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Recce Ltd (ASX: RCE)

US institutional investor sees the potential

19 June 2017

Share Price: A$0.22

Speculative Buy

Higher Risk

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- RCE announced on 16 June 2017 that it had entered into an agreement for a flexible funding commitment of up to A$6.05m with The Australian Special Opportunity Fund (ASOF). ASOF is managed by New York-based The Lind Partners (Lind). Lind invests in small and mid-cap publically traded companies (focusing on natural resources, biotechnology, and sustainable/alternative energy) primarily in Australia, Canada, and the UK.
- Over a 24-month period, ASOF has committed to invest up to a total of A$6.05m, with a minimum investment of A$1.45m (i.e., initial A$250k in convertible securities plus 24 x A$50k tranches). At RCE's sole option, monthly tranche amounts can be reduced to A$25k, or increased up to A$250k by mutual consent.
- The funds will be used to support RCE's Investigative New Drug (IND) Application to the US Food and Drug Administration (FDA) and to assist in the early stages of the group's Phase 1 (Human-Safety) clinical trials, planned to commence from the December 2017 quarter.
- ASOF will acquire ordinary shares in RCE for its equity investments at a purchase price equal to 90% of the best five consecutive day VWAP during the 20 trading day period prior to the issue of shares (note: a max of 2 tranche issues can be purchased at A$0.25935 per share).
- RCE can terminate the agreement at no cost at any time after three tranches have been funded. The agreement also includes a number of selling and shorting protection safeguards, and provisions for minimising dilution for existing shareholders (i.e., if the purchase price is less than A$0.15ps, RCE may elect to repay the prepaid tranche with a 5% premium, rather than issue shares).
- ASOF intends to be a passive investor with no Board participation rights; the agreement contains a provision that ASOF will not hold more than 19.99% of RCE's shares at any one time.

State One comments: "insto" endorsement of RCE's product

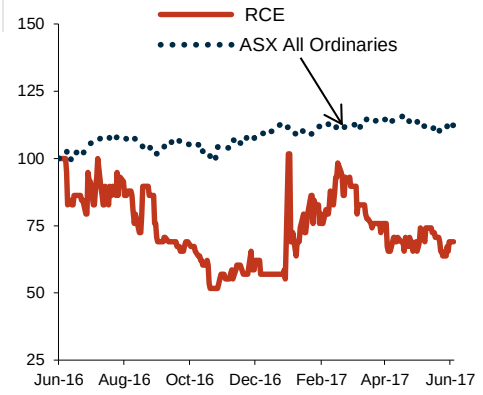
- We see Lind's investment in RCE as an institutional-grade endorsement of RCE's commercial potential and management capabilities.
- The funding provides RCE with some additional (financial) security as the group focuses on delivering key clinical development milestones over the next 24 month
- Successfully completing pre-clinical trials and moving to Phase 1 testing is an important step in the drug development process, and **typically acts as a significant share price catalyst.**

Based on a global antibiotic market of US$40bn (2014), we estimate the potential NPV of a royalty/licencing stream to RCE for its RECCE® antibiotics could be some US$400m (A$530m). At RCE's current diluted m'cap of A$23m, the market is valuing the group at only 4% of our NPV (i.e. the market has attached a 96% risk discount).

We believe that at the beginning of clinical testing, a discount to 90% is appropriate; this would effectively double our indicative valuation to A$53m (A$0.51 per fully diluted share). We believe that RCE offers exciting capital upside for speculative investors as the RECCE® antibiotic NPV is progressively de-risked.

Recce Ltd	
ASX Code	RCE
52 week range	A$0.15-A$0.37
Avg. Daily Turnover (shares)	73k
Shares Quoted (million)	34.5
Quoted M'Cap (A$m)	7.6
Fully diluted no of shares (m)	103.6
Fully diluted M'Cap (A$m)	22.8
Cash (end-March 2017)	A$1.6m

Relative Price Performance (base =100)



Valuation

In 2010, health care providers in the US prescribed 258 million courses of antibiotics (equivalent to 833 prescriptions per 1,000 persons). Source: The New England Journal of Medicine, 2013.

Predicated on securing a royalty/licencing agreement with "Big Pharma" - one of several options RCE will be actively exploring to commercialise its IP - **we estimate the NPV of the US antibiotic market to RCE at ~US$180m (with a global NPV estimate closer to ~ US$400m)**. See table below.

We believe that the assumptions used in our NPV valuation are not unrealistic, and suggest that the resultant valuation illustrates the significant potential upside relative to RCE's current market capitalisation.

At the current spot US$0.77 exchange rate, our indicative valuation of US$412m equates to A$530m. Thus, at RCE's current (fully-diluted) market capitalisation of ~A$28m, we suggest that the market is only attaching a 5% probability that the RECCE® antibiotic product will achieve commercial success.

Indicative NPV valuation:

~US$400m

RCE: indicative NPV of RECCE® antibiotics (un-risked) (US$m)

	Development & FDA Approval						*Patents granted up to 2029 for Australia, USA,Europe, Japan , China and pending for ALL PCT Countries up to 2034*												
	2016	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**	**2026**	**2027**	**2028**	**2029**	**2030**	**2031**	**2032**	**2033**	**2034**
No. of Prescriptions (million)	258	259	261	262	263	265	266	267	269	270	271	273	274	275	277	278	279	281	282
ARP per Prescription (US$)	50	51	52	53	54	55	56	57	59	60	61	62	63	65	66	67	69	70	71
Market value of Prescriptions (US$m)	12,900	13,224	13,556	13,896	14,245	14,602	14,969	15,345	15,730	16,124	16,529	16,944	17,369	17,805	18,252	18,710	19,180	19,661	20,155
% share RECCE antibiotic	na	na	na	na	na	na	1.0%	2.5%	3.5%	5.0%	5.0%	5.0%	5.0%	5.0%	2.5%	2.5%	2.5%	2.5%	2.5%
RECCE antibiotic Revenue (US$m)	0	0	0	0	0	0	150	384	551	806	826	847	868	890	456	468	480	492	504
Margin	na	na	na	na	na	na	90%	90%	90%	90%	90%	90%	90%	90%	90%	90%	90%	90%	90%
Profit (US$m)	0	0	0	0	0	0	135	345	495	726	744	762	782	801	411	421	432	442	453
Royalty rate to RCE (%)	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%
Royalty to RCE (US$m)	0	0	0	0	0	0	17	43	62	91	93	95	98	100	51	53	54	55	57
PAT (US$m)	0	0	0	0	0	0	12	30	43	63	65	67	68	70	36	37	38	39	40
Discount rate	*10%*																		
NPV - US market (US$m)	**183**																		
ROW as % US market	125%																		
NPV - ROW (US$m)	229																		
RECCE antibiotic NPV (Total) (US$m)	**412**																		

Source: State One Stockbroking forecasts

Key assumptions include:

- ✓ 258m antibiotic prescriptions in the US in 2016 growing at 0.5%pa,
- ✓ Base-case average received price (ARP) of US$50 per prescription escalated at 2%pa,
- ✓ Production and sales of RECCE® antibiotic commencing in 2022 with 1% market share,
- ✓ Market share peaking at 5% by 2026, patents expiring in 2034 => 13 year patent protection from Year 1 production,
- ✓ 12.5% royalty rate to RCE,
- ✓ Rest of World (ROW) market at 125% of US market.

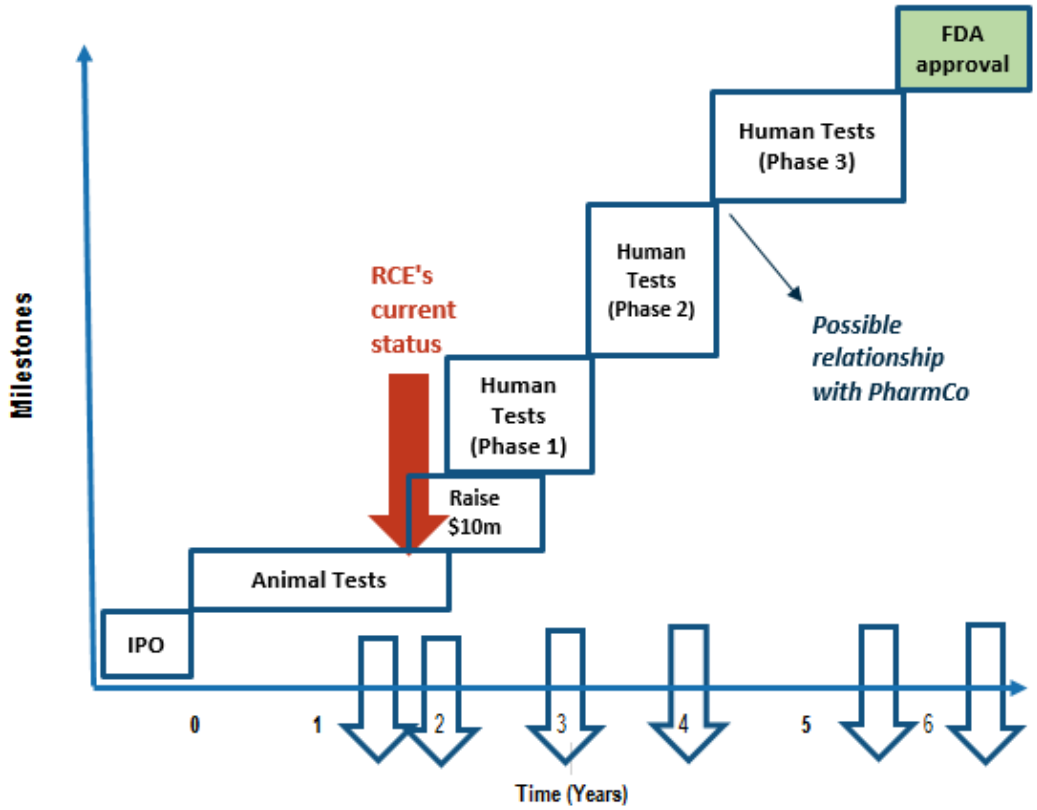
Note: We attribute zero value to the RECCE® antibiotic IP after 2034; we have not factored in 2016-2021 drug development costs (State One estimate: US$50m) or (off-setting) milestone payments over this development period.

Note: We do not attach any anti-cancer value to the RECCE® antibiotics. On 23 Feb, RCE announced that it was suspending its anti-cancer program to focus on commercialising its product(s) for antibiotic and anti-virus applications.

The high risk discount attached to RCE's valuation reflects the relatively early-stage nature of the group's product development - RECCE® antibiotics are (only) three quarters of the way through a program of animal tests for safety and efficacy, part of a longer-term six-year program to (final) FDA approval.

However, we believe that as the development program progresses, RCE's share price should increase significantly as the probability of commercial success increases. See graph below.

Forecast RECCE® antibiotic development timeline and RCE indicative valuation



NPV- unrisked (A$m)	530	530	530	530	530	530
Risk discount (%)	95%	90%	80%	45%	30%	25%
NPV - risked (A$m)	27	53	106	292	371	398
NPV - risked (A$ per share)	**0.26**	**0.51**	**1.02**	**2.81**	3.58	3.84
Current share price (A$)	0.22	0.22	0.22	0.22	0.22	0.22
% upside / (downside)	16%	133%	365%	1179%	1528%	1644%

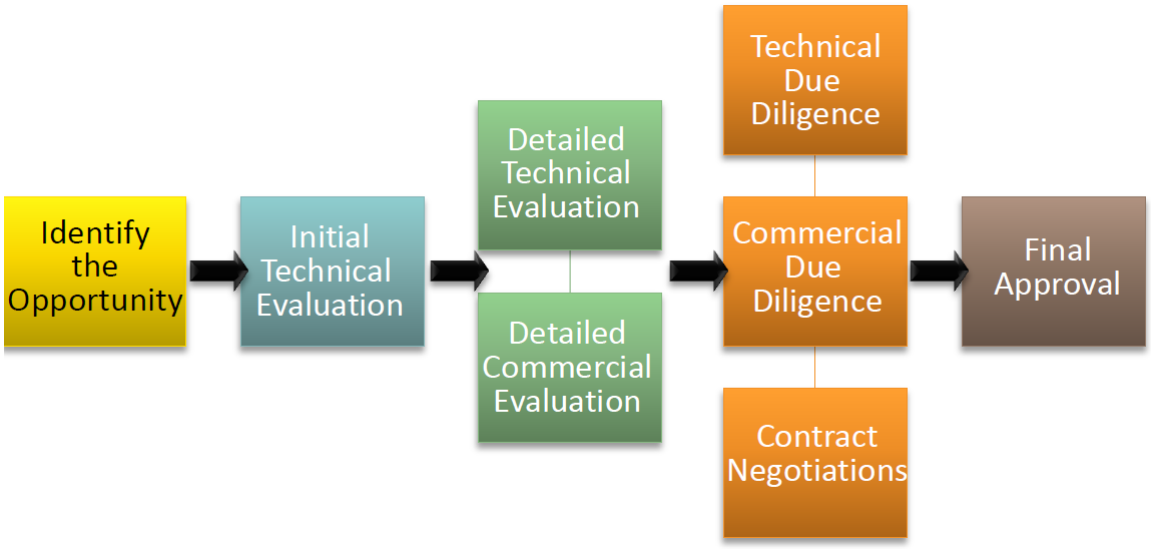
Source: Company, State One Stockbroking forecasts

- ✓ **At the start of Human Tests (Phase 1 – Safety), which are targeted for the December quarter 2017, we suggest a 90% risk-adjusted valuation for RCE of A$53m (or A$0.51 per fully diluted share (103.6m)).**
- ✓ **If Phase 1 clinical tests are successfully completed towards the end of 2018/beginning of 2019, we suggest an 80% risk-adjusted valuation of A$106m (or A$1.02 per fully diluted share).**

Valuation risks

- Expenses and costs of 2016-2021 trials/development and compliance with regulations,
- High rate of failure for drug candidates (animals) proceeding through pre-clinical trials, and or failure/setbacks at any stage (Phase 1, 2,3) of the clinical trials (humans),
- Serious adverse events or safety risks could require Recce to abandon developments, and to preclude, delay, or limit approval of its products,
- Reliance on a relatively small number of key personnel,
- If Recce develops and manufactures the RECCE® antibiotic (versus selling the IP to Big Parma in exchange for a royalty), Recce will face the inherent risk of exposure to liability claims and regulatory action,
- The Company may be forced to litigate to enforce or defend its intellectual property rights,
- The Company may not be able to protect its proprietary technology in the marketplace,
- Competitors may be more successful than the Company,
- Failure to secure a Licencing/Royalty with one of the big PharmCos. The big players in the pharmaceutical industry have significant portfolios of early-stage/development prospects to evaluate; most prospects will not make it through the rigorous selection process. See graph below.

Licensing Process at Bristol-Myers Squibb



Source: Torreya Partners presentation, January 2014

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State One was Lead Manager for Recce Limited's IPO in January 2016.

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