 March 2006

RESEARCH TEAM

SOPHIE MITCHELL	-	Head of Research	ROSS MACLEOD CAREY	-	Trainee Analyst
CHRIS BROWN	-	Senior Analyst	AMANDA MILLER	-	Senior Analyst
FIONA BUCHANAN	-	Analyst	BELINDA MOORE	-	Analyst
LINDSAY HURST	-	Trainee Analyst	SCOTT POWER	-	Senior Analyst
MICHAEL KNOX	-	Director of Strategy & Chief Economist	TANYA SOLOMON	-	Analyst
ROGER LEANING	-	Deputy Head of Research	REBECCA SULLIVAN	-	Retail Strategy
JOSEPHINE LITTLE	-	Trainee Analyst			

ABN AMRO MORGANS OFFICES

BRISBANE	(07) 3334 4888	COFFS HARBOUR	(02) 6651 5700
BRISBANE INVESTOR CENTRE	(07) 3334 4888	HURSTVILLE	(02) 9570 5755
BUNDABERG	(07) 4153 1050	MERIMBULA	(02) 6495 2869
BURLEIGH HEADS	(07) 5520 8788	NEUTRAL BAY	(02) 8969 7500
CAIRNS	(07) 4052 9222	NEWCASTLE	(02) 4926 4044
CALOUNDRA	(07) 5491 5422	NEWPORT	(02) 9997 3232
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EMERALD	(07) 4988 2777	PORT MACQUARIE	(02) 6583 1735
GLADSTONE	(07) 4972 5599	SCONE	(02) 6545 9811
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IPSWICH	(07) 3202 3995	BERWICK	(03) 9796 2676
MACKAY	(07) 4957 3033	BRIGHTON	(03) 9592 4555
MILTON	(07) 3114 8600	CAMBERWELL	(03) 9813 2945
NOOSA	(07) 5449 9511	GEELONG	(03) 5222 5128
ROCKHAMPTON	(07) 4922 5855	TRARALGON	(03) 5176 6055
SPRINGWOOD	(07) 3808 7588	WARRNAMBOOL	(03) 5559 1500
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TOWNSVILLE	(07) 4771 4577	PERTH	(08) 9261 0888
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ARMIDALE	(02) 6772 1288	DARWIN	(08) 8981 9555
BALLINA	(02) 6686 4144	HOBART	(03) 6236 9000
CHATSWOOD	(02) 9411 8988		

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RECOMMENDATION STRUCTURE

Absolute performance, long-term (fundamental) recommendation: The recommendation is based on implied upside/downside for the stock from the target price. A Buy/Sell implies upside/downside of 10% or more and a Hold less than 10%. The target price is the level the stock should currently trade at if the market accepted the analyst's view of the stock, provided the necessary catalysts are in place to effect the change in perception. If it is felt that the catalysts are not fully in place to effect a re-rating of the stock to its warranted value the target price will differ from 'fair' value. Given the volatility of share prices and our pre-disposition not to change recommendations frequently, these performance parameters should be interpreted flexibly. Performance in this context only reflects capital appreciation and the horizon is 12 months.

For listed property trusts (LPTs) the recommendation is based upon the target price plus the dividend yield, ie total return. A Buy implies a total return of 10% or more; a Hold 5-10%; and a Sell less than 5%.

Absolute performance, short-term (trading) recommendation: The Trading Buy/Sell recommendation implies upside/downside of 3% or more. The trading recommendation time horizon is 0-60 days.

Each stock has been assigned a Volatility Rating to assist in assessing the risk of the security. The rating measures the volatility of the security's daily closing price data over the previous year relative to other stocks included in either the S&P/ASX200 Index (large caps) or the Small Ordinaries Index (small caps) of which it is a member. This rating is a quantitative (objective) measure provided as an additional resource and is independent of the qualitative research process undertaken by our research analysts.

A rating of Low indicates very little movement in price over the previous year (Coefficient of Variation < 4 for small caps or < 5 for large caps). A Moderate rating implies average price movement over the previous year (Coefficient of Variation of 9 - 21 for small caps or 7.25 - 15 for large caps). A High rating implies significant price movement over the past year (Coefficient of Variation greater than 25 for small caps or 35 for large caps).

REGULATORY DISCLOSURES

Subject companies: **CXS**

Mentioned companies: **CXS, ACL, PGL, AVX, CYT, PEP**

ABN AMRO Morgans Corporate Limited acted as Adviser and Lead Manager to the placement of shares and Share Purchase Plan for Chemgenex in May 2006 and received fees in this regard. ABN AMRO Morgans was Joint Lead Manager to the placement of shares in Peplin Limited in December 2005 and received fees in this regard. ABN AMRO Morgans was Lead Manager to the placement of shares in Alchemia Limited in November 2005 and received fees in this regard. ABN AMRO Morgans Corporate Limited acted as Co-Manager to the placement and rights issue for Avexa in April 2006 and received fees in this regard. The Analyst owns shares in Cytopia. The Analyst owns shares in Alchemia.