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INSTITUTIONAL RESEARCH

Healthcare & Biotechnology

UPDATE REPORT

Conceptus (CPTS)

Well Positioned Competitively

BUY

August 9, 2007

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Current Price

\$19.32

Target Price

\$24.00

Investment Highlights:

- Substantial Head Start - Limited Competition:** Two companies, Cytyc (Ticker: CYTC) and American Medical Systems (Ticker: AMMD), are developing products that potentially would compete with the Essure device.
 - AMMD Suspends Ovion Trial:** AMMD recently announced that it has suspended enrollment in the PREVENT IDE study for permanent female contraception, despite the fact that the product has met or exceeded the company's performance expectations. To date, over 200 of the planned 600 patients have been enrolled – with no reported pregnancies. We had expected enrollment to be complete by the end of 2007. With this announcement, this clearly pushes out enrollment and potential approval and market launch of the product. As a reminder, American Medical Systems purchased Ovion in 2005 and initiated enrollment in the clinical study in 4Q06 – behind initial expectations.
 - Cytyc Expects to File PMA by mid-August:** In-line with our expectation, Cytyc recently announced that it expects to file the completed PMA application by mid-August. Assuming a 180-day review, management expects to receive approval in 1Q08. One potential issue with the Adiana device will be the pregnancy rate – in the published literature, there have been two reported pregnancies in the pivotal trial group (vs. zero pregnancies after 5 years in the Essure pivotal trial group). Management has not commented on the pregnancy rate with the Adiana device.

In our view, while both Cytyc and American Medical Systems have a significant presence in the women's health market, the >5 years of data supporting the Essure procedure remains a substantial hurdle for adoption for any competitive offering.

Stock Data

52-Week Range	\$14.68 – \$23.69		
Shares Outstanding (Mill)	29.4		
Market Capitalization (\$Mill)	\$560		
Average Daily Volume	432,447		
Book Value/Share	\$0.74		
Price/Book	25.6		
Cash / Securities (\$Mill)	\$96		
Cash/Share	\$3.25		
Insider Ownership	1.0%		
Institutional Ownership	88%		
Debt (\$Mill)	-		
Dividend/Yield	-		
Short Interest (\$Mill) / %	\$93 / 16.9%		

<u>Estimates (Dec)</u>	2005	2006	2007E
Sales (\$Mill)	\$21.2	\$41.9	\$65.7
EPS	(\$0.82)	(\$0.64)	(\$0.31)
Net Inc. (Loss) (\$Mill)	(\$21.8)	(\$18.8)	(\$9.2)

Management

President & CEO	Mark M. Sieczkarek
CFO and Treasurer	Gregory E. Lichtwardt



Price target and ratings changes over the past 3 years:
Initiated April 10, 2007 – BUY – Price Target \$24.00.

See last page for important disclosures and analyst certification.

- 2) **FDA Approval of 3rd Generation Device:** The company also announced that it has received approval from the FDA for its 3rd generation device and expects to launch the product in the US later this year and in Europe in 3Q07. This new device is designed to be easier to use for the physician while maintaining the clinical effectiveness of the current generation device. Importantly, the FDA did not require physicians to be re-trained.
- 3) **Sales Infrastructure Re-Organization Impacts 2Q07:** In mid-January, management reorganized the sales force by creating an additional 30 territories and 6 regions. As of the end of 2Q07, management is 10% behind plan in filling these positions, which, according to management, accounted for the revenue shortfall this quarter and the downward revision for FY07. Ultimately, the goal of this re-org is to improve adoption and utilization by moving physicians through the training program into performing the procedure in the office setting.
- 4) **Physician Interest Remains Strong:** As evidenced by the enrollment in the company's preceptorship program, interest in the Essure procedure remains strong. As of 2Q07, the company has certified >2,600 physicians, an increase of over 300 over the prior quarter, with >1,400 performing the procedure in the office setting. Ultimately, building physician and customer awareness will drive adoption and improve utilization. As the survey of Ob/Gyn's we completed in May indicates, utilization clearly improves with the transition from the hospital to the office and with the experience.
- 5) **Move to the Office Continues:** For the quarter, office based procedures accounted for 40% of revenue, up from 36% of revenue in 1Q07. This is critical as the "office based" approach is the most convenient and beneficial for the patient and the physician and the lowest cost site of service for the payer. Management expects to exit the year with approximately 50% of revenue from office based procedures.
- 6) **Reiterate BUY Recommendation:** We continue to find the stock attractive and reiterate our BUY recommendation and \$24 price target.

INVESTMENT CONCLUSION & VALUATION

We are reiterating our BUY recommendation and \$24 per share price target on Conceptus.

Conceptus is uniquely positioned in the female contraception market as it has the only FDA approved permanent birth control device on the market. The company continues to build its physician network and should benefit from a move to office-based procedures (vs. hospital based).

As a pioneer in the field, Conceptus has had to lay the foundation with respect to physician and patient education as well as tackling reimbursement issues. However, considering the need for long-term data in this field, we expect the company will benefit from the fruit of its labor through an essential monopoly for several years out.

The company's Essure procedure is as efficacious as tubal ligation and can be performed without incisional surgery or general anesthesia and may be performed in an office setting. **Essure equals reduced cost to the healthcare system, long-term clinical benefit to the patient equal or superior to traditional tubal occlusion and improved financials to the provider (Ob/Gyn).**

Given the company's market position, competitive position, large and growing addressable markets, we find the stock attractive at current levels. At \$19, the stock trades at 25x Price/Book and 6.4x FTM Price/Sales. The Russell 2000 Growth Medical & Dental Instruments Index (of which Conceptus is a member) trades at 4.7x Price/Book and 3.2x Price/Sales. Our \$24.00 per share target price is based on applying a 10x EV/Sales (FTM sales). We are confident in the management team, product pipeline and market opportunities.

Competitive Position Continues to Look Attractive

Two companies, Cytac (through its acquisition of privately held Adiana) and American Medical Systems (through its acquisition of privately held Ovion), are developing products that potentially would compete with the Essure device.

Earlier this month, American Medical Systems announced that it has suspended enrollment in the PREVENT IDE study (Ovion) for permanent female contraception, despite the fact that the product has met or exceeded the company's performance expectations. To date, over 200 of the planned 600 patients have been enrolled – with no reported pregnancies. We had expected enrollment to be complete by the end of 2007. With this announcement, this clearly pushes out enrollment and potential approval and market launch of the product. As a reminder, American Medical Systems purchased Ovion in 2005 and initiated enrollment in the clinical study in 4Q06 – behind initial expectations.

Cytac has completed enrollment in its pivotal trial. As of the end of the 1Q07, the company had filed two of the four modules with the FDA. On its 2Q07 conference call (July 31st), management commented that it hopes to file the completed application by mid-August. Assuming a 180-day review, management expects to receive approval in 1Q08. One potential issue with the Adiana device will be the pregnancy rate – in the published literature, there has been two reported pregnancies in the pivotal trial group (vs. zero pregnancies after 5 years in the Essure pivotal trial group). One of these pregnancies occurred after proper placement of the Adiana device and HSG follow-up, while the second occurred in a patient whose implant placement was later determined to be unilateral. Management has not commented on the pregnancy rate with the Adiana device.

In our view, while both Cytac and American Medical Systems have a significant presence in the women's health market, the >5 years of data supporting the Essure procedure remains a substantial hurdle for adoption for any competitive offering.

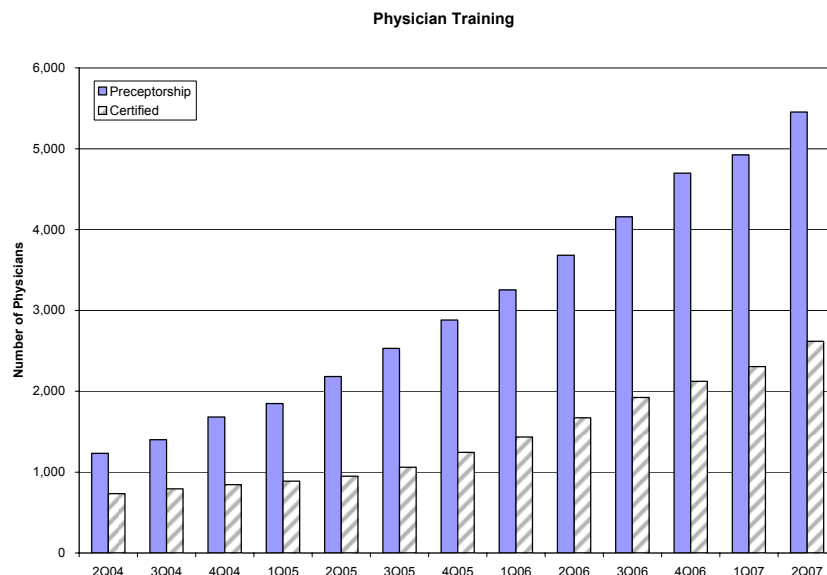
FDA Approval of 3rd Generation Device

The company also announced that it has received approval from the FDA for its 3rd generation device and expects to launch the product in the US later this year and in Europe in 3Q07. This new device is designed to be easier to use for the physician while maintaining the clinical effectiveness of the current generation device. Importantly, the FDA did not require physicians to be re-trained. An added benefit, the third generation device will reduce the per unit cost by approximately 20%.

Sales & Marketing

The company markets its products through a direct sales force in the US to Ob/Gyn's. In mid-January, management reorganized the sales force by creating an additional 30 territories and 6 regions. As of the end of 2Q07, management is 10% behind plan in filling these positions, which, according to management, accounted for the revenue shortfall this quarter and the downward revision for FY07. Ultimately, the goal of this re-org is to improve adoption and utilization by moving physicians through the training program into performing the procedure in the office setting.

We estimate the company ended 2Q07 with just over 100 sales reps and 12 regional managers. Sales force productivity should improve as we progress through 2007 as the average tenure in the sales force is 13 months with 30% of the group with less than 6 months experience.



In addition, the company has stepped up its advertising/marketing efforts in the area of consumer awareness. We expect these activities to continue to drive adoption.

With regards to the international opportunity, the company is in the process of developing its plans for a direct presence in Europe (vs. going through distributors).

FY07 Estimates

While 2Q07 and the revised guidance for FY07 are clearly disappointing, we continue to see the long-term potential of CPTS. We have revised our estimates for FY07 and now expect revenue and GAAP net income loss of \$65.7M and \$0.31, respectively.

Acquisition Candidate

We continue to view Conceptus as an attractive acquisition target for any of the large players in the women's health sector. Recent acquisitions in the medical device space include:

<u>Target</u>	<u>Acquirer</u>	<u>Price</u>	<u>Revenue Multiple</u>
Closure Medical	Johnson & Johnson	\$370Mln	9.25x
Advanced Bionics	Boston Scientific	\$740Mln	6x
MiniMed	Medtronic	\$3.3Bln	8x
Guidant	Boston Scientific	\$25B	7x
Ovion	American Medical Systems	\$30M+	
Adiana	Cytec	\$215M	
Cytec	Hologic	\$6.2B	8.3x
Conceptus			10x = \$24

Key Modeling Assumptions

Increase Penetration of Permanent Sterilization Market – Our forecast assumes continued adoption of the company's Essure device for permanent female contraception.

Improved Physician Adoption – The company has been developing its physician base through its certification program. Physician productivity should improve as more Ob/Gyns progress through the program.

New Product Introduction – We expect continued investment in R&D to broaden the product offering.

Sales Force Expansion and Productivity – The company has been building out its sales force and its ultimate success will depend on its ability to improve sales force productivity.

Improving Margins – With increased sales volumes, margins have continued to improve en route to profitability. We expect modest improvement in margins driven by increased sales volume and improvements in manufacturing efficiency, offset by new product introduction.

RISKS

We believe a BUY position with Conceptus involves the following risks:

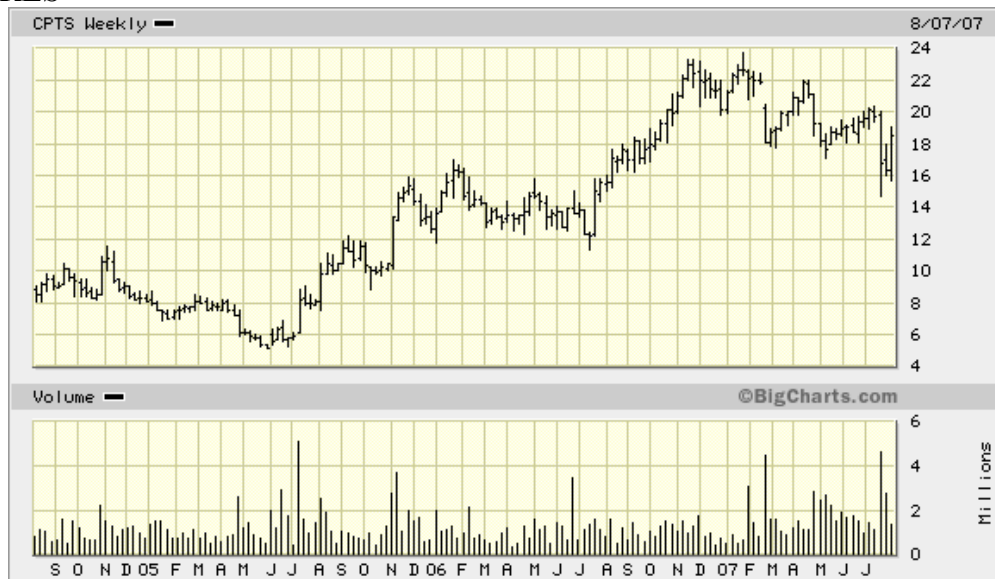
- **Clinical Data** – At present, the Essure procedure is the only approved hysteroscopic permanent female contraceptive device. Past or future procedures resulting in pregnancies (failures) may negatively impact the company.
- **Regulatory** – Conceptus relies on its products receiving approval from the Food and Drug Administration. The company currently has several products under development that must go through the approval process prior to commercial availability. Any delay will negatively impact the company.
- **Reimbursement** – As with many medical devices, the adoption of the company's products will depend not only on clinical science, but adequate reimbursement from government and private insurers.
- **Competition** – There are a number of private and public companies targeting the female permanent sterilization market.
- **Need For Additional Funding** – Conceptus is not profitable and may require additional funding.
- **Sector Rotation** – Conceptus is a medical device company and is often held in a portfolio with other device companies. A material event affecting one company many times affects the entire group.

Conceptus
 Ticker: CPTS

	Mar-05 1Q05	Jun-05 2Q05	Sep-05 3Q05	Dec-05 4Q05	Mar-06 1Q06	Jun-06 2Q06	Sep-06 3Q06	Dec-06 4Q06	Mar-07 1Q07	Jun-07 2Q07	Forecast Sep-07 3Q07e	Dec-07 4Q07e	FY04	FY05	FY06	FY07e
Income Statement																
Product Sales	3,871	5,032	5,499	6,767	7,962	10,003	11,013	12,922	13,780	15,669	15,962	20,324	11,612	21,169	41,900	65,735
Cost of Product Sales	1,727	2,102	1,999	2,568	2,883	3,651	3,486	4,007	3,705	4,238	4,230	5,284	7,112	8,396	14,027	17,457
Gross Profit	2,144	2,930	3,500	4,199	5,079	6,352	7,527	8,915	10,075	11,431	11,732	15,040	4,500	12,773	27,873	48,278
Operating Expenses																
R&D	966	909	1,145	1,244	1,200	1,069	1,030	1,067	1,642	1,061	1,066	1,072	4,067	4,264	4,366	4,841
SG&A	7,737	8,213	7,618	7,687	10,000	10,935	10,265	12,118	13,009	13,172	13,589	15,240	27,075	31,255	43,318	55,010
Other													0	0	0	0
Total	8,703	9,122	8,763	8,931	11,200	12,004	11,295	13,185	14,651	14,233	14,655	16,312	31,142	35,519	47,684	59,851
Operating Income	(6,559)	(6,192)	(5,263)	(4,732)	(6,121)	(5,652)	(3,768)	(4,270)	(4,576)	(2,802)	(2,923)	(1,272)	(26,642)	(22,746)	(19,811)	(11,573)
Other income (expense):																
Interest (income) expense, net	190	161	260	334	333	323	329						573	945	985	
Other (income) expense, net																
Total Other Income (Expense)	190	161	260	334	333	323	329	339	476	662	600	600	573	945	985	2,338
Income Before Taxes	(6,369)	(6,031)	(5,003)	(4,398)	(5,788)	(5,329)	(3,439)	(3,931)	(4,100)	(2,140)	(2,323)	(672)	(26,069)	(21,801)	(18,826)	(9,235)
Income Tax Expense													0	0	0	0
Net Income	(6,369)	(6,031)	(5,003)	(4,398)	(5,788)	(5,329)	(3,439)	(3,931)	(4,100)	(2,140)	(2,323)	(672)	(26,069)	(21,801)	(18,826)	(9,235)
Basic Share Count	25,447	25,453	27,218	28,741	28,860	28,918	29,034	29,153	29,260	29,420	29,400	29,400	24,750	26,715	28,991	29,370
Diluted Share Count																
EPS (Basic)	\$ (0.25)	\$ (0.24)	\$ (0.18)	\$ (0.15)	\$ (0.20)	\$ (0.18)	\$ (0.12)	\$ (0.13)	\$ (0.14)	\$ (0.07)	\$ (0.08)	\$ (0.02)	\$ (1.06)	\$ (0.82)	\$ (0.64)	\$ (0.31)
EPS (Diluted)																
Non-GAAP Net Income																
GAAP Net Income Before Taxes	(6,369)	(6,031)	(5,003)	(4,398)	(5,788)	(5,329)	(3,439)	(3,931)	(4,100)	(2,140)	(2,323)	(672)	(26,069)	(21,801)	(18,826)	(9,235)
Stock based compensation expense																
COGS	28				40	71							223	28		
R&D	38	33			173	196	200						1,883	71		
SG&A	194	217			1,241	1,311	1,300	1,700	1,500	1,700	1,600	1,600	626	411		
Other																
Non-GAAP Income Before Taxes	(6,109)	(5,781)	(5,003)	(4,398)	(4,334)	(3,751)	(1,939)	(2,231)	(2,600)	(440)	(723)	928	(23,337)	(21,291)	(18,826)	(9,235)
Income Tax																
Non-GAAP Net Income	(6,109)	(5,781)	(5,003)	(4,398)	(4,334)	(3,751)	(1,939)	(2,231)	(2,600)	(440)	(723)	928				
Non-GAAP EPS (Basic)	\$ (0.24)	\$ (0.23)	\$ (0.18)	\$ (0.15)	\$ (0.15)	\$ (0.13)	\$ (0.07)	\$ (0.08)	\$ (0.09)	\$ (0.01)	\$ (0.02)	\$ 0.03	\$ (1.06)	\$ (0.80)	\$ (0.42)	\$ (0.10)
Non-GAAP EPS (Diluted)																
% of Revenue																
Revenue	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
COGS	44.6%	41.8%	36.4%	37.9%	36.2%	36.5%	31.7%	31.0%	26.9%	27.0%	26.5%	26.0%	61.2%	39.7%	33.5%	26.6%
Gross Profit	55.4%	58.2%	63.6%	62.1%	63.8%	63.5%	68.3%	69.0%	73.1%	73.0%	73.5%	74.0%	38.8%	60.3%	66.5%	73.4%
R&D	25.0%	18.1%	20.8%	18.4%	15.1%	10.7%	9.4%	8.3%	11.9%	6.8%	6.7%	5.3%	35.0%	20.1%	10.4%	7.4%
SG&A	199.9%	163.2%	138.5%	113.6%	125.8%	109.3%	93.2%	93.8%	94.4%	84.1%	85.1%	75.0%	233.2%	147.6%	103.4%	83.7%
Operating Income	(169.4%)	(123.1%)	(95.7%)	(69.9%)	(76.9%)	(56.5%)	(34.2%)	(33.0%)	(33.2%)	(17.9%)	(18.3%)	(6.3%)	(229.4%)	(107.4%)	(47.3%)	(17.6%)
Income Tax													0.0%	0.0%	0.0%	0.0%
Net Income													(224.5%)	(103.0%)	(44.9%)	(14.0%)
Net Income (Non-GAAP)													(4.5%)	4.6%		
Q/Q % Change																
Revenue	6.9%	30.0%	9.3%	23.1%	17.7%	25.6%	10.1%	17.3%	6.6%	13.7%	1.9%	27.3%				
COGS	(1.7%)	21.7%	(4.9%)	28.5%	12.3%	26.6%	(4.5%)	14.9%	(7.5%)	14.4%	(0.2%)	24.9%				
R&D	18.1%	(5.9%)	26.0%	8.6%	(3.5%)	(10.9%)	(3.6%)	3.6%	53.9%	(35.4%)	0.5%	0.5%				
SG&A	0.8%	6.2%	(7.2%)	0.9%	30.1%	9.3%	(6.1%)	18.1%	7.4%	1.3%	3.2%	12.1%				
Operating Income	(1.0%)	(5.6%)	(15.0%)	(10.1%)	29.4%	(7.7%)	(33.3%)	13.3%	7.2%	(38.8%)	4.3%	(56.5%)				
Net Income	(0.8%)	(5.3%)	(17.0%)	(12.1%)	31.6%	(7.9%)	(35.5%)	14.3%	4.3%	(47.8%)	8.6%	(71.1%)				
Net Income (Non-GAAP)	(4.8%)	(5.4%)	(13.5%)	(12.1%)	(1.5%)	(13.5%)	(48.3%)	15.1%	16.5%	(83.1%)	64.3%	(228.4%)				
Y/Y % Change																
Revenue	62.6%	81.7%	93.6%	86.8%	105.7%	98.8%	100.3%	91.0%	73.1%	56.6%	44.9%	57.3%				
COGS	(18.5%)	25.4%	28.2%	46.2%	66.9%	73.7%	74.4%	56.0%	28.5%	16.1%	21.3%	31.9%				
R&D	(25.8%)	0.4%	9.6%	52.1%	24.2%	17.6%	(10.0%)	(14.2%)	36.8%	(0.7%)	3.5%	0.4%				
SG&A	26.3%	25.5%	13.1%	0.2%	29.2%	33.1%	34.7%	57.6%	30.1%	20.5%	32.4%	25.8%				
Operating Income	(8.4%)	(2.6%)	(19.0%)	(28.6%)	(6.7%)	(8.7%)	(28.4%)	(9.8%)	(25.2%)	(50.4%)	(22.4%)	(70.2%)				
Net Income	(10.6%)	(2.4%)	(21.1%)	(31.5%)	(9.1%)	(11.6%)	(31.3%)	(10.6%)	(29.2%)	(59.8%)	(32.4%)	(82.9%)				
Net Income (Non-GAAP)	(14.3%)	(6.5%)	(21.1%)	(31.5%)	(29.1%)	(35.1%)	(61.2%)	(49.3%)	(40.0%)	(88.3%)	(62.7%)	(141.6%)				
Balance Sheet																
Assets																
Current Assets																
Cash and cash equivalents	24,320	19,769	37,001	32,492	28,550	25,577	25,756	25,838	97,209	95,617						
Accounts receivable, net	2,102	2,677	3,477	4,519	4,975	5,324	6,153	6,976	8,919	10,616						
Inventories, net	2,950	3,348	3,711	3,392	2,817	1,806	1,079	810	2,036	2,600						
Other current assets	1,410	1,094	734	1,110	961	860	1,028	1,064	1,233	1,496						
Total	30,782	26,888	44,923	41,513	37,303	33,567	34,016	34,488	109,397	110,329						
PPE, net	1,355	1,401	1,949	2,743	2,884	2,926	2,848	2,917	2,849	2,695						
Other intangible assets, net	1,700	1,650	1,600	1,550	1,500	1,450	1,400	1,350	1,300	1,266						
Other	1,752	1,679	1,701	1,603	1,488	1,344	1,184	996	3,791	3,424						
Total	35,589	31,618	50,173	47,409	43,175	39,287	39,448	39,751	117,337	117,714						
Liabilities																
Current Liabilities																
Accounts payable																
Accrued compensation and benefits																
Accrued liabilities																
Total																
Other long-term liabilities																
Total	4,612	6,422	6,616	7,238	6,677	6,340	6,800	8,737	96,334	95,886						
Minority Interest																
Shareholders' Equity																
Common Shares	220,675	220,925	245,546	245,301	247,416	249,194	252,334	254,631	248,720	251,685						
Additional paid in capital																
Accumulated deficit	(189,698)	(195,729)	(200,732)	(205,130)	(210,918)	(216,247)	(219,686)	(223,617)	(227,717)	(229,857)						
Accumulated other																
Total	30,977	25,196	43,577	40,171	36,498	32,947	32,648	31,014	21,003	21,828						
Total Liabilities and Shareholders' Equity	35,589	31,618	50,173	47,409	43,175	39,287	39,448	39,751	117,337	117,714						

Note: As of December 31, 2006, the company had net operating loss carry forwards for federal and state income tax purposes of approximately \$205.5 million and \$118.7 million, respectively. If not utilized, these carryforwards will begin to expire starting in 2008 for federal purposes and 2012 for state tax purposes.

DISCLOSURES



Initiated April 10, 2007 – BUY – Price Target \$24.00

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Ratings definitions: 1) **Speculative Buy:** the stock is expected to appreciate and produce a total return of at least 30% over the next 12-18 months but **the volatility and investment risk is substantially higher** than our "Strong Buy" recommendation; 2) **Strong Buy:** the stock is expected to appreciate and produce a total return of at least 30% over the next 12-18 months; 3) **Buy:** the stock is expected to appreciate and produce a total return of at least 20% over the next 12-18 months; 4) **Neutral:** the stock is fairly valued for the next 12-18 months; 5) **Sell:** the stock is expected to decline at least 20% over the next 12-18 months and should be sold; 6) **Sell Short:** the stock is expected to decline at least 30% over next 12-18 months and should be sold short, however **the volatility and investment risk is substantially higher** than our "Sell" recommendation; 7) **Under Review:** the previous rating and/or price target is suspended due to a significant event which now requires additional analysis and the previous rating and/or price target cannot be relied upon; and 8) **Restricted:** coverage cannot be initiated or has been temporarily suspended to comply with applicable regulations and/or firm policies in certain circumstances such as investment banking or an advisory capacity involving the company.

Ratings Distribution	Company Coverage		Investment Banking	
	# of Companies	% of Total	# of Companies	% of Totals
Speculative Buy	6	21%	3	50%
Strong Buy	2	7%	1	50%
Buy	17	61%	1	6%
Neutral	3	11%	0	0%
Sell	0	0%	0	0%
Sell Short	0	0%	0	0%
Under Review	0	3%	1	0%
Restricted	0	0%	0	0%
Total	28	100%	5	18%

Information about valuation methods and risks can be found in the “STOCK VALUATION” and “RISKS” sections of this report.

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