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INSTITUTIONAL RESEARCH

Healthcare & Biotechnology

TERMINATION REPORT

Valentis (VLTS)

Terminating Coverage

Phase IIb Data in July

SPECULATIVE BUY

April 4, 2006

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Current Price

\$2.94

Target Price

\$7.50

Investment Highlights:

- 1) **Phase IIB Dosing of VLTS 934 Completed:** Valentis believes top line Phase IIb data will be available by July with Phase III commencing late calendar 4Q06/early 1Q07. Enrollment for the Phase III study may begin without a partner. Additionally, the company plans to initiate a multiple-dose Phase I study in 2H06.
- 2) **Compelling case for successful Phase IIb study:** If the placebo response rate remains at similar levels as seen in the interim analysis and VLTS 934-treated patients achieve similar response as in the Phase IIa, the current study should comfortably achieve its primary endpoint.
- 3) **VLTS 934 partnership unlikely before 2007:** Given the large field sales force required for the PAD market, we believe big pharma companies are the only logical partners, which will lengthen the negotiation process. In our opinion, a partnership agreement could garner \$35-45M in upfront fees.
- 4) **Target of \$4M from business development in Q2'06:** Management hopes to raise up to \$4 million from outlicensing an angiogenesis antibody, outlicensing other IP and contract manufacturing services. Combined with their \$5M raise in Q1, Valentis should have enough cash to fund operations for 2006.
- 5) **Terminating Coverage-Reiterating Speculative Buy rating:** VLTS 934 offers a very compelling risk/reward profile for a product in mid-stage development for the treatment of vascular disease. **However, due to analyst transition and resources we are terminating formal research coverage at this time.**

Stock Data	12/31	3/06	PIPE
52-Week Range	\$1.48- \$3.95		
Shares Outstanding (Mill)	14.8 / 16.9		
Market Capitalization (\$Mill)	\$44.1		
Average Daily Volume	120,318		
Book Value/Share	\$0.34		
Price/Book	8.7X		
Cash / Securities (\$Mill)	\$6.4 / \$11.4		
Cash/Share	\$0.43 / \$0.67		
Insider Ownership	17.5%		
Institutional Ownership	24.4%		
Debt (\$Mill)	\$0.0		
Dividend/Yield	\$0.00/0%		
Short Interest / %	353,000 / 2.6%		

Estimates (June)	2005	2006E	2007E
EPS	(\$0.85)	(\$0.83)	(\$0.96)
Net Inc. (Loss) (\$Mill)	(\$11.1)	(\$14.0)	(\$16.3)

Management

President, CEO Ben McGraw
 COO, SVP Research John Reddington
 SVP, Finance Joe Markey



Price target and ratings changes over the past 3 years:
 Initiated September 29, 2005—Spec. Buy— Price Target \$6.00
 Upgrade January 11, 2006 – Spec. Buy – Price Target \$7.50
 Termination April 4, 2006—Spec. Buy—Price Target \$7.50

See last page for important disclosures and analyst certification.

Aggressive Development Timeline – Phase III to Begin Enrollment in Early 2007

On February 13th, Valentis announced that it had completed the dosing on schedule for the 140-patient VLTS 934 Phase IIb trial for the treatment of patients suffering with peripheral arterial disease (PAD) and that **the efficacy results are on course for July 2006.**

On January 10th, Valentis reviewed the statistical analysis for the Phase IIb study and highlighted management's plan to rapidly advance VLTS 934 into phase III development if the current study is successful. The interim analysis, which evaluated improvement in peak walk time after 90 days for 30 patients receiving placebo, indicated the control arm is performing within the expect parameters of the study (an improvement in walk time of less than roughly 18% for the placebo group).

In preparation for Phase III development, Valentis plans to begin enrolling a small Phase I multiple-dose study (the Phase IIb is evaluating a single dose) shortly after presentation of Phase IIb results. The Phase III protocol may be completed late in 2006 with enrollment beginning early in 2007. We would note that management is committed to rapidly moving the program into Phase III regardless of the status of partnership discussions and, in our opinion, will likely begin enrollment before finalizing a collaboration agreement.

VLTS 934 Partnership Unlikely Before 2007

In our opinion, the large field sales force required to promote a PAD product limits the list of prospective partners to a handful of large pharmaceutical companies. **We do not believe any of the likely partners could complete the due diligence process in less than six to nine months, which does not leave enough time to complete a deal prior to the Phase IIb data.** As such, we believe partnership discussions will not gain steam until after the Phase IIb data is released in July with a deal sometime in 2007. In our opinion, an agreement could garner \$35-45M in upfront fees.

Target of \$4M from Business Development in Q2'06

Our discussions with management revealed that Valentis hopes to raise up to \$4 million during Q2'06 from outlicensing an angiogenesis antibody, outlicensing other IP (primarily related to manufacturing) and contract manufacturing services. We estimate the outlicensing opportunities could each garner \$1-2 million in upfront payments while the contract manufacturing services could be worth roughly \$1 million.

Investment Conclusion

In our opinion, the company's lead product, VLTS 934, for the treatment of Peripheral Arterial Disease (PAD) is likely to achieve the primary endpoint in an ongoing 140-patient Phase IIb study. If the clinical trial is successful – preliminary top line data is due in July – we expect Valentis to seek a lucrative partnership with a pharmaceutical company to fund Phase III development and commercialization. We believe the most likely timing for a partnership is 1H07.

We feel the Street has misinterpreted results from a Phase IIa clinical trial completed in the fall of 2004. That study evaluated Deltavasc (a pro-angiogenic gene, DEL-1, plus VLTS 934) compared to a VLTS 934-only group. While there was no difference between the Deltavasc arm of the study and the VLTS 934-only control arm, both groups showed a dramatic improvement in both walk time and Ankle Brachial Index (ABI) after 90 days. **The overall efficacy profile for both arms in the Phase IIa was superior to clinical data for the current standard of care, Pletal, and with a better safety profile.**

We view the improvement in ABI - a ratio measuring the difference in blood pressure in the upper arm and the ankle – in both arms of the Phase IIa study as very compelling and strongly suggests the patients were not experiencing a placebo effect.

We also believe many investors do not appreciate the medical – and pharmacoeconomic – impact of PAD. According to an article in the *Journal of General Internal Medicine* entitled “Current Strategies in the Diagnosis and Management of Lower Extremity Peripheral Vascular Disease”, one million Americans present with symptomatic PAD each year. Several studies have shown that these patients have a three-fold to six-fold increase in cardiovascular mortality compared to an age-matched population.

Timeline of Key Events

Event	Expected Date (calendar year)	Importance
Outlicensing of angiogenesis antibody	1H06	Low
Phase IIb PAD results	Early 3Q06	High
Initiate Phase III PAD study	1Q07	Low
Pharmaceutical partnership for VLTS 934	1H07	High
Phase III PAD results	1H08	High

Source: Dawson James Estimates

Stock Valuation

Our \$7.50 target price is based primarily on a 10-year DCF valuation using a 33% discount rate and 12% long-term revenue growth rate for the terminal year (see table on Page 7 for additional details).

We also compared Valentis to several companies developing treatments for PAD and cardiovascular disease (see table below). The closest comparable public company is Vasogen. However, a Phase III study of Vasogen's treatment for PAD, Celacade, was stopped in August after the External Safety and Efficacy Monitoring Committee determined the clinical trial was unlikely to meet its efficacy target. The committee also noted a slight increase in cancer risk in the Celacade group. A Phase III study of Celacade in advanced chronic heart failure continues to enroll patients. Our \$7.50 target price for Valentis equates to a \$10 million discount to the current enterprise value for Vasogen.

We also looked at a peer group of vascular disease companies with products in late-stage development or that have launched products in the past several years to provide a quantitative measure of the potential upside for Valentis as VLTS 934 moves toward commercialization. All of these products target subgroups of the cardiovascular disease market and, in our opinion, are generally viewed by investors as second-tier cardiovascular companies.

Comparable Company Analysis

(\$ in millions)	Market Value	Cash	Debt	Pipeline Value
<i>PAD</i>				
Vasogen	\$168	\$63	\$30	\$135
<i>Vascular Disease</i>				
Myogen	\$1,490	\$177	\$0	\$1,313
CV Therapeutics	\$971	\$460	\$400	\$911
Encysive Pharmaceuticals	\$280	\$128	\$130	\$282
CoTherix	\$244	\$103	\$0	\$141
Genvec	\$135	\$32	\$3	\$106
Corautus Genetics	\$69	\$31	\$16	\$54
Valentis	\$44	\$6	\$0	\$38

Source: Dawson James Estimates and company reports

RISKS

We believe a Speculative Buy position with Valentis involves the following risks:

- **Clinical** – Valentis is currently conducting mid-stage clinical trials of VLTS 934 for the treatment of PAD in the United States and expects to eventually enroll clinical trials in Europe. As with all clinical trials, there can be no assurance the study will meet its designated efficacy and safety endpoint.
- **Regulatory** – Valentis hopes to use the ongoing Phase IIb study as one of two pivotal studies required to win FDA approval for the treatment of PAD. There can be no assurances the FDA will classify the Phase IIb as a pivotal study. Additionally, the company may seek to pursue an accelerated clinical trials program in Europe for the treatment of PAD. Additionally, we expect Valentis to file a NDA in 2008. Failure to win timely approval could have a material adverse impact on our financial forecast.
- **Partnerships** – The company hopes to sign a worldwide commercialization partnership for VLTS 934 following completion of Phase IIb studies. In our opinion, there are only a handful of large pharmaceutical companies with the necessary sales and infrastructure to detail the PAD market. There can be no assurance Valentis will secure a partnership on favorable economic terms or that the partner will have the necessary commercial infrastructure to maximize the sales potential of VLTS 934.
- **Financial Solvency** – Valentis raised approximately \$5M in March 2006 yielding approximately \$8M in cash as of the date of this report. With a burn rate of slightly more than \$1M per month, we believe that Valentis may be required to raise additional capital during 2006 if a licensing agreement for their angiogenesis antibody is not concluded. If the company does raise additional capital, existing shareholders could face significant dilution.
- **Reimbursement** – We expect Valentis to eventually seek reimbursement from Medicare under medical codes for a medical procedure. There can be no assurance Medicare will agree to provide reimbursement or that reimbursement levels will be comparable to medical devices currently used to treat PAD.
- **Sector Rotation** - Valentis is a drug discovery company often kept in a portfolio with similar companies. In such cases, a significant event for one company may have a material impact on the valuation of all similar companies regardless of their unique qualities.

VALENTIS
INCOME STATEMENT (\$000's)

FYE June 30th	<u>2005</u>	<u>1Q06</u>	<u>2Q06</u>	<u>3Q06E</u>	<u>4Q06E</u>	<u>2006E</u>	<u>2007E</u>
Product Sales	\$2.2	\$0.3	\$0.2	\$0.5	\$0.6	\$1.6	\$2.5
Cost of products Sold	\$0.5	\$0.0	\$0.0	\$0.1	\$0.1	\$0.2	\$1.0
Gross Profit	\$1.7	\$0.3	\$0.2	\$0.4	\$0.5	\$1.4	\$1.5
General & Admin.	\$3.8	\$1.2	\$1.3	\$1.0	\$0.9	\$4.4	\$4.4
Research & Development	\$9.2	\$2.8	\$2.8	\$2.8	\$2.8	\$11.2	\$13.5
Marketing	<u>\$0.0</u>	<u>\$0.0</u>	<u>\$0.0</u>	<u>\$0.0</u>	<u>\$0.0</u>	<u>\$0.0</u>	<u>\$0.0</u>
Operating Expenses	\$13.0	\$4.0	\$4.1	\$3.8	\$3.7	\$15.6	\$17.9
Operating Income (Loss)	(\$11.3)	(\$3.7)	(\$3.9)	(\$3.4)	(\$3.2)	(\$14.2)	(\$16.4)
Other Income (Expense)	\$0.2	\$0.1	\$0.1	\$0.0	\$0.0	\$0.2	\$0.1
Taxes	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0
Net Profit (Loss)	(\$11.1)	(\$3.6)	(\$3.8)	(\$3.4)	(\$3.2)	(\$14.0)	(\$16.3)
Per Share	(\$0.85)	(\$0.24)	(\$0.22)	(\$0.20)	(\$0.19)	(\$0.83)	(\$0.96)
Weighted Avg. Diluted Shares	13.0	14.8	16.9	16.9	16.9	16.9	16.9

BALANCE SHEET

<u>ASSETS</u>	<u>6/30/05</u>	<u>12/31/05</u>	<u>3/06 PIPE</u>
Cash & Equivalents	\$12.5	\$6.4	+\$5M 2.1M shares @ \$2.50 & 1.1M warrants @ \$3.00
Prepaid & Other Assets	<u>\$0.7</u>	<u>\$0.6</u>	
Total Current Assets	\$13.2	\$7.0	
Plant Property & Equip	\$0.0	\$0.0	
Goodwill	\$1.0	\$0.9	
Other Assets	<u>\$0.0</u>	<u>\$0.0</u>	
Total Assets	<u>\$14.2</u>	<u>\$7.9</u>	
<u>LIABILITIES</u>			
Accounts Payable	\$2.6	\$2.8	
Other Current Liabilities	<u>\$0.0</u>	<u>\$0.0</u>	
Total Current Liabilities	\$2.6	\$2.8	
Stockholder's Equity	<u>\$11.6</u>	<u>\$5.1</u>	
Total Liabilities	<u>\$14.2</u>	<u>\$7.9</u>	

Valentis Discounted Cash Flow Assumptions

	2006	2007	2008	2009	2010	2011	2012	2013	2014	TERMINAL
<i>Fiscal year end June 30</i>										
Operating profit	(\$14.0)	(\$16.4)	(\$20.2)	(\$11.8)	\$29.2	\$87.6	\$140.0	\$188.3	\$239.2	
Depreciation & amortization	0.0	0.0	0.1	0.1	0.2	0.3	0.5	0.6	0.8	
Taxes	0.0	0.0	0.0	0.0	0.0	0.0	(28.6)	(58.2)	(87.3)	
Stock-based compensation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Interest Income - net	0.2	0.1	1.1	0.7	0.3	1.0	3.0	5.7	9.0	
Change in working capital	(0.0)	0.1	0.2	(0.8)	(4.2)	(5.9)	(5.4)	(5.0)	(5.3)	
Capital expenditures	(0.0)	(0.3)	(0.4)	(0.6)	(0.8)	(1.0)	(1.3)	(1.5)	(1.7)	
Total free cash flow	(\$13.8)	(\$16.6)	(\$19.2)	(\$12.4)	\$24.8	\$82.0	\$108.3	\$129.9	\$154.6	\$766.6
Revenue growth rate	-71%	-5%	20%	-16%	557%	323%	107%	47%	30%	12%
Discount rate	33%	33%	33%	33%	33%	33%	33%	33%	33%	33%
Discount factor	1.0	0.8	0.6	0.4	0.3	0.2	0.2	0.1	0.1	0.1
Discounted cash flow	(\$13.8)	(\$12.5)	(\$10.9)	(\$5.3)	\$8.0	\$20.1	\$20.0	\$18.1	\$16.3	\$80.7

Source: Dawson James estimates

DISCLOSURES



Initiated September 29, 2005 – Speculative Buy – Price Target \$6.00
 Upgrade January 11, 2006 – Speculative Buy – Price Target \$7.50
 Termination April 4, 2006–Spec. Buy–Price Target \$7.50

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Ratings Distribution	Company Coverage		Investment Banking	
	# of Companies	% of Total	# of Companies	% of Totals
Speculative Buy	4	22%	1	25%
Strong Buy	2	11%	1	50%
Buy	8	44%	0	0%
Neutral	2	11%	1	50%
Sell	1	6%	0	0%
Sell Short	0	0%	0	0%
Under Review	1	6%	1	100%
Restricted	0	0%	0	0%
Total	18	100%	4	22%

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

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