

Telecoms/Internet

15 June 2009

Phorm

BUY[#]*Initiation of Coverage: Rocket Science*548p[#]

Year-end December	2008E	2009E	2010E	2011E
Gross Turnover (US\$m)	0.0	3.2	126.6	639.2
EBITDA (US\$m)	(50.1)	(47.5)	(41.2)	67.8
Adj. Pre-tax Profit (US\$m)	(49.1)	(46.2)	(40.9)	64.3
Adj. EPS (p)	(146.06)	(149.42)	(123.21)	139.44
DPS (p)	0.00	0.00	0.00	0.00
Net Cash/(Debt) (US\$m)	138.26	30.44	(118.61)	50.08
P/E	(3.9)	(3.7)	(4.4)	3.9
Dividend yield	0.0%	0.0%	0.0%	0.0%
EV/EBITDA	(1.8)	(1.9)	(2.2)	1.3

Source: Astaire Securities estimates

[#]Priced at market close, 11 June 2009

Key Data	
Ticker	PHRM.L
Shares in issue	13,032m
Market cap	£71.4m
12-mth price range	200-1,175
Net debt	£48.0m
Next event	Finals, June

Advertisers have long 'got it' as regards the value of targeted advertising on the Internet. With the launch of a 'personal Internet' offering, using the same profiling of users' browsing behaviour to deliver a genuinely personalised, or customised Internet experience, Phorm has demonstrated the practical value of its technology also to the two other critical constituencies – consumers and publishers. While Phorm carries the risk of any pre-revenue company, the potential rewards are sufficiently large for us to recommend that everybody owns a slice.

- **Not Just a Better Widget** – Phorm's OIX and Webwise platforms promise to change the economics of the Internet. The online advertiser wins by more efficient use of its budget. The publisher benefits through more efficient utilisation of its real estate. The ISP benefits through the generation of a new revenue source. And the customer wins by enjoying a better Internet experience – and, incidentally, a better funded Internet.
- **Manageable Risks** – Seven years after serious development work began, Phorm's technology risk is low. Privacy issues have been addressed, with the company setting new standards for privacy protection. As a category-busting start-up on the brink of launch, however, commercial uncertainty is very high, regarding adoption rates and the inevitable competitor response. Uncertainty should not be equated to risk, however, and management's response to the privacy storm should provide comfort to investors that adaptability, as well as resilience, is 'engineered in'.
- **Forecasting is Hazardous** – Since we last published estimates on Phorm, BT's expected commercial launch has been delayed, but more countries have lined up ready to go. We have adjusted our forecasts for these, as well as for the launch of Webwise Discover and the recent £15m financing.

Company description

Phorm has developed a sophisticated technology that enables ISPs to deliver highly targeted advertising and content to consumers based on their browsing habits, while guaranteeing their anonymity.

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Recent Developments

We are **re-initiating coverage** of Phorm, with a **BUY** rating and price target of **£20, representing a 250% upside** from current levels. The recent launch of Webwise Discover and the successful £15m financing represent significant milestones in the company's development.

While we have been following Phorm's progress over the past couple of years, we have been stunned by the sophistication and elegance of its technology; impressed by the loftiness of management's ambitions; dismayed by the efforts of the privacy campaigners to derail the company; and frustrated by the seeming slowness of BT finally to roll out the service. After the recent presentation to the web publishing community of Webwise Discover – the personalised Internet – we are finally also convinced of its real relevance for consumers.

We have been arguing for some time that, even though management has done a good job of wearing down the privacy activists – having long ago, it seemed, won the intellectual debate – it had become distracted from the real challenge of convincing that its service would be indispensable, in the way that Google's search capability had become.

Until now, Phorm's direct appeal to the consumer has been necessarily limited:

First, its core technology, Webwise, has been presented as a B2B offering – establishing an efficient on-line advertising exchange between web publishers and advertisers;

Second, its technology, based on Deep Packet Inspection, has required it to be hosted by ISPs such as BT, TalkTalk and Virgin Media who, by their nature, have been very slow to launch the technology; and

Third, its controversial nature, creating a firestorm around the issue of personal privacy, even though, as it happens, Webwise offers unprecedented levels of privacy protection.

Phorm's direct appeal to the consumer has until now been limited to its offering of an anti-phishing filter, together with the promise of a 'better Internet experience' through the avoidance of irrelevant advertising, as inducements to the consumer to 'opt in' to the Webwise system. And until now, we have assumed that, in the absence of a really strong positive and tangible benefit to the consumer, it would be tough for Phorm/Webwise to make material impact on the online advertising world in the way that Google has done through providing its eminently useful search service. So, until now, we have assumed that BT, TalkTalk and Virgin Media would be obliged to offer other sorts of 'goodies' – discounted broadband subscriptions, or premium upload speeds, for example – as a continuing inducement to consumers to maintain high 'opt in' rates.

Not any more! Webwise Discover takes an essentially B2B capability – an ad serving engine that delivers personally targeted advertising to web browsers – and makes it immediately relevant to the browser him/herself. So, the same DPI scanning technology that builds the interest profile of the browser for the purposes of delivering relevant advertising is used to build a user's own relevant Internet. So, not only does the user get far fewer annoying pop-up and other irrelevant adverts, but he also gets to build his own personalised internet. Think of the

Light at the end of the tunnel

Hijacked by the privacy debate

A B2B proposition

Mass market appeal

Amazon or iTunes recommendation engine – “if you bought this, you might also like this” – applied not just to your Amazon- or iTunes-based shopping, but applied to your entire Web experience. And not just for that individual session – the ‘interests’ profile that is built up cumulatively from your browsing history keeps being enriched as long as you remain ‘opted in’. And future versions will take the degree of user control even further, with the option to ‘tune’ the algorithms to one’s own preferences for relevancy, ‘recency’ and latency – e.g. how much weight is given to recent vs past history.

The benefits for publishers and advertisers are clear. **First**, and most important, is the ability to monetise more effectively: a ‘switched on’ user is another relevant eyeball to target advertising towards. But **second** is the ability for publishers to personalise a web page to an individual’s preference by delivering not just relevant advertising, but also relevant content – so, large publishers can bring in content from sister publications, and small publishers can bring in content from third-party publishers – both to enhance ‘engagement’ or ‘stickiness’ in that particular website.

We have reworked our original model to reflect events over the year, principally relating to the timing of roll-out – we are now assuming that BT and the other UK ISPs start commercial service between Q4/09 and Q1/10 (6 quarters later than originally assumed), that South Korea also goes ‘live’ in Q4/09, followed inter alia by Brazil and Japan in H1/10 and the US and Canada in H2/10. We assume a domino effect takes over once the UK and South Korea have successfully launched and demonstrated the real-world results and benefits, and that other countries adopt the technology at more rapid rates thereafter.

Explicitly modelling 10 countries, we estimate gross revenues of US\$3m in 2009, with the business scaling dramatically thereafter, to US\$125m and US\$639m in 2010 and 2011, respectively. We expect EBITDA breakeven in Q1 2011. Discounted at 25%, the NPV emerges at £35 per share.

Taking only the two countries where ISP agreements have been signed – the UK and South Korea – we arrive at gross revenues of US\$3m in 2009 and US\$77m and US\$252m in 2010 and 2011, respectively. Although this is slightly lower than consensus estimates, to our mind this simply reflects the high variability of forecasts, rather than a flaw in either the business model or in our assumptions.

There are two obvious categories of risk. **First**, as the experience of the last year has shown, rolling out a technology that promises to revolutionise something as ubiquitous and embedded as the Internet (albeit it is itself only 15-or so years old) is hazardous and fraught with forecast uncertainty – and that’s even before the real challenge, which is to manage the inevitable competitor response. Even though our forecasts assume that Phorm’s ad-serving technology takes only 7% share of the global online advertising market, Google will likely not go quietly. And **second**, we expect Phorm to remain cashflow negative until 2011, assuming 10-country roll-out, and assuming that Phorm carries all start-up costs on its own books, consuming some US\$90m of cash in the process. The recent £15m fund-raise should therefore not be regarded as the last. Given the size of the free float and of the opportunity, we would regard this as less of a risk than an opportunity to participate.

Clear benefits to publishers and advertisers

The numbers

The risks

Investment Case

Strongly Supportive Macro Trends – Phorm resides at the confluence of two immensely powerful trends in communications. **First**, the commoditisation and/or maturing of traditional Internet revenue sources – Internet access and advertising – is occurring at a time when the explosion of peer-to-peer file sharing, particularly video, is putting unprecedented strain on the capacity of the Internet to carry that traffic. And **second**, the emergence of ‘web 2.0’ marks the personalisation of the Internet, with the consumer at the centre of his/her social network and web content experience. Phorm’s technology allows it to exploit these two trends directly, by enabling the ISP to intermediate between advertiser and publisher.

Clear Growth Market – Phorm is operating in one of the clearest growth segments of the economy, with on-line advertising spending predicted to double over the next four-five years from a current level of some US\$50 billion, even if growth rates have inevitably slowed in the current recession.

Opening WWW to Targeted Advertising – Phorm acts as match-maker or clearing house between the advertiser and the publisher. By personalising the delivery of advertising to the web user, according to his/her recent browsing behaviour, it can increase the relevance and therefore the value of an individual ad placement, for which the advertiser will typically pay more. It can also deliver that ad to any site that has signed up with the OIX platform, thereby hugely extending the reach of online advertising beyond the conventional high-traffic sites. Moreover, by virtue of the control exercised by the advertiser over the destination of the advert, the OIX platform opens up a greater potential for brand advertising. Phorm’s technology therefore promises to monetise the ‘long tail’ of Internet real estate – the 70%-or-so of web pages that currently carry no advertising messages because of their low traffic rates – as well as to raise the impact value of individual advertising messages.

Strictest Privacy Policies – Setting new standards for privacy protection, Phorm offers this ‘holy grail’ of behavioural advertising without compromising the personal privacy of the user. Indeed, through ‘engineering in’ data anonymity from the outset, and by offering an upfront, anytime ‘opt in/opt out’ option, the company is employing a ‘belt and braces’ approach to data privacy protection.

Critical Mass Established – Phorm has struck exclusive deals with the leading ISPs in the UK – BT, Carphone Warehouse and Virgin Media, together representing some 70% of the ISP market. Not only has this allowed Phorm to achieve a level of access to the UK market that took Google years to develop, but it also gives a degree of access to the hardware, software, intellectual and other intangible assets of its partners. Other ISPs in Korea, the US, Brazil and other countries are expected to fall in behind the UK’s initial launch experience.

Management Team – Founder and CEO Kent Ertugrul has attracted an immensely strong management and governance team, with executive management including senior people from the publishing, entertainment, telecommunications and online advertising industries.

Clear Consolidation Candidate – As the company moves towards commercial launch, it is likely to become an increasingly highly attractive target for companies

Power trends

Operating in a clear growth segment

Opening up new internet real estate, expanding the pie

Personalising the user’s advertising message... without compromising privacy issues

Critical mass from the start

The ‘A’ Team

Operating in a clear growth segment

such as Microsoft that have so far failed to make a significant impact in the online advertising business.

Super-normal Growth Potential – Following market trials, while ISPs test optimal ‘opt in’ strategies, the consumer response, and the resilience and scalability of the OIX platform, and while advertisers apply a ‘suck it and see’ approach to the new platform, we assume a rapid growth in revenues across the top ten markets, to a Base Case assumption of US\$1,835m in 2012, with the OIX platform taking an approximate 7% share of the online advertising market

Significant growth prospect

Valuation – Reflecting the 18-months later than expected launch in the UK and the volatility in financial markets, we have trimmed our share price expectations to £20, still a four-fold increase from current levels. This represents a blend between the stand-alone per share value of £9.87 for the UK and South Korea, and the £33 per share probability-adjusted value of all ten modelled markets.

Substantial value upside

Triggers to the achievement of this target price include:

1. Having completed commercial trials last December, the full deployment of service by BT, followed thereafter by VirginMedia and TalkTalk;
2. The successful completion of South Korea’s commercial trials over the coming weeks;
3. The launch of the South Korea commercial service;
4. The announcement of any or all of Japan, Brazil and the US as launch markets;
5. The general abatement of public concerns over privacy; and
6. The generation of tangible operating metrics from both the UK and South Korean customer bases, validating modelling assumptions.

Investment Issues

Phorm’s volatile share price speaks volumes about the uncertainty surrounding the company’s business model. In our view, the company exhibits relatively low technology risk for a near start-up, and similarly low funding risk, following the successful US\$65 million financing in March 2008, and the additional US\$25m financing just completed. Although many aspects of the commercial case are unclear, we would urge investors not to confuse uncertainty with risk. As Google found before it, companies in a position to (re)shape an industry, have the best chance to shape it to their own relative advantage.

Technology Risk – For a technology start-up company, we judge the technology risks themselves to be unusually low. **First**, the management team’s own technical credentials are immensely strong, with recent highly relevant experience in the adware market, via Phorm’s predecessor company, 121 Media, with a highly capable software development team in Russia, and with senior technologists who formerly held comparable positions within BT and Microsoft, amongst others. **Second**, the development of the concept and technology has been undertaken over seven years. And **third**, BT has carried out extensive laboratory and commercial trials of the technology, and by its nature is conservative and risk-averse in its approach to new technology adoption.

Technology risk is low

High Commercial Uncertainty – Phorm’s technology platform is on the brink of commercial launch, when commercial uncertainty is at its highest, by the nature of

High commercial risks

a) the consumer's untested response to highly targeted advertising, and Phorm's reliance on ISPs to test that response; b) the potential adverse consequences of the over-blown privacy issue; c) the competitor response, and d) the evolving market it operates within, specifically the development of advertising beyond the conventional 'web/push' model. Moreover, by virtue of seeking to establish an open exchange, Phorm needs to convince all the players more or less simultaneously of the benefits of participating – not just the ISPs, but also the publishers and ad networks that will deliver the internet 'real estate', as well as the advertisers that will deliver the advertising inventory. Commercial uncertainty should not be confused with commercial risk, however, which is more a function of management's specific choices and behaviours and of the adaptability of the business model.

The Privacy Storm – Massive journalistic and blogger space and time have been devoted to the privacy issue, and for good reason, with privacy being absolutely central to Phorm's proposition to the ISPs. The legal and technical issues surrounding the privacy issue have been exhaustively discussed elsewhere, and do not bear repeating; suffice to say that we have little doubt that Phorm's OIX platform complies wholly with the letter and spirit of current privacy legislation – even though both the EU and the US are currently considering a further tightening of privacy legislation.

The Privacy storm

Consumer Uptake – The consumer's reaction is relatively untested: although focus group studies conducted by BT and Phorm in partnership indicated a strong preference for efficiently targeted ads, we have yet to see how stated intentions translate into user behaviour. We have had three general concerns. First, 'the smartest company on the planet' is relying for access to the market on ISPs with individually highly dubious track records of service innovation, consumer marketing, service delivery and/or customer service. Second, we are concerned that the 'monetisation of the long tail' risks triggering a consumer backlash. It is a question of balance, but there may be some resistance to excessive intrusion of advertising, however efficiently delivered. And third, as the ultimate customer is the advertising agency, a residual concern is whether the OIX platform risks being too complicated for its own good, when advertisers are crying out for simplicity, and widget-based offerings are constantly springing up.

Uncertain consumer acceptance

Competition – Competitive threats to Phorm's pioneering model come from three directions. **First**, incumbent players: Google dominates online advertising, and it is inconceivable that it will not react in some way to the emergence of a well funded competitor staking a claim to a behavioural targeting space that its own DoubleClick seeks to occupy. Although a widget-based approach that relies heavily on stored data might not seem to stack up against Phorm's platform, the 6-7 years that Phorm's technology has been in development should not be seen as a reliable guide to the time required for Google to develop a copycat response.

Crowded competitor landscape

Second, emerging players: although the majority of behavioural targeting companies are limited in their reach by the ad networks that provide the behavioural data, there is a handful of companies that are also working with ISPs that share many of Phorm's differentiating characteristics. Although NebuAd may have abandoned its ISP-based approach, it and other ad network-based providers such as Atigeo still threaten to take mind-share, and maybe market share.

A well populated market

And third, emerging platforms and markets: Phorm management has focused on the online, text- and contextual-based advertising opportunity – understandable, given that is where the majority of the current US\$50bn+ of online ad spending is destined. However, it could be argued that this represents ‘yesterday’s war’, and that the next battlegrounds for ad spending will be video (and Google launched its own AdSense for Video service the same week as Phorm announced its ISP deals) and mobile. Meanwhile, as the web and its users mature, the browsing habits of those users evolve to less predictable patterns of online behaviour – to take a live current example: all online advertising players are wrestling with challenge of exploiting the advertising potential of social networks, without alienating the user. Phorm management is of course fully aware of these developments, although its immediate focus must necessarily continue to be the established, and more conventional, market opportunity.

Online advertising is fragmenting

Lack of revenues and low revenue visibility – For all of the reasons cited above, the visibility on Phorm’s revenue model is extremely low. Although we know the technology works, the commercial variables are simply too many, too varied and too large to allow for easily defensible forecasting.

Revenue visibility is low, but revenues can still be modelled

However, this has not prevented our trying to capture the critical revenue drivers in a multi-scenario model. The workings are discussed in the **Financials** section below. In brief, for each of the top ten markets that we see as obvious candidates for Phorm’s technology we have modelled partner ISP market shares, consumer ‘opt in’ rates, and advertiser adoption rates. We have tested different assumptions regarding overall adspend as well as Phorm’s potential share of the adspend channelled through the OIX platform. Our model delivers a 2012 revenue forecast for the UK and South Korean markets alone of US\$545 million. Assuming all ten markets are served, with commercial launch dates extending through 2009 and 2011, the 2012 revenue range becomes US\$463m to US\$3,786m, with a Base Case estimate of US\$1,764m.

Summary Gross Revenue Estimates

Year to December	2008E	2009E	2010E	2011E	2012E
(US\$m)					
UK	0.0	2.7	64.2	208.7	450.3
USA	0.0	0.0	3.5	164.8	582.1
Canada	0.0	0.0	0.2	7.9	28.0
South Korea	0.0	0.5	12.9	43.4	94.9
Japan	0.0	0.0	21.8	96.0	267.9
Brazil	0.0	0.0	11.5	44.4	109.6
France	0.0	0.0	4.3	24.5	75.9
Germany	0.0	0.0	7.7	43.4	134.6
Italy	0.0	0.0	0.3	3.2	10.6
Spain	0.0	0.0	0.2	3.0	9.9
Total	0.0	3.2	126.6	639.2	1,763.8
EBITDA	(50.1)	(47.5)	(41.2)	67.8	399.3
Margin	nm	nm	nm	10.6%	22.6%

Source: Astaire Securities estimates

The Phorm Proposition

Phorm's OIX platform promises a revolution in online advertising and privacy. By guaranteeing the anonymity of the browsing activity of ISP's customers, the entire browsing behaviour of a consumer across the entire Internet can be profiled – and not just within the limited confines of ad networks. Also for the first time, potentially the entire stock of Internet websites becomes available to carry advertising, opening up the 'long tail' of hitherto un-monetisable sites. The 'opted in' consumer wins out by receiving more relevant advertising, and in the process benefiting from a better funded Internet. Additionally, and since the launch of Webwise Discover, the consumer is also promised more relevant content from the Internet, as the same cumulative knowledge of the user's interests as is applied to relevant advertising can be utilised to ensuring more relevant content, and more immediately accessible.

Phorm has signed agreements with the UK's three leading ISPs, BT, Virgin Media and TalkTalk, for the promotion of Phorm's unique technology solution to two of the most pressing issues in Internet advertising – **first**, the relative inefficiency of both contextual and behavioural display advertising to capture the full 'real estate' potential of the 'long tail' of the Internet's billions of pages.

And **second**, the paralysis amongst digital media players triggered by privacy laws, which inhibits them from exploiting the full granular potential of behavioural advertising, and thereby directly linking adverts to a user's browsing behaviour and possible buying intentions.

Phorm's technology is very clever – having been upwards of seven years in the development. Essentially, it guarantees a customer's privacy, even while the software engine is accumulating a real-time profile of that customer's search profile and preferences, traffic patterns, buying intentions – in short, the whole 'database of intentions' that drives the optimal placing of adverts.

And yet, significantly, without having to maintain a stored database behind it. Phorm's technology has been built from the start on the premise that customer profiling data should not be stored, but should be kept anonymised (via its association with a 24-digit randomly generated number), and immediately discarded. This commitment to preserving guaranteed anonymity puts Phorm in immediate contrast to the typical search engine or behavioural advertiser, whose concession to privacy concerns is typically to offer a shorter period for storing personal data.

Working with ISPs addresses two of the key limitations of first generation behavioural targeting.

First, by definition, an ISP can monitor the browsing behaviour of its customer across the entire web, whereas an ad network or Behavioural Targeting (BT) network can only track behaviour across the websites of partner companies and publishers; and

Second, with as many as 30% of Internet users deleting the cookies that BT companies place on their computers, the historic data collected by BT companies is often very patchy. For an ISP, the historic data 'belong' to the ISP so, subject to

Addressing a clear need

The benefits of deep traffic data....

.... without the downside

storage costs and privacy issues, there is no limit to the amount of behavioural data that can be trawled and analysed.

The current generation of targeted ad server technologies collects users' browsing behaviour only from participating sites, via cookies placed on the participating sites, and aggregates the data according to pre-defined broad category 'buckets' ('women', 'sport', 'cars', 'celebrity', 'fashion' etc.).

In contrast, Phorm's Open Internet Exchange (OIX) technology, by virtue of its highly secure privacy protection protocols and policies, has unique access to the entire browsing behaviour of an ISP's opted-in users. Combined with search words and URLs, this provides the data to support extremely precise targeting, using a potentially limitless combination of behavioural screens.

The Phorm website provides an extensive and detailed description of the workings of the OIX platform – see www.phorm.com – but an abbreviated description follows here.

The OIX platform attaches an anonymous cookie to the opted-in user's browser, identified only by the randomly-generated 24-digit ID number. This anonymised cookie follows the browsing activity of the user, and compares the pages seen, including its keyword, URL identifier and other contents, with the various categories, or channels, held in memory. As pages are loaded and their contents are compared with the channels, the record of that page is instantly deleted – the only data that is stored is the random-number ID, the advertising channel that this ID matched, and the date. When that random-number ID next arrives at a website that is participating in the OIX, a relevant ad is then served to that site for that ID (and no other) to see.

In practice, there are four principal players in the OIX ecosystem.

Advertising agencies are the ultimate customer and paymaster. For a particular campaign, they load the relevant 'creatives' to the platform, and define a set of campaign rules. They set the targeting rules – specifying the URLs visited within a specific time period, the keyword terms employed, etc. They set specific campaign constraints such as the number of times an ad can be presented to an (anonymised) individual, or the geography of that individual. They set the campaign goals, in respect of the number of clicks and impressions, etc. And they set the price for an individually targeted ad.

Website publishers and Ad Networks – this is where the ads are ultimately shown, with ad slots made available by the publisher inserting a tag into its system (or multiple tags to cover different areas of the website), with a threshold price for showing an OIX ad.

The ISPs provides access to the clickstream data that Phorm then anonymises.

The OIX Platform – this provides the enabling software to carry out real-time auctions between advertisers and publishers, as well as delivering the adverts on behalf of the advertiser and carrying out the billing and payment function on behalf of the ISPs and publishers.

What the OIX does

How it works

Ad agencies pay the bills

Websites host the ads

The ISPs provide the browsing data

The OIX provides the software and does the billing

Conceivably, a fifth category of player may emerge, the **Behavioural Targeting Optimisers** – analogous to the Search Engine Optimiser, or SEO, that works in a conventional Google or Yahoo search context, the ad agency may or may not choose to work with a Behavioural Targeting Optimiser, a separate class of expertise that may develop and be rewarded for optimising channel match strategies.

A new player emerges

The privacy issue

Since first 'going public' on 14 February 2008, with the announcement of the BT, TalkTalk and Virgin Media trials, Phorm has found itself at the centre of a 'perfect storm' in relation to the privacy issue. In fact, the issue of the use of 'personal' traffic and browsing data has been on the industry and legislative menu for years, at least since the emergence of behavioural advertising 3-4 years ago, and even more since Google launched its bid for DoubleClick in 2007.

A 'perfect storm', but not a total surprise

We believe that Phorm's technology sets a new standard for consumer protection, a view endorsed by the UK's Home Office, the Prime Minister's Office and the Office of the Information Commissioner. However, the debate rumbles on, particularly in the EU and USA, where new legislation focusing on behavioural advertising is currently being discussed.

As the subject has been discussed at great length elsewhere, we do not seek to prolong the tedium any further. Suffice to say that, in our view, Phorm has conducted an impressively consistent campaign to: a) set new standards for privacy protection, to which its competitors can barely aspire; and b) face down the privacy campaigners through a process of full disclosure and transparency.

The result is that, once full commercial service is available and consumers, publishers and advertisers can experience for themselves the benefit of a user-centric and personalised internet, the privacy storm will abate and the market will be allowed to decide.

The competition

Phorm claims a revolutionary new approach to online advertising, although it acknowledges that it is not alone in the behavioural targeting (BT) arena. All of the major online portals have developed BT strategies, and other independent players are also emerging. Phorm would argue that its ability to guarantee data anonymity and to establish an open auction between publisher and advertiser puts its technology generations ahead of its peers – a view that would seem to be shared by the UK ISPs that have carried out their own comparison of competitive alternatives. However, we would urge some caution, given the examples of Betamax and other superior technologies that ended up losing the standards battle.

Technology leap-frog

We identify three forms of competition to Phorm.

First, incumbent players: Most obviously, Google dominates online advertising, and it is inconceivable that it will not react in some way to the emergence of a well funded competitor staking a claim to a behavioural targeting space that its own recently acquired DoubleClick seeks to occupy. Although a cookie-based approach that relies heavily on stored data might not seem to stack up against Phorm's platform, the 6-7 years that Phorm's technology has been in development should not be seen as a reliable guide to the time required for Google to develop a copycat response, given its massive resources.

The incumbent giants will not 'roll over'

In addition, Yahoo! acquired RightMedia in April 2007 for US\$680 million, and also BlueLitthium. Acquired by AOL in July 2007 for some US\$275 million, Tacoda is a pioneer in the BT segment, and joins other recent AOL acquisitions, including Adtech and Qquigo. Finally, Microsoft's stated ambition is to derive 25% of its revenues from advertising, and it acquired aQuantive in May 2007 for US\$6.0 billion, while its abortive US\$45 billion bid for Yahoo! and more recent launch of its search engine Bing clearly indicates its ambitions.

Second, emerging players: Although the majority of behavioural targeting companies are limited in their reach by the ad networks that provide the behavioural data, there is a handful of companies that, like Phorm, have seen the potential of bringing ISPs into the equation, as a way to raise the value of the approximately three-quarters of ads that are currently un-targeted, and that share many of Phorm's differentiating characteristics.

A new generation of behavioural targeting competitors

Interestingly, the most prominent of these, NebuAd (Phorm's nearest competitor at the time, and apparently pursuing a similar, although far less well developed business model without Phorm's open exchange platform) has recently abandoned its ISP model – reportedly because it depended on third party ad-serving companies, thereby breaching rules regarding the protection of personal data. Other companies working with ISPs in the US and Asia include **Front Porch**, working at the 'edge' of the network, and able to track all the browsing behaviour of an ISP's customers, but also working with existing ad networks, rather than competing directly against them.

Come and gone

JumpStart works with ad networks, tracking the behaviour of the eight million people that visit its collection of car websites, and delivers targeted ads when they move onto other, non-auto sites. According to the company, it has the potential to reach 75% of US Internet users via its network of ad network and publishing partners. In certain respects, what JumpStart offers to its advertisers in respect of flexibility of targeting is very similar to that offered by Phorm. The difference is: a) JumpStart does not cover all internet real estate; b) it is focused on a single industry vertical – cars; and c) the logic rules are those determined and refined by JumpStart – not those determined by an open ecosystem of channel developers. Notwithstanding this, JumpStart claims an improvement in cost efficiency for the advertiser of between 37%, for pure optimisation, and up to 100% for sports cars.

Very vertical

eXelate, a behavioural data exchange, argues for a very simple linkage between a web user's browsing action within a particular industry vertical, and the subsequent delivery of a relevant advert when that vertical is next accessed. In this case, no sophisticated user profile is generated based on past or current browsing behaviour, so user privacy is maintained. Additionally, the simple connection between a single action and the subsequent delivery of an advert,

Simple is better?

albeit delayed, promises a more up-to-date and therefore relevant placement than one driven by perhaps days and weeks of browsing activity.

And, perhaps simplest of all, Atigeo has developed MyPageo, providing the user with the ability to specify his or her own interests.

Phorm differentiates itself from these players in multiple ways – by subscribing to higher privacy protection guarantees, by establishing a real-time price clearing function between advertiser and publisher and, perhaps most important, by providing access to the browsing behaviour of individuals across virtually the entire web, rather than simply within a specific ad network.

And third, emerging platforms and markets: Phorm management has focused on the online, text- and display-based advertising opportunity – understandable, given that is where the majority of the current US\$50 billion of online ad spending is destined. However, it could be argued that this represents ‘yesterday’s war’, and that the next battlegrounds for ad spending will be video (and interestingly Google launched its own AdSense for Video service the same week as Phorm announced its ISP deals) and mobile. We understand that Phorm is working on video, IP TV and mobile platforms – but that the conventional and mature text-based online opportunity represents the obvious first priority.

Meanwhile, as the web and its users mature, the browsing habits of those users evolve, to less predictable patterns of online behaviour – to take an obvious current example: all online advertising players are wrestling with the challenge of exploiting the advertising potential of social networks, without alienating the user.

Broader, deeper and cleverer

Online advertising is fragmenting, into new platforms....

.... new forms of user-generated content.....

Financial Model

By its nature, Phorm is not easy to model. The company has been in ‘stealth mode’ for the greater part of its existence. It is operating at the cutting edge of innovation, both technically and commercially. It has yet to launch commercial service. The regulatory and competitor responses are highly uncertain. The rate of adoption of the OIX platform and WebWise service by advertisers, publishers and consumers, although explored in numerous focus groups and trials, has never really been tested in the crucible of experience.

All the more reason to attempt to model it! Our approach to modelling the company is to recognise three broad categories of variability:

1. Adoption rates, amongst advertisers, web publishers, and consumers;
2. The number of countries in which the OIX platform will be offered; and
3. The economics of online advertising, and Phorm’s participation in the value chain.

To reflect this inherent variability, we model a **Base Case**, **Optimistic** and **Pessimistic** scenario for each of these categories. Although this approach would lend itself well to Monte Carlo simulation, for simplicity and transparency’s sake, we confine ourselves to a limited number of discrete/stand-alone scenarios.

Adoption rates

In the interests of modelling simplicity, we make a range of assumptions about general market behaviour, and apply these consistently to each country, varying each scenario by the date of first commercial launch. Assumptions about the rate of take-up are modelled to follow classic ‘S-Curve’ adoption patterns, varied by the starting and ending levels, the time to start the accelerating growth curve, and the duration of fast growth.

ISP market shares – For the UK, the three launch partners have a combined starting share of more than 75%, and we use this as a known starting point. In Korea – probably the first market actually to go fully ‘live’, Phorm’s partner, Korea Telecom, serves around 44% of the market, although we expect other ISPs to ‘fall in line’ soon after KT’s launch, so that in aggregate, Phorm should end up serving approaching 80% of South Korea’s online market. In the US, we estimate that the top six ISPs account for close to 70% of the broadband market, and we take this as a given. For other potential markets, we have to make an initial assumption about the critical minimum level of market penetration that Phorm would seek to have tied up at launch in order to attract the interest of advertisers – for reasons of prudence, and for simple lack of visibility on the state of partner discussions in these territories, we take this to be 50% in the Base Case.

Looking forward, we assume that over a five year period, continuing industry consolidation and the competitive advantage conferred on the ISPs by the OIX platform lead to a rise in their combined market shares towards a peak of 65% (85% in the UK).

Take-up rates are assumed to follow the ‘normal’ S-Curve adoption pattern

We assume a minimum critical ISP market share at launch

And we assume ISP market shares to rise over time

OIX Platform share of online advertising – In all markets, our Base Case assumption is for a standard growth in adoption amongst advertisers towards a peak of 15% after five years. This reflects our belief that, however compelling the OIX platform as a mechanism for delivering superior ROI to advertisers, it will continue to compete alongside conventional search-based advertising, as well as other behavioural and other forms of ad placement.

We assume advertisers will adopt an initial ‘suck it and see’ approach

Consumer adoption rates – As evidenced by the privacy debate, the ‘opt in/opt out’ issue is massively contentious. To be conservative, and reflecting the very different levels of concern and engagement with the privacy issue in different jurisdictions, our standard **Base Case** assumption is that ISPs adopt a range of launch strategies, with effective adoption rates growing from an initial 50% towards 70% at the peak. Our **Optimistic Case** assumption is for ISPs to launch on a purely ‘opt out’ basis, with 70% initial adoption rising over time to 80%.

The way ‘opt in’ alternatives are presented will be key

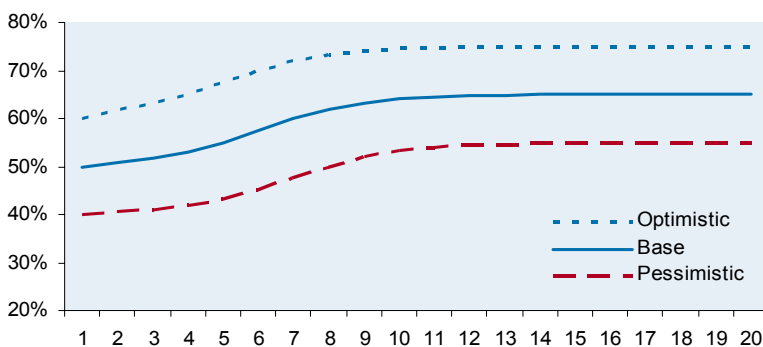
These assumptions are broadly consistent with the findings of the March 2008 Harris poll, reported on 11 April, that indicated that 41% of US adult Internet users (and 49% of 18-31 year-olds) were comfortable with behavioural targeting – a figure that rises to 55% when privacy and security policies were explained.

Some supportive polling data

They are also well supported by Phorm’s own market research, which revealed acceptance reaching in excess of 80%. We are additionally reassured by the recent Webwise Discover product launch, where the prospect of a tangible benefit to the consumer beyond improved advertising should underpin high consumer adoption rates.

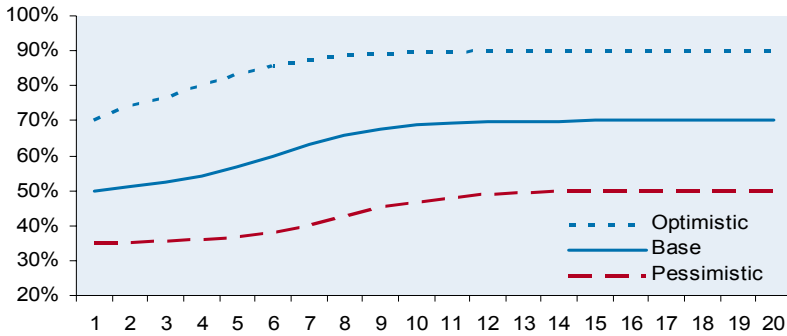
Overall adoption rates – taking the product of the above assumptions (65%-85% ISP share, times 15% advertiser adoption, times 70% consumer adoption), we arrive at a generic assumption for market adoption of approximately 7% of online advertising spend in each market being carried on the OIX platform within five years. The slope of the S-Curves in each case is apparent in the following charts.

Phorm: ISP Share of Market, by Quarter



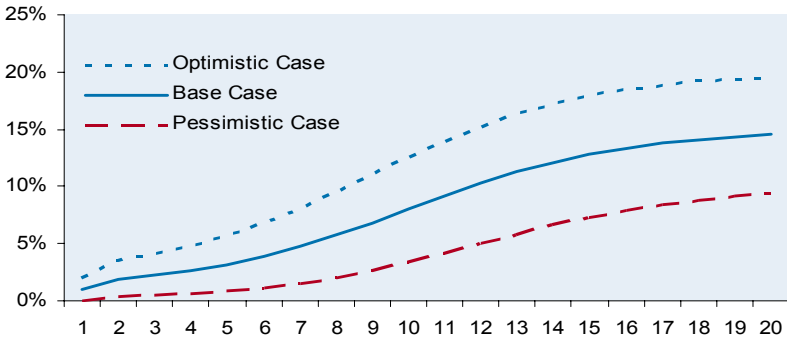
Source: Company, Astaire Securities estimates

Phorm: Consumer Adoption Rate, by Quarter



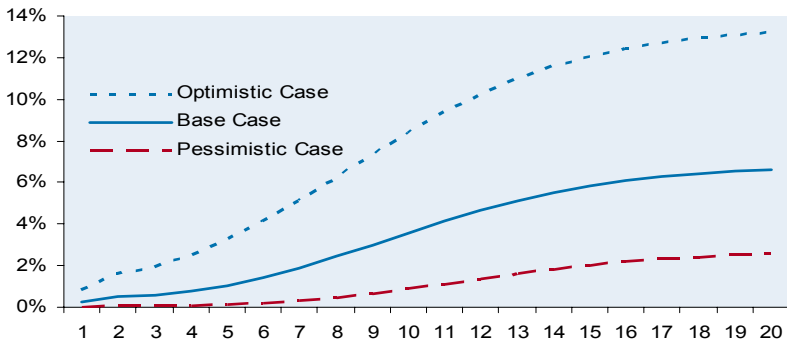
Source: Company, Astaire Securities estimates

Phorm: Advertiser Share of Market, by Quarter



Source: Company, Astaire Securities estimates

Phorm: Overall Share of Market, by Quarter



Source: Company, Astaire Securities estimates

Launch countries

Phorm announced the tie-up with BT, Virgin Media and Carphone Warehouse on 14/2/08 and, after an initial favourable press response, was soon dealing with a firestorm of orchestrated vitriol from disgruntled bloggers, companies and self-styled privacy campaigners. Fifteen months later, the company is at last on the brink of BT's commercial launch. This highlights the controversial nature of Phorm's offering, in some eyes, and the hazards of forecasting the timing of any future market launches.

Detailed estimates for ten countries

However, we do forecast this: our **Base Case** assumption has the UK and South Korea both going commercial during Q4/09; Japan and Brazil in Q2/10 and Q1/10; France and Germany in Q3/10, and Italy, Spain, the USA and Canada all in Q4/10. Our **Optimistic** scenario brings many of these dates forward by one quarter. Our **Pessimistic** scenario assumes only the UK and USA launch.

In all case, we assume that the first few markets to launch – the UK and South Korea – represent test markets, both for proving the OIX platform, and for testing and proving advertisers' willingness to devote significant share of their online spending to a new supplier. Accordingly, the rate of ramp-up in advertising spend and therefore also in revenues is assumed to be slower in these two markets.

The UK and US are assumed to be test markets, with slower rates of revenue ramp-up

Economics of the OIX platform

For obvious reasons of commercial confidentiality, this is an area where management keeps its cards closest to its chest. Again, we have to make some sort of intelligent assumptions. We do not vary these according to the different high, medium and low scenarios, however, as this would introduce a greater level of complexity to the model than is useful. Instead, we use the scenario options to test the sensitivity of the model to different assumptions – as we discuss below.

Advertising spend

We take as a given the current levels of online advertising spend in each market, derived from publicly available market research sources. For example, according to a report by Zenith Media, the UK market for on-line advertising spend in the UK amounted to US\$5.8 billion in 2008, US\$1.6bn for South Korea, US\$19.5bn for the US and US\$6.0bn for Japan.

Online advertising already close to 10% of all advertising spend

These estimates equate to around US\$13 per user per month in the UK – the highest levels of 'per capita' spending in the world – whereas the US 'per user' figure is close to US\$7. The comparable figure for Germany is around US\$6.75, and for all other modelled countries less than US\$5.00, reflecting a host of factors relating to the lower and slower adoption of e-commerce in these countries. Averaged over the ten modelled countries, our assumptions for online ad spending emerge at a fraction over US\$6.00 per Internet user per month.

We assume this amount grows on an annual basis, reflecting the secular shift towards online marketing – for which the OIX platform is an obvious catalyst. Our **Base Case** scenario assumes that 'per Internet user' spending rises at 5% per annum. The blended estimate for 'per user' spending emerges at a fraction over US\$9.00 per month by the end of the five year forecast period.

Online advertising estimated to be the fastest growing form of advertising

Phorm's share of spend: gross revenues, net revenues & gross profit

We would expect that this represents one of Phorm's most closely guarded commercial secrets, and our guess of an effective 30% 'take' is just that – a guess, albeit a guess based on reasonable assumptions.

In fact, we understand that Phorm will be carrying out the entire billing and collection function for the OIX platform, having invested in and developed its own Oracle-based billing engine. In practice, Phorm will invoice the advertisers and collect the money (we assume on 'normal' 30-day payment terms). As we understand the format of Phorm's P&L, this will represent Phorm's **gross**

From gross revenues to net revenues...

revenues. Phorm will then pay away the publisher's share – we estimate at 40% of gross income. The remaining 60% will represent Phorm's net revenues, to be split between the ISP and Phorm.

By the nature of things, at this stage our assumption of a 40% payaway to the publishers is an almost inestimable amount – we suspect that even Phorm has only partial knowledge of how the dynamics will work through. On the one hand, individual ads will be placed with increased accuracy, and therefore should command individually higher prices; at the same time, a vastly larger quantity of 'real estate' will become available, theoretically driving placement costs down. In the meantime, the OIX will be competing against established forms of ad placement.

Unpredictable economics

In the absence of better understanding or knowledge, we make a standard working assumption – namely, that each advertising dollar is effectively split according to our sense of relative value contribution. Thus, the publisher retains the largest share at 40 cents, with the remaining 60 cents being split equally (and eventually, after an initial phase-in period) between the ISP and Phorm. On the basis of gross revenues, this yields a mature gross margin for Phorm of 30% (30 cents as a percentage of 100 cents). On the basis of net revenues, this yields a mature gross margin for Phorm of 50% (30 cents as a percentage of 60 cents).

Our **Base Case** estimate of Phorm's gross revenues are set out in the table below: as can be seen, we estimate gross revenues in 2012 of some US\$1.764 billion (this compares with US\$21.8 billion of revenues reported by Google for 2008), and of US\$545m for the UK and South Korea alone.

Phorm: Revenues, by Market

Year to Dec (US\$'000)	2008E	2009E	2010E	2011E	2012E	Share
UK	0.0	2.7	64.2	208.7	450.3	26%
USA	0.0	0.0	3.5	164.8	582.1	33%
Canada	0.0	0.0	0.2	7.9	28.0	2%
South Korea	0.0	0.5	12.9	43.4	94.9	5%
Japan	0.0	0.0	21.8	96.0	267.9	15%
Brazil	0.0	0.0	11.5	44.4	109.6	6%
France	0.0	0.0	4.3	24.5	75.9	4%
Germany	0.0	0.0	7.7	43.4	134.6	8%
Italy	0.0	0.0	0.3	3.2	10.6	1%
Spain	0.0	0.0	0.2	3.0	9.9	1%
Total	0.0	3.2	126.6	639.2	1,763.8	100%
EBITDA	(50.1)	(47.5)	(41.2)	67.8	399.3	
Margin	nm	nm	nm	10.6%	22.6%	

Source: Company, Astaire Securities estimates

The ISP's portion of these receipts – we estimate 50% in the longer term – will be counted as Phorm's direct costs, leaving a 50% gross margin for Phorm, equivalent to around 30% of the original gross revenues.

SG&A Costs and Operating Margins – At the operating level, we assume around 40 software and other technical support engineers are required to support the launch of service in each country and to carry out ongoing customer-specific

development work, falling to 20 for the later countries. With an allowance for corporate overhead, varying with the rate of adoption of the OIX platform, **Base Case** estimates EBITDA breakeven in H1 2011, and margins of 23% in 2012.

There should be no working capital issue, as Phorm is likely to pay out to the ISP only once the advertisers have settled their invoice, and Phorm has carried out whatever reconciliation process is necessary.

On the basis of our 10-country model, we assume Phorm remains cash negative until 2011, and we assume that, even with a modicum of debt as well as joint-venturing with local ISPs in certain markets, the company may seek additional equity in the next 12-18 months, as additional countries are signed up.

Consensus estimates tend only to model the UK and South Korea, on the basis that these are the only countries formally to have signed up for the OIX platform. To my mind, this is akin to valuing an oil prospector and disallowing anything other than P2 reserves – the fact is that Phorm's business model and Kent Ertugrul's ambitions are geared towards a significant adoption of the OIX technology across multiple territories. If it is proven in the UK and South Korea, it is almost bound to be adopted in many other countries as well – the only issue is the rate and extent of adoption, and on what commercial terms.

However, for the sake of comparison, we also include our stand-alone UK & South Korea estimates, with consensus numbers alongside. Unsurprisingly, as we are slightly more cautious in our rate of take-up by the various constituencies, and as we maintain the full loading of development costs associated with additional territories, our estimates emerge somewhat more conservative. However, even on this basis, our estimates deliver an NPV, discounted at 25%, of £10 per share.

Astaire UK & Korea Estimates vs. Consensus

	Astaire			Conse		
	2009E	2010E	2011E	2011	2011	2011
				Mir	Evo	Can
Financial Assumptions:						
Total Gross Revenues	3	77	252	451	539	n/av
Net Revenues	2	46	151	271	n/av	192
% of gross	60.0%	60.0%	60.0%	60.0%	n/av	n/av
ISP share	(1)	(30)	(89)	(149)	n/av	(96)
% of net	(42.0%)	(39.1%)	(35.2%)	(33.0%)	n/av	n/av
Gross profit	1	16	63	122	129	96
% of gross	18.0%	20.9%	24.8%	27.0%	24.0%	n/av
EBITDA	(45)	(35)	8	85	99	70
% of gross	nm	(46.1%)	3.3%	18.8%	18.4%	n/av
Operational Assumptions:						
Consumer adoption	50%	60%	69%	60%	n/av	70%
Publisher adoption	1%	3%	7%	12%	n/av	16%
Revenue-share						
Publisher	40%	40%	40%	40%	40%	40%
ISP	42%	39%	35%	33%	36%	30%
OIX	18%	21%	25%	27%	24%	30%

Source: Astaire Securities estimates, Mirabaud, Evolution Securities, Canaccord

Further funding to come

Apples and oranges

Valuation

There are two approaches to valuation – one based on strategic value to a potential bidder, the other based on continuing stand-alone operations. We will not attempt the former, although do offer the following table of recent relevant take-out values. We also note the publicly stated intention of Microsoft to derive 25% of its revenues from advertising.

Clear strategic value potential, with established players challenged by regulatory changes

Digital Advertising M&A, 2007

Acquisition	Buyer	Date	Value
Digitas	Publicis	January	\$1.3 billion
Adscape	Google	February	\$23 million
Reprise Media	Interpublic	April	Undisclosed
DoubleClick	Google	April	\$3.1 billion
Right Media	Yahoo	April	\$680 million
24/7 Real Media	WPP	May	\$649 million
aQuantive	Microsoft	May	\$6.0 billion
TACODA	AOL	July	\$275 million
Total			\$12.027 billion-

Source: Compiled by Online Media Daily

As discussed above, we employ a multi-scenario forecasting approach to Phorm, to reflect the profound uncertainties inherent within the business. This enables a highly granular approach to valuation.

Our **Base Case** forecasts assume that Phorm launches service in ten countries within two years, that it captures an average 7% of online advertising spend, generating gross revenues of some US\$1.8 billion in 2012. We assign a 45% probability to this outcome.

Our **Optimistic Case** forecasts assume higher levels of adoption within individual markets, with Phorm capturing 13% of online advertising spend by 2012, generating US\$3.8 billion of revenues in 2012. We assign a 10% probability to this scenario.

Our **Pessimistic Case** forecasts assume lower levels of adoption within individual markets, with Phorm capturing a mere 3% of online advertising spend, generating US\$463m of gross revenues in 2012, and generating an NPV of only £1.50 per share. We assign a 45% probability to this scenario.

On a probability-adjusted basis, and discounting at 25%, we arrive at an NPV per share of £27.

Phorm: P&L Estimates

Year to December (US\$'000)	2006	2007	2008E	2009E	2010E	2011E
Group revenue	0	0	0	3,189	126,564	639,150
% inc	nm	nm	nm	#DIV/0!	3868.3%	405.0%
Gross Profit	869	(294)	0	574	26,690	158,990
Gross Margin	nm	nm	nm	18.0%	21.1%	24.9%
SG&A	(12,470)	(32,535)	(50,140)	(48,103)	(68,061)	(92,389)
% of Sales	nm	nm	nm	1508.2%	53.8%	14.5%
EBIT	(11,601)	(32,829)	(50,140)	(47,529)	(41,372)	66,601
EBIT Margin	nm	nm	nm	-	-32.7%	10.4%
Net interest	66	680	992	1,291	437	(2,258)
Pre-tax Profits	(11,535)	(32,149)	(49,148)	(46,237)	(40,934)	64,342
Tax	(13)	(4)	0	0	0	(18,016)
Net result	(11,548)	(32,153)	(49,148)	(46,237)	(40,934)	46,327
Net Margin	nm	nm	nm	-	-32.3%	7.2%
EBITDA	(11,601)	(32,628)	(50,148)	(47,512)	(41,167)	67,769
EBITDA Margin	nm	#DIV/0!	#DIV/0!	-	-32.5%	10.6%
Net (Debt)/Cash at y/e	3,754	16,537	30,109	7,288	(37,641)	(10,027)
No. of shares, diluted	10.2	18.8	17.4	15.7	17.2	17.2
EPS, diluted (p)	(113.00)	(171.25)	(146.06)	(149.42)	(123.21)	139.44
Dividend (p)	0.00	0.00	0.00	0.00	0.00	0.00

Source: Company, Astaire Securities estimates

Phorm: Balance Sheet Estimates

Year to December (US\$'000)	2006	2007	2008E	2009E	2010E	2011E
Goodwill	0	0	0	0	0	0
Investments	0	0	0	0	0	0
Prop. Plant&Equipment	129	661	35	50	985	4,929
Total Fixed Assets	129	661	35	50	985	4,929
Stocks	0	0	0	0	0	0
Debtors	594	1,350	1,350	1,654	13,417	62,288
Cash	3,805	16,558	30,129	7,309	-37,620	-10,007
Total Current Assets	4,399	17,908	31,480	8,963	-24,203	52,282
TOTAL ASSETS	4,527	18,569	31,514	9,013	-23,218	57,211
Equity	18,737	53,903	118,543	142,543	142,543	142,543
Retained Earnings	(15,512)	(38,798)	(87,946)	(134,183)	(175,117)	(128,791)
Shareholders' Equity	3,224	15,106	30,598	8,360	-32,574	13,753
Long-term debt &	36	401	401	401	401	401
Non-current liabilities	36	401	401	401	401	401
Short-term debt	39	15	15	15	15	15
Trade Creditors	1,228	3,047	500	236	8,939	43,042
Current liabilities	1,267	3,062	515	251	8,954	43,057
TOTAL LIABILITIES	4,527	18,569	31,514	9,013	-23,218	57,211

Source: Company, Astaire Securities estimates

Phorm: Cashflow Estimates

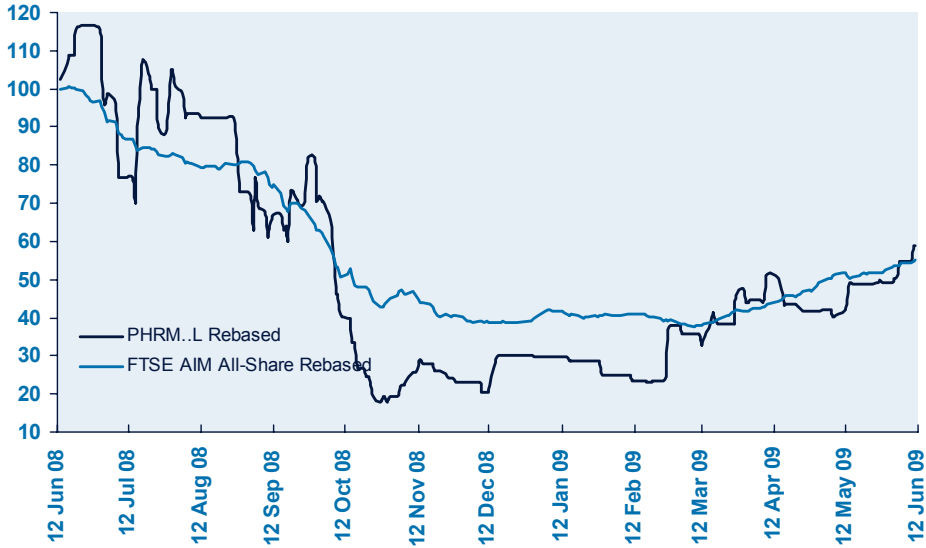
Year to Dec (US\$'000)	2006	2007	2008E	2009E	2010E	2011E
EBIT	(11,601)	(32,829)	(50,140)	(47,529)	(41,372)	66,601
Depreciation	226	202	(8)	17	204	1,169
Amortisation	0	0	0	0	0	0
Change in working	1,552	1,544	(29)	(568)	(3,059)	(14,769)
Cashflow from	(9,823)	(31,083)	(50,177)	(48,080)	(44,227)	53,001
Interest paid	66	680	992	1,291	437	(2,258)
Tax Paid	(13)	(4)	0	0	0	(18,016)
Dividends	0	0	0	0	0	0
Capex	(175)	(722)	(100)	(32)	(1,139)	(5,113)
Investments &	0	0	0	0	0	0
Cashflow from	(8,411)	(22,262)	(49,285)	(46,821)	(44,928)	27,613
New equity	11,690	0	64,640	24,000	0	0
Increase in (debt)/cash	3,279	(22,262)	15,355	(22,821)	(44,928)	27,613

Source: Company, Astaire Securities estimates

Recommendation Tracker

PHRM.L	Rec	Price at Rec. (p)	Price at close (p) 15 Jun 2009	% Change in Price	Target Price (p)	Target Price Date
15 June 2009	BUY	548	548	---	2000	June 2010

Share Price Performance – PHRM.L UK FTSE All-Share (rebased)



Source: Proquote International

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