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Booking Gain as Human Genome Sciences Offers Limited Near-Term Upside

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Biotech

- We are downgrading Human Genome Sciences to neutral from buy.
- Several catalysts have come through, with modest benefit to shareholders.

Summary

Human Genome Sciences (HGSI) has been a very volatile stock, but has come through with generally favorable clinical and financial progress since our initiation late last year. The company now has two late-stage projects entering phase-III studies, and has solidified its balance sheet through a recent financial transaction and attractive collaboration agreements with **GlaxoSmithKline (GSK)** and **Novartis (NVS)**. I'm disappointed in the price action though, as the shares have faded over the past few months despite these constructive developments. I believe the stock will continue to face headwinds, due to the far-off time frame of future pipeline contributions, and heightened risk aversion in the market. As a result, we are moving from a buy to a neutral rating, and locking in a 10% gain on this position. Longer-term, I believe HGSI is on the right track, but the lack of further near-term catalysts and increasing investor caution, should limit upside in the share price.

Taking Profit on Technical Factors, Market Headwinds, Lack of Short-Term Catalysts

HGSI shares have been in a gradual downtrend over the past few months with the shares hitting lower highs and experiencing fading relative momentum. We are taking profits at this time, as the stock looks vulnerable to a break below \$9.25 and re-visit its prior lows around the \$8.00 level. On the upside, the stock is likely to encounter nearing technical resistance at the 50-day moving average, or the \$10 level. Although the stock may eventually stabilize at current levels, I believe the shares will need to develop a consolidation range before resuming upward momentum. Due to general caution in the market and the lack of further short-term catalysts, I expect the shares to continue to struggle in the very near future.

Human Genome Sciences

Biotech

HGSI: Nasdaq

Human Genome Sciences is a biotech company that discovers, develops, manufactures and markets gene-based protein and antibody drugs that serve patients with unmet medical needs.

Last Close: **\$9.42** **↑ \$0.02**

52-Week Range: \$7.63-\$14.15

P/E on Current-year Est.: N/A

Market Cap: \$1,231.79 million

Float: 107.453 million shares

Short Interest: 16.01%

Institutional Ownership: 96%

2006 Revenue Estimate: \$37.67 million

2006 EPS Estimate: -\$1.91

2005 Revenue: \$19.11 million

2005 EPS: -\$1.82

NEUTRAL

UPDATE

NONE

SOURCE: Company Reports, Baseline

Good Pipeline and Financial Progress

The initial recommendation on HGSI shares was based on an expected recovery following disappointing clinical data on *Lymphostat* in its lupus indication. Just last week, the company finalized its plan for two additional late-stage trials for *Lymphostat* in collaboration with development partner GlaxoSmithKline. This follows extensive discussions with the regulatory agencies in the U.S. and Europe, which has established efficacy endpoints, target populations and dosing schemes. HGSI and GSK will now be able to target *Lymphostat* toward the subset of patients that showed positive response trends in a prior retrospective analysis. These two large-scale, phase-III trials are scheduled to begin by year-end. This event is also expected to trigger a \$24 million milestone payment from GSK to HGSI. The results from these studies are still very far off with an anticipated 2010 completion date. In the past, this disease has proven very difficult to treat, with many prior product failures throughout the industry. As a

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result, investors do not appear to be awarding much value to this project, without greater clarity on its clinical profile.

HGSI also expects to commence phase-III studies for its hepatitis C (HCV) treatment, *Albupheron* by the end of this year. This project is in collaboration with Novartis, and also has the potential to deliver significant milestone and royalty payments. Once again, this key trial data is still several years away. In the meantime, investors appear skeptical that the product's profile will be adequately differentiated in an increasingly crowded HCV segment. There is little opportunity for the company to boost investor enthusiasm in the short term.

But Upside Limited by Sentiment

Although these two deals have gotten the company's late-stage pipeline back on track, they are not expected to provide immediate relief for shareholders. I'm encouraged by the ability of HGSI to collaborate on these deals and reduce its ongoing R&D burden. On last week's earnings release, management downgraded near-term R&D expenditures by 15% to 20% for the full-year, due to the Novartis deal. These collaborations, and the company's recent sale and leaseback of its manufacturing facility and headquarters have left the company with a large \$785 million cash balance.

Human Genome now appears to be in a less risky situation from a financing standpoint, with cash available to fund operations through 2009. The company is still not expected to reach profitability until 2010 or 2011, based on the current clinical and regulatory time frames for these late-stage projects. The difficulty in assessing this far-off earnings stream makes the shares vulnerable from a valuation perspective and highly sensitive to sentiment shifts in the short term. Therefore, I don't expect the shares to reach our prior \$13 target under current market conditions. As mentioned, I expect the stock's upside to be limited by technical resistance at \$10.

Second-Quarter Results

HGSI reported second-quarter results that were a penny better than expected on an adjusted basis at a loss of 45 cents a share. The GAAP loss of 47 cents a share included a \$16.8 million lease termination charge and a \$14.8 million gain on the sale of Cambridge Antibody Technologies stock. The company recorded revenues of \$2.2 million in the quarter. The quarter's upside was largely due to lower-than-expected spending, with R&D expense of \$50 million and SG&A of \$12 million.

Management updated full-year financial guidance to incorporate recent collaboration agreements and the sale/leaseback transaction. The company expects \$22 million in full-year revenues, a 15% to 20% drop in R&D spend and relatively flat SG&A vs. last year. The full-year cash burn rate was also downgraded by management to a \$75 million to \$125 million range compared to \$237 million last year.

No positions

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