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# INSTITUTIONAL RESEARCH

## *Healthcare & Biotechnology*

### UPDATE REPORT

## FoxHollow Technologies (FOXH)

**One Step Forward, One Step Back**

**NEUTRAL**

May 31, 2007

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|                      |                |                     |                |
|----------------------|----------------|---------------------|----------------|
| <b>Current Price</b> | <b>\$22.77</b> | <b>Target Price</b> | <b>\$26.00</b> |
|----------------------|----------------|---------------------|----------------|

### Investment Highlights:

- 1) **1Q07 Revenue Inline:** The company announced 1Q07 revenue of \$49.2M, inline with guidance. Product revenue was \$41.1M with the balance due to the collaboration with Merck.
- 2) **Reiterate 2007 Guidance:** Management reiterated guidance for 2007 for revenue of \$205-215M, including \$173-183M of product revenue and \$32M from the collaboration with Merck, and GAAP EPS of \$0.00-0.20. As a point of reference, for 2006, the company had product revenue of \$182M and Merck collaboration revenue of \$10.8M. Clearly, 2007 guidance implies continued weakness in the SilverHawk franchise, especially when considering product revenue includes SilverHawk, Kerberos, and Cook. That said, we have left our estimates for FY07 essentially unchanged. We now expect FY07 revenue of \$205M and EPS of \$0.44 (untaxed, excluding one time charges and stock-based compensation expense). Our FY07 estimates assume modest growth with the non-SilverHawk products and a timely launch of the RockHawk, and TurboHawk.
- 3) **SilverHawk Continues to Disappoint:** These results underscore our continued concern in the slowdown in the core SilverHawk franchise. Management indicated that the impact of the excess field inventory is behind the company, and does not expect any lingering effects beyond 1Q07.
- 4) **New Product Roadmap:** Management provided some detail on the new product roadmap including:
  - **NightHawk** – This product brings on-board, real-time imaging to the SilverHawk. Developed in house, the NightHawk adds optical coherence tomography capabilities to the SilverHawk, thus enabling better intravascular visualization. Management initially submitted a 510(k) application to the FDA in April, but since then, has decided to forego the 510(k) process and instead plans to conduct a clinical study with the NightHawk system under an Investigational Device Exemption. This clearly delays product launch well into 2008 or 2009.

#### Stock Data

|                                   |                    |  |  |
|-----------------------------------|--------------------|--|--|
| 52-Week Range                     | \$19.02. – \$38.85 |  |  |
| Shares Outstanding (Mill)         | 27.6               |  |  |
| Market Capitalization (\$Mill)    | \$670              |  |  |
| Average Daily Volume              | 324,535            |  |  |
| Book Value/Share                  | \$6.85             |  |  |
| Price/Book                        | 3.3x               |  |  |
| Cash / Securities (\$Mill)        | \$170              |  |  |
| Cash/Share                        | \$6.15             |  |  |
| Insider Ownership                 | 30%                |  |  |
| Institutional Ownership           | 51%                |  |  |
| Debt (\$Mill)                     | -                  |  |  |
| Dividend/Yield                    | -                  |  |  |
| Short Interest (\$Mill) / % float | \$63 / 12.2%       |  |  |

| <u>Estimates (Dec)</u>   | <b>2005</b> | <b>2006</b> | <b>2007E</b> |
|--------------------------|-------------|-------------|--------------|
| Revenue                  | \$128.2     | \$193.1     | \$205        |
| EPS                      | (\$0.51)    | (\$0.61)    | (\$0.01)     |
| Net Inc. (Loss) (\$Mill) | (\$11.6)    | (\$15.3)    | (\$0.4)      |

#### Management

President & CEO, John B. Simpson, PhD, MD  
CFO, Matt Ferguson



Price target and ratings changes over the past 3 years:  
Initiated August 9, 2005 – SELL – Price Target \$38.00  
Upgraded December 14, 2005 – NEUTRAL – \$35.91  
Update February 28, 2006 – NEUTRAL – \$31.00  
Update February 24, 2007 – NEUTRAL – \$26.00

See last page for important disclosures and analyst certification.

- RockHawk – Designed to treat calcified lesions. Although the regulatory path continues to be refined, management expects to have the device on the market by 4Q07.

Ultimately, these product enhancements aim to make the SilverHawk easier to use and shorten procedure times. However, if the clinician has to swap out one device for another to treat various types of lesions (eg heavily calcified, long diffuse, soft thrombus, etc), procedure times are not likely to decrease and the associated costs are likely to increase.

5) Clinical Activity:

- PROOF Trial: The PROOF trial is a 400 patient, 40 center study to compare SilverHawk to open surgical bypass for patients with critical limb ischemia (CLI). The primary endpoint is amputation-free survival. The study also will also measure additional endpoints including limb salvage, quality of life, re-intervention rates and the cost efficiency of each procedure. Management had originally expected enrollment to be complete by the end of 2007. Management is currently exploring options to accelerate enrollment, as enrollment has been challenging. That said, initial data is not expected for at least a year, with final data several years out.
- STEP UP: Announced in February, the STEP UP trial targets treatment with the SilverHawk vs. traditional therapy with balloon angioplasty and stenting. Management had hoped to have finalized the trial design by the end of 1Q07, but has delayed this until it has received input from the company's newly created Scientific Advisory Board.

- 6) **Maintain Neutral, Remain on the Sidelines:** All in, we believe the company is not quite out of the woods. We remain on the sidelines.

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## INVESTMENT CONCLUSION & VALUATION

We are reiterating our NEUTRAL recommendation and \$26 per share price target on FoxHollow Technologies.

We believe the company is not quite out of the woods as growth with the core SilverHawk product line continues to slow. To offset this slowdown, management has a number of new products on the horizon, most expected in 2H07 or later. However, when introduced, we believe these products will partly cannibalize existing SilverHawk revenue.

Based on FY07 revenue and EPS of \$205Mln and \$0.44 (untaxed, excluding one time charges and stock based compensation expense), respectively, at \$23, FOXH trades at 3.3x Price/Book, 3.3x FY07 Price/Sales, and 52x FY07 P/E vs. 4.5x Price/Book, 3.3x Price/Sales, and 54x P/E for the peer group (Russell 2000 Growth Medical & Dental Instruments Index). Although we maintain that significant issues remain with the FoxHollow story, at the current price, we believe the stock's valuation to be reasonable, considering its strong balance sheet, growth prospects, competitive position and potential as an acquisition target.

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## 1Q07 Results

The company reported 1Q07 revenue of \$49.2M and GAAP EPS loss of \$0.02. Revenue was inline with management's guidance and ahead of our \$48.2M estimate. Product revenue was \$41.1M with the balance due to the collaboration with Merck.

SilverHawk product revenue growth continues to decelerate. SilverHawk revenue increased 2% q/q but decreased 12.7% y/y. These results underscore our continued concern in the slowdown in the core SilverHawk franchise. Management indicated the company has essentially worked through the field inventory issue from 4Q06 and sees no impact to 2Q07 or beyond. Although management stated that pricing remained stable during the quarter, we expect pricing to come under pressure in the coming quarters as the SilverHawk is a premium priced device.

We estimate the company sold 14,900 units in the quarter (vs. 14,400 in 4Q06 and 16,300 in 1Q06) and sold product to ~1,130 hospital accounts. Average selling price remained stable at \$2,700. Utilization (or devices per account) increased modestly to 13.3 from 12.8 in 4Q06, but is still below year ago levels of 14.8 (1Q07).

Sales outside the US continue to be modest – we estimate approximately \$600k. Management expects to expand its international presence in FY07.

Product gross margins improved in the quarter to 78%, from 74% in 4Q06. Management believes margins will remain in the mid-to-high 70% range for FY07.

Operating expenses increased sequentially, reflecting increased investment in R&D.

GAAP net loss for the quarter of \$713k was ahead of our \$1.1M estimate.

The company ended the quarter with \$169.7M in cash and cash equivalents, with no debt. Inventory turns decreased to 2.2x (vs. 2.9x for 4Q06 and 3x for 1Q06). Days sales outstanding improved to 43 days (vs. 44 days for 4Q06 and 49 days in 1Q06).

### ***Sales Force***

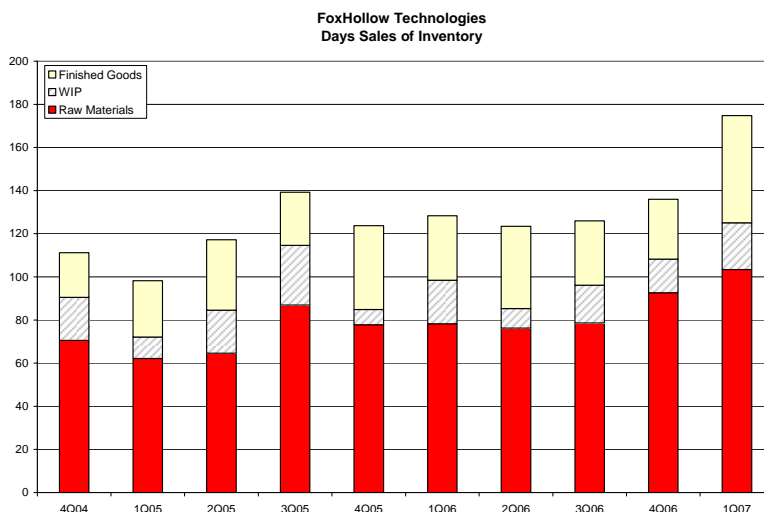
The company ended the quarter with a sales force of 192 people, up from 184 at the end of 3Q06. Of the 192, 162 are sales reps and 30 are peripheral vascular consultants (with a focus on the referral community). Sales force productivity (revenue/sales rep) improved sequentially to \$254k/rep from \$232k/rep in 4Q06.

Management also announced the addition of Kevin Cordell as Senior VP of Global Sales. Mr. Cordell brings more than 12 years of sales and marketing experience to the company. He was most recently vice president of sales at Cordis Cardiology.

## Inventory

Management indicated that the company has worked through the field inventory issue from 4Q06, and does not expect any impact in 2Q07 or beyond.

Inventory levels at the end of 1Q07 increased to \$16.5M from \$14.3M at the end of FY06. Although the increase may be attributed to upcoming product launches, it is worth some attention. In the chart below is plotted Days Sales of Inventory (DSI) for each inventory component. As is evident, total DSI of 175 days is much higher than historical levels.



## New Product Development

Management provided some detail on the new product roadmap including:

### *NightHawk – Another Delay*

The NightHawk brings on-board real-time imaging to the SilverHawk. Developed in house, the NightHawk adds optical coherence tomography capabilities to the SilverHawk, thus enabling better intravascular visualization. In April, management announced that it had filed a 510(k) application with the FDA based on data from the device's use in 20 patients in Poland and Germany, with the expectation of a limited product launch by the end of the year.

Earlier this week, the company announced that it has decided to forego the 510(k) process and instead plans to conduct a clinical study with the NightHawk system under an Investigational Device Exemption (IDE) application. The study will evaluate the ability of the device to estimate the catheter's location with respect to the vessel wall. As management hopes to initiate enrollment in 3Q07, this clearly delays product launch well into 2008 or 2009.

### *RockHawk*

The RockHawk device is designed to treat calcified lesions. Management announced in January that it will be collaborating with eV3 (Ticker: EVVV Rating: BUY) to incorporate the SpiderRX filter with the RockHawk. Although the company continues to refine the appropriate regulatory path for the device, management expects to have the device on the market by 4Q07. We view this as optimistic.

### *SXL*

Management announced the availability of the SilverHawk SXL. Intended for use in the arteries of the lower leg, this device features an extended nose cone as well as laser-drilled vent holes near the tip of the catheter to allow for increased plaque collection and fluid release. These attributes should reduce procedure time as the device will not have to be emptied as often.

Ultimately, these product enhancements aim to make the SilverHawk easier to use and shorten procedure times. However, if the clinician has to swap out one device for another to treat various types of lesions (eg heavily calcified, long diffuse, soft thrombus, etc), procedure times are not likely to decrease and the associated costs are likely to increase.

In addition, we do expect the company to use its balance sheet to acquire ancillary or complimentary technologies to broaden its product offering.

### ***Clinical Trial Activity***

The company announced that it has initiated a number of clinical trials to study the efficacy of the SilverHawk plaque excision system in the treatment of peripheral arterial disease (PAD).

- **PROOF Trial:** The PROOF trial is a 400 patient, 40 center study to compare SilverHawk to open surgical bypass for patients with critical limb ischemia (CLI). The primary endpoint is amputation-free survival. The study also will also measure additional endpoints including limb salvage, quality of life, re-intervention rates and the cost efficiency of each procedure. Management had originally expected enrollment to be complete by the end of 2007. Management is currently exploring options to accelerate enrollment, as enrollment has been challenging. That said, initial data is not expected for at least a year, with final data several years out.
- **STEP UP:** Announced in February, the STEP UP trial targets treatment with the SilverHawk vs. traditional therapy with balloon angioplasty and stenting. Management had hoped to have finalized the trial design by the end of 1Q07, but has delayed this until it has received input from the company's newly created Scientific Advisory Board.

We view these efforts as a step in the right direction. We have always and continue to view the SilverHawk as one of many tools available to treat peripheral arterial disease. Unfortunately, there is not enough data to claim that the SilverHawk has superior long-term results vs. alternate therapies (eg angioplasty/stent, cryoplasty, laser atherectomy).

### ***Reiterate FY07 Guidance***

Management reiterated guidance for 2007 for revenue of \$205-215M, including \$173-183M of product revenue and \$32M from the collaboration with Merck, and GAAP EPS of \$0.00-0.20. As a point of reference, for 2006, the company had product revenue of \$182M and Merck collaboration revenue of \$10.8M. Clearly, 2007 guidance implies continued weakness in the SilverHawk franchise, especially when considering product revenue includes SilverHawk, Kerberos, and Cook.

Assuming the contribution from non-SilverHawk products remain at the 1Q07 run-rate, FY07 guidance implies SilverHawk revenue of between \$166.2-176.2M vs. \$180.5M for FY06 – a y/y decrease of 2-8%. Clearly, the company is facing growing pains with its core product. In our view, new product introduction will cannibalize existing SilverHawk sales to some degree – thus, the potential benefit will be marginal.

That said, we have left our estimates for FY07 essentially unchanged. We expect FY07 revenue of \$205M and EPS of \$0.44 (untaxed, excluding one time charges and stock-based compensation expense). Our FY07 estimates assume modest growth with the non-SilverHawk products.

**Valuation**

Although we maintain that significant issues remain with the FoxHollow story, at the current price, we believe the stock's valuation to be reasonable. Based on FY07 revenue and EPS of \$205Mln and \$0.44 (untaxed, excluding one time charges and stock based compensation expense), respectively, at \$23, FOXH trades at 3.3x Price/Book, 3.3x FY07 Price/Sales, and 52x FY07 P/E vs. 4.5x Price/Book, 3.3x Price/Sales, and 54x P/E for the peer group (Russell 2000 Growth Medical & Dental Instruments Index). At the current price, we believe the stock's valuation to be reasonable, considering its strong balance sheet, growth prospects, competitive position and potential as an acquisition target.

**Key Modeling Assumptions**

**Increase penetration of PAD market** – Our forecast assumes continued modest adoption of the SilverHawk system in the PAD market. in the U.S. and overseas.

**New Product Introduction** – FoxHollow is essentially a one product company. We expect continued investment in R&D as well as acquisitions and distribution agreements to broaden the product offering.

**Expand Indications** – We expect the company to commence a clinical trial for use of the SilverHawk in coronary applications.

**Sales Force Productivity** – We expect improvement in sales force productivity, but don't expect the company to reach the levels seen in FY05 in the near-term.

## RISKS

We believe a NEUTRAL position with FoxHollow involves the following risks:

- **Clinical Indications** – FoxHollow continues to explore additional indications for use of the SilverHawk System.
- **Clinical Data** – The company has or is planning to initiate a number of clinical studies.
- **Regulatory** – FoxHollow 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.
- **M&A Activity** – FoxHollow may acquire or may be acquired by another company.
- **Plaque Analysis Partnership** – The announcement of a partnership deal would be a positive for the company.
- **Sector Rotation** – FoxHollow 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.

**FoxHollow Technologies (FOXH)**  
Fiscal year ends Dec

| Pro Forma  | 1Q05           | 2Q05           | 3Q05           | 4Q05           | 1Q06            | 2Q06           | 3Q06           | 4Q06           | 1Q07           | Forecast       |                |                |                 | FY04            | FY05            | FY06           | FY07e |
|--|----------------|----------------|----------------|----------------|-----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|-----------------|-----------------|-----------------|----------------|-------|
|  | Mar-05         | Jun-05         | Sep-05         | Dec-05         | Mar-06          | Jun-06         | Sep-06         | Dec-06         | Mar-07         | 2Q07e          | 3Q07e          | 4Q07e          |                 |                 |                 |                |       |
| <b>Income Statement</b>                            |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| <b>Revenue</b>                                     |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| Merck Collaborative Agreement                      |                |                | 431            | 2,363          | 2,064           | 216            | 3,926          | 4,634          | 8,111          | 8,000          | 8,000          | 8,000          | 0               | 2,794           | 10,840          | 32,111         |       |
| Cook, Kerberos, other                              |                |                |                |                |                 |                | 1,700          | 1,700          | 1,850          | 1,800          | 2,300          |                |                 |                 | 1,700           | 7,350          |       |
| SilverHawk   | 21,478         | 28,724         | 35,645         | 39,515         | 44,583          | 47,951         | 49,826         | 38,185         | 39,706         | 40,320         | 41,881         | 43,425         | 38,552          | 125,362         | 180,545         | 165,332        |       |
| <b>Total</b>                                       | <b>21,478</b>  | <b>28,724</b>  | <b>36,076</b>  | <b>41,878</b>  | <b>46,647</b>   | <b>48,167</b>  | <b>53,752</b>  | <b>44,519</b>  | <b>49,217</b>  | <b>50,170</b>  | <b>51,681</b>  | <b>53,725</b>  | <b>38,552</b>   | <b>128,156</b>  | <b>193,085</b>  | <b>204,793</b> |       |
| <b>COGS</b>  |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| <b>Product</b>                                     |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| Research Collaboration                             | 8,718          | 8,737          | 9,695          | 11,635         | 10,825          | 10,266         | 9,865          | 10,176         | 8,619          | 9,112          | 9,381          | 9,771          | 23,417          | 38,785          | 41,132          | 36,883         |       |
| Gross Profit                                       | 12,760         | 19,987         | 26,381         | 29,835         | 34,702          | 37,193         | 42,997         | 33,933         | 38,496         | 37,698         | 38,700         | 39,794         | 15,135          | 88,963          | 148,825         | 154,688        |       |
| <b>Operating Expenses</b>                          |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| R&D  | 2,080          | 2,105          | 2,562          | 2,714          | 3,564           | 4,271          | 4,967          | 5,546          | 6,189          | 6,251          | 6,282          | 6,314          | 5,586           | 9,471           | 18,348          | 25,036         |       |
| SG&A   | 15,836         | 19,940         | 23,547         | 26,602         | 31,582          | 30,191         | 29,210         | 33,661         | 31,316         | 31,104         | 30,880         | 31,652         | 32,971          | 85,925          | 124,644         | 124,952        |       |
| Amortization                                       |                |                |                |                |                 |                | 79             | 395            | 395            |                |                |                |                 |                 |                 |                |       |
| Stock Based Compensation                           | 1,776          | 1,866          | 2,195          | 1,240          | 14,793          | 2,890          | 2,938          | 3,105          | 3,550          | 3,200          | 3,400          | 3,400          | 6,826           | 7,077           | 23,726          | 13,550         |       |
| <b>Total</b>                                       | <b>19,702</b>  | <b>23,911</b>  | <b>28,304</b>  | <b>30,556</b>  | <b>49,939</b>   | <b>37,352</b>  | <b>37,194</b>  | <b>42,707</b>  | <b>41,450</b>  | <b>40,555</b>  | <b>40,562</b>  | <b>41,366</b>  | <b>45,383</b>   | <b>102,473</b>  | <b>167,192</b>  | <b>163,933</b> |       |
| <b>Operating Income</b>                            | <b>(6,942)</b> | <b>(3,924)</b> | <b>(1,923)</b> | <b>(721)</b>   | <b>(15,237)</b> | <b>(159)</b>   | <b>5,803</b>   | <b>(8,774)</b> | <b>(2,954)</b> | <b>(2,857)</b> | <b>(1,862)</b> | <b>(1,571)</b> | <b>(30,248)</b> | <b>(13,510)</b> | <b>(18,367)</b> | <b>(9,245)</b> |       |
| <b>Other Income</b>                                |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| Interest Income                                    | 419            | 484            | 480            | 579            | 599             | 691            | 925            | 1,623          | 2,241          | 2,200          | 2,200          | 2,200          | 376             | 1,962           | 3,838           | 8,841          |       |
| Other, net   |                | (2)            |                | (18)           |                 |                |                |                |                |                |                |                | (3)             | (20)            |                 |                |       |
| <b>Income before income taxes</b>                  | <b>(6,523)</b> | <b>(3,442)</b> | <b>(1,443)</b> | <b>(160)</b>   | <b>(14,638)</b> | <b>532</b>     | <b>6,728</b>   | <b>(7,151)</b> | <b>(713)</b>   | <b>(657)</b>   | <b>338</b>     | <b>629</b>     | <b>(29,875)</b> | <b>(11,568)</b> | <b>(14,529)</b> | <b>(404)</b>   |       |
| Income Tax expense                                 |                |                |                |                |                 |                | 805            |                |                |                |                |                |                 |                 |                 | 0              |       |
| <b>Net Income</b>                                  | <b>(6,523)</b> | <b>(3,442)</b> | <b>(1,443)</b> | <b>(160)</b>   | <b>(14,638)</b> | <b>532</b>     | <b>6,728</b>   | <b>(7,956)</b> | <b>(713)</b>   | <b>(657)</b>   | <b>338</b>     | <b>629</b>     | <b>(29,875)</b> | <b>(11,568)</b> | <b>(15,334)</b> | <b>(404)</b>   |       |
| Net Income (w/o Stock Based Comp)                  | (4,747)        | (1,576)        | 752            | 1,080          | 155             | 3,422          | 9,666          | (4,851)        | 2,837          | 2,543          | 3,738          | 4,029          | (23,049)        | (4,491)         | 8,392           | 13,146         |       |
| <b>Net Income per share</b>                        |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| <b>Basic</b>                                       |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| \$   | (0.29)         | (0.15)         | (0.06)         | (0.01)         | (0.60)          | 0.02           | 0.26           | (0.29)         | (0.02)         | (0.02)         | 0.01           | 0.02           | (1.45)          | (0.51)          | (0.61)          | (0.01)         |       |
| <b>Diluted</b>                                     |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| \$   | (0.29)         | (0.15)         | (0.06)         | (0.01)         | (0.60)          | 0.02           | 0.26           | (0.29)         | (0.02)         | (0.02)         | 0.01           | 0.02           | -               | (0.51)          | (0.61)          | (0.01)         |       |
| <b>Net Income per share (w/o Stock Based Comp)</b> |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| <b>Basic</b>                                       |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| \$   | (0.21)         | (0.07)         |                |                |                 |                |                |                |                |                |                |                | (1.12)          | (0.28)          | -               | -              |       |
| <b>Diluted</b>                                     |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| \$   |                |                | 0.03           | 0.04           | 0.01            | 0.13           | 0.37           | (0.05)         | 0.10           | 0.09           | 0.12           | 0.13           | -               | 0.07            | 0.46            | 0.44           |       |
| <b>Weighted average shares</b>                     |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| <b>Basic</b>                                       |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
|  | 22,345         | 22,711         | 23,189         | 23,642         | 24,304          | 24,847         | 25,236         | 27,571         | 27,600         | 27,700         | 27,700         | 27,700         | 20,917          | 23,642          | 27,571          |                |       |
| <b>Diluted</b>                                     |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
|  | 22,345         | 22,711         | 25,000         | 25,000         | 24,304          | 25,807         | 25,803         | 27,571         | 29,320         | 29,600         | 30,000         | 30,500         | 20,917          | 25,000          | 27,571          | 30,500         |       |
| <b>% of Revenue</b>                                |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| <b>Revenue</b>                                     |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| Product 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%         |       |
| <b>COGS</b>  |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| Product  | 40.6%          | 30.4%          | 26.9%          | 29.4%          | 24.3%           | 21.4%          | 19.8%          | 26.6%          | 21.7%          | 22.6%          | 22.4%          | 22.5%          | 60.7%           | 30.3%           | 21.3%           | 18.0%          |       |
| Research Collaboration                             |                |                |                | 17.3%          | 54.3%           | 327.8%         | 22.7%          | 8.8%           | 25.9%          | 42.0%          | 45.0%          | 52.0%          |                 |                 |                 |                |       |
| Gross Profit                                       | 59.4%          | 69.6%          | 73.1%          | 71.2%          | 74.4%           | 77.2%          | 80.0%          | 73.2%          | 78.2%          | 77.1%          | 74.9%          | 74.1%          | 39.3%           | 69.7%           | 78.7%           | 82.0%          |       |
| R&D  | 9.7%           | 7.3%           | 7.1%           | 6.5%           | 7.6%            | 8.9%           | 9.2%           | 12.5%          | 12.6%          | 12.5%          | 12.2%          | 11.8%          | 14.5%           | 7.4%            | 9.5%            | 12.2%          |       |
| SG&A   | 73.7%          | 69.4%          | 65.3%          | 63.5%          | 67.7%           | 62.7%          | 54.3%          | 75.6%          | 63.6%          | 62.0%          | 59.8%          | 58.9%          | 85.5%           | 67.0%           | 64.6%           | 61.0%          |       |
| Operating Income                                   | (32.3%)        | (13.7%)        | (5.3%)         | (1.7%)         | (32.7%)         | (0.3%)         | 10.8%          | (19.7%)        | (6.0%)         | (5.7%)         | (3.8%)         | (2.9%)         | (78.5%)         | (10.5%)         | (9.5%)          | (4.5%)         |       |
| Income before taxes                                | (30.4%)        | (12.0%)        | (4.0%)         | (0.4%)         | (31.4%)         | 1.1%           | 12.5%          | (16.1%)        | (1.4%)         | (1.3%)         | 0.7%           | 1.2%           | (77.5%)         | (9.0%)          | (7.5%)          | (0.2%)         |       |
| Taxes  |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| Net Income   | (30.4%)        | (12.0%)        | (4.0%)         | (0.4%)         | (31.4%)         | 1.1%           | 12.5%          | (17.9%)        | (1.4%)         | (1.3%)         | 0.7%           | 1.2%           | (77.5%)         | (9.0%)          | (7.9%)          | (0.2%)         |       |
| <b>q/q % Change</b>                                |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| <b>Revenue</b>                                     |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| Product Revenue                                    | 46.1%          | 33.7%          | 25.6%          | 16.1%          | 11.4%           | 3.3%           | 11.6%          | (17.2%)        | 10.6%          | 1.9%           | 3.0%           | 4.0%           |                 |                 |                 |                |       |
| <b>COGS</b>  |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| Product  | 31.5%          | 0.2%           | 11.0%          | 20.0%          | (7.0%)          | (5.2%)         | (3.9%)         | 3.2%           | (15.3%)        | 4.0%           | 1.5%           | 3.7%           |                 |                 |                 |                |       |
| Gross Profit                                       | 59.4%          | 69.6%          | 73.1%          | 71.2%          | 74.4%           | 77.2%          | 80.0%          | 73.2%          | 78.2%          | 77.1%          | 74.9%          | 74.1%          |                 |                 |                 |                |       |
| R&D  | 51.8%          | 0.7%           | 21.7%          | 5.9%           | 31.3%           | 19.8%          | 16.3%          | 11.7%          | 11.6%          | 1.0%           | 0.5%           | 0.5%           |                 |                 |                 |                |       |
| SG&A   | 36.6%          | 25.9%          | 18.1%          | 13.0%          | 18.7%           | (4.4%)         | (3.2%)         | 15.2%          | (7.0%)         | (0.7%)         | (0.7%)         | 2.9%           |                 |                 |                 |                |       |
| Operating Income                                   | 36.6%          | 25.9%          | 18.1%          | 13.0%          | 18.7%           | (4.4%)         | (3.2%)         | 15.2%          | (7.0%)         | (0.7%)         | (0.7%)         | 2.9%           |                 |                 |                 |                |       |
| Income before taxes                                |                |                |                |                |                 | (103.6%)       | 1164.7%        | (206.3%)       | (90.0%)        | (7.8%)         | (151.4%)       | 86.3%          |                 |                 |                 |                |       |
| Taxes  |                |                |                |                |                 | (103.6%)       | 1164.7%        | (218.3%)       | (91.0%)        | (7.8%)         | (151.4%)       | 86.3%          |                 |                 |                 |                |       |
| Net Income   |                |                |                |                |                 | (103.6%)       | 1164.7%        | (218.3%)       | (91.0%)        | (7.8%)         | (151.4%)       | 86.3%          |                 |                 |                 |                |       |
| <b>y/y % Change</b>                                |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| <b>Revenue</b>                                     |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| Product Revenue                                    | 348.8%         | 283.1%         | 211.5%         | 184.9%         | 117.2%          | 67.7%          | 49.0%          | 6.3%           | 5.5%           | 4.2%           | (3.9%)         | 20.7%          |                 | 232.4%          | 50.7%           | 6.1%           |       |
| <b>COGS</b>  |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| Product  | 114.1%         | 46.9%          | 43.2%          | 75.5%          | 24.2%           | 17.5%          | 1.8%           | (12.5%)        | (20.4%)        | (11.2%)        | (4.9%)         | (4.0%)         |                 | 225.2%          | 44.0%           | (8.4%)         |       |
| Gross Profit                                       | 82.9%          | 27.8%          | 80.5%          | 97.1%          | 70.5%           | 102.9%         | 93.9%          | 104.3%         | 73.7%          | 46.4%          | 26.5%          | 13.8%          |                 | 65.6%           | 6.1%            | (10.3%)        |       |
| R&D  | 231.9%         | 165.2%         | 159.1%         | 129.4%         | 99.4%           | 51.4%          | 24.0%          | 26.5%          | (0.8%)         | 3.0%           | 5.7%           | (6.0%)         |                 | 69.5%           | 93.7%           | 36.4%          |       |
| SG&A   | 11.6%          | (55.6%)        | (74.3%)        | (90.6%)        | 119.5%          | (95.3%)        | (401.8%)       | 1119.9%        | (80.6%)        | 1697.0%        | (132.1%)       | (82.1%)        |                 | 160.6%          | 45.1%           | 0.2%           |       |
| Operating Income                                   | 11.6%          | (55.6%)        | (74.3%)        | (90.6%)        | 119.5%          | (95.3%)        | (401.8%)       | 1119.9%        | (80.6%)        | 1697.0%        | (132.1%)       | (82.1%)        |                 | 160.6%          | 45.1%           | 0.2%           |       |
| Income before taxes                                | 5.3%           | (60.9%)        | (80.6%)        | (97.9%)        | 124.4%          | (115.5%)       | (566.3%)       | 4369.4%        | (95.1%)        | (223.5%)       | (95.0%)        | (108.8%)       |                 |                 |                 |                |       |
| Taxes  | 5.3%           | (60.9%)        | (80.6%)        | (97.9%)        | 124.4%          | (115.5%)       | (566.3%)       | 4872.5%        | (95.1%)        | (223.5%)       | (95.0%)        | (107.9%)       |                 |                 |                 |                |       |
| Net Income   | 5.3%           | (60.9%)        | (80.6%)        | (97.9%)        | 124.4%          | (115.5%)       | (566.3%)       | 4872.5%        | (95.1%)        | (223.5%)       | (95.0%)        | (107.9%)       |                 |                 |                 |                |       |
| <b>Balance Sheet</b>                               |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| <b>Assets</b>                                      |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| <b>Current Assets</b>                              |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| Cash and cash equivalents                          | 12,506         | 18,790         | 27,201         | 24,249         | 24,048          | 24,140         | 37,179         | 59,546         | 38,929         |                |                |                |                 |                 |                 |                |       |
| Short-term investments                             | 44,992         | 39,493         | 35,257         | 35,666         | 35,319          | 41,661         | 19,097         | 107,369        | 130,787        |                |                |                |                 |                 |                 |                |       |
| Accounts Receivables, net                          | 11,322         | 14,060         | 16,349         | 21,831         | 23,759          | 25,073         | 27,029         | 19,450         | 19,421         |                |                |                |                 |                 |                 |                |       |
| Research collaboration receivable                  |                |                |                |                |                 |                | 4,100          | 2,826          |                |                |                |                |                 |                 |                 |                |       |
| Inventories  | 9,197          | 11,064         | 14,605         | 15,607         | 14,752          | 13,463         | 13,122         | 14,346         | 16,508         |                |                |                |                 |                 |                 |                |       |
| Prepaid expenses and other current                 | 2,342          | 1,904          | 2,202          | 1,846          | 1,890           | 1,583          | 2,455          | 2,826          | 1,525          |                |                |                |                 |                 |                 |                |       |
| <b>Total</b>                                       | <b>80,359</b>  | <b>85,311</b>  | <b>97,614</b>  | <b>99,199</b>  | <b>99,768</b>   | <b>105,920</b> | <b>102,982</b> | <b>206,363</b> | <b>207,170</b> |                |                |                |                 |                 |                 |                |       |
| <b>PPE, net</b>                                    |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| Long-term investments                              | 5,319          | 6,476          | 7,983          | 8,442          | 8,439           | 8,700          | 8,737          | 8,328          | 9,004          |                |                |                |                 |                 |                 |                |       |
| Intangibles, net                                   | 4,238          |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| Goodwill   |                |                |                |                |                 |                | 12,511         | 12,116         | 11,720         |                |                |                |                 |                 |                 |                |       |
| Other assets                                       | 562            | 562            | 564            | 564            | 565             | 568            | 1,103          | 1,119          | 1,139          |                |                |                |                 |                 |                 |                |       |
| <b>Total</b>                                       | <b>90,478</b>  | <b>92,349</b>  | <b>106,161</b> | <b>108,205</b> | <b>108,772</b>  | <b>115,188</b> | <b>144,514</b> | <b>247,112</b> | <b>248,257</b> |                |                |                |                 |                 |                 |                |       |
| <b>Liabilities</b>                                 |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| <b>Current Liabilities</b>                         |                |                |                |                |                 |                |                |                |                |                |                |                |                 |                 |                 |                |       |
| Accounts Payables                                  | 5,974          | 6,640          | 7,936          | 7,072          | 6,140           | 6,610          | 9,153          | 9,385          | 9,902          |                |                |                |                 |                 |                 |                |       |
| Accrued Liabilities                                | 7,576          | 8,433          | 10,925         | 11,163         | 13,58           |                |                |                |                |                |                |                |                 |                 |                 |                |       |

**DISCLOSURES**


Initiated August 9, 2005 – SELL – Price Target \$38.00  
 Upgraded December 14, 2005 – NEUTRAL – \$35.91  
 Update February 28, 2006 – NEUTRAL – \$31.00  
 Update February 22, 2007 – NEUTRAL – \$26.00

**Analyst Certification:** The analyst(s) whose name appears on this research report certifies that 1) all of the views expressed in this report accurately reflect his personal views about any and all of the subject securities or issuers discussed; and 2) no part of the research analyst's compensation was, is, or will be directly or indirectly related to the specific recommendations or views expressed by the research analyst in this research report; and 3) All Dawson James employees, including the analyst(s) responsible for preparing this research report, may be eligible to receive non-product or service specific monetary bonus compensation that is based upon various factors, including total revenues of Dawson James and its affiliates as well as a portion of the proceeds from a broad pool of investment vehicles consisting of components of the compensation generated by investment banking activities, including but not limited to shares of stock and/or warrants, which may or may not include the securities referenced in this report.

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|                      | Company Coverage |            | Investment Banking |             |
|----------------------|------------------|------------|--------------------|-------------|
| Ratings Distribution | # of Companies   | % of Total | # of Companies     | % of Totals |
| Speculative Buy      | 5                | 17%        | 2                  | 40%         |
| Strong Buy           | 3                | 10%        | 1                  | 33%         |
| Buy                  | 17               | 59%        | 1                  | 6%          |
| Neutral              | 3                | 10%        | 0                  | 0%          |
| Sell                 | 0                | 0%         | 0                  | 0%          |
| Sell Short           | 0                | 0%         | 0                  | 0%          |
| Under Review         | 1                | 3%         | 1                  | 100%        |
| Restricted           | 0                | 0%         | 0                  | 0%          |
| Total                | 29               | 100%       | 5                  | 17%         |

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

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