

To our shareholders



Our Executive Chairman Doug Wilson uses this informal update as a forum to put recent news and events in context for shareholders in a consolidated newsletter.

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Dear Shareholder

We recognise the importance of keeping our shareholders updated on a regular basis, particularly when the markets remain volatile. We are also well aware that the guidance provided to shareholders in our last newsletter was to anticipate the announcement of new partnerships prior to the end of the financial year. We have fallen behind our expected time lines for signing new deals, but I want to assure our shareholders that we are still making solid progress and remain confident in the achievement of our previously stated goals of advancement of our existing relationships and signing new partnerships to drive revenue growth, albeit on a slightly extended time line. I am pleased to report that we now have four sets of discussions with new prospective partners that have advanced to the stage of contractual or term-sheet negotiations.

PARTNERSHIP ACTIVITIES HAVE NEVER BEEN BUSIER

More deal opportunities than ever before

The resilience of the Phylogica team in a challenging environment has been commendable. Recent specialist international meetings have shown that Phylogica's unique Phylomer libraries of prototype drugs are more in demand than ever before as one potential lifeline for Pharma companies seeking to carve out fresh approaches to drug discovery against challenging targets.

There is considerable interest in the field of drug targeting to the intracellular space, where Phylomers are being considered as a unique approach for delivering other biological payloads across the cell membrane into cells. To date, it has proved challenging for the Pharma industry to get biological payloads into the intracellular space, where the majority of candidate therapeutic targets reside, most of which have proved intractable with both biological approaches or with conventional 'small molecule' drugs.

In June 2012, the management team attended the industry's largest annual partnering event, hosted this year in Boston in the USA. At this International Convention, organised by the US Biotechnology Industry Organisation (BIO), with over 16,000 attendees, Phylogica had 30 meetings with prospective partners. Most of these meetings were with large Pharma or large biotech whose interest level in Phylogica has increased dramatically over the past 12 months.

In addition to the BIO International Convention, the executive team has had extensive international exposure over the last quarter, including podium presentation slots at three of the most prestigious specialist biotherapeutics discovery conferences. These were as follows:

- **Cambridge Heath Institute, Protein Engineering Summit (PEGS)** in Boston (30 April - 4 May 2012): This is the leading protein-engineering meeting with over 1,200 participants from the biotech and Pharma industries.
- **IBC Life Sciences OligonucleoTIDE and PepTIDE (TIDES), Research, Technology and Development Conference** in Las Vegas (20-23 May 2012): This is another leading meeting, which focuses on cutting-edge oligonucleotide and peptide drug discovery. There were over 800 industry

attendees with access to the Phylogica presentation.

- **IBC Life Sciences Next Generation Protein Therapeutics Summit** in San Francisco (25-27 June 2012): This leading specialist meeting focuses on antibody alternatives and was attended by over 300 delegates this year. At this meeting, our CEO, Paul Watt, gave an oral presentation on using Phylomers to access intractable targets inside of cells. He also chaired three other sessions, including a panel discussion, which included Richard Hopkins, Phylogica's VP Research on the discovery of new cell-penetrating peptides.

Several new prospective partners at these events approached Phylogica, and some of these discussions are moving rapidly towards alliances, covering a broad range of Phylomer applications.

PHARMA INDUSTRY REORGANISATIONS

Impacting the pace of biotech-Pharma partnerships

Rapid changes to the pharmaceutical industry in recent months have been slowing the pace of closing contracts for all biotech companies, not just for Phylogica. Within the drug industry there have been recent major restructurings, layoffs and retrenchments.

In some Pharma companies, the losses of professional personnel have reached thousands. Several of these retrenchments have affected companies with whom Phylogica has existing partnerships. For example, AstraZeneca, the parent of MedImmune, announced in April 2012 the departure of their CEO and their Chairman in quick succession along with reductions in R&D staff. In addition, Roche has recently announced the intended closure of their long-standing US R&D site at Nutley, New Jersey, with the loss of close to 1,000 jobs. Last year, another of our partners, Pfizer, announced the closure of their UK R&D site in Sandwich, Kent.

This situation provides Phylogica with longer-term opportunities

The opportunities arise because, as Pharma companies continue to reduce their internal drug discovery capabilities, they will increasingly look outside for fresh ideas and partnerships with biotech companies that are leaders in their respective fields, as is the case for Phylogica in the area of peptide drug discovery.

PHYLOGICA IS NOT IMMUNE TO INDUSTRY DYNAMICS

Prolonged deal discussions have extended our time lines

The reason that our deal discussions have taken longer than expected to reach fruition in the first half of this calendar

year is not that our Phylomer platform is any less attractive to prospective partners or that our partnering activities have slowed. On the contrary, as outlined above, the management team has never been busier in terms of the number of ongoing partnership discussions.

The sole reason for the delay is that our advanced deal opportunities have been prolonged due to reorganisations implemented by the respective Pharma companies. These internal preoccupations of our prospective partners arose after we had set out guidance earlier in the year and, naturally, were not anticipated at that time, either by Phylogica or the specific individuals with whom we are negotiating.

Fortunately, all of these prospective partners are still in dialogue with us and we are now in a position to finalise our most advanced deal negotiations.

BIOLOGICAL DRUGS ARE LEADING THE WAY

Phylomers are well positioned in the evolving drug market

Another reason to remain optimistic about the changing dynamics within the industry is that the market growth for biological drugs, which is Phylogica's arena, continues to outpace traditional pharmaceuticals.

DataMonitor, an independent industry analysis group, has estimated the sales trajectory of all major drugs and concluded that seven of the top-ten selling drugs over the next few years will be biologicals. The same analysts estimate compound annual sales growth across the major pharmaceutical companies of only 0.7% out to 2016 compared with 7.6% from 2004 to 2010, a profound down turn. This highlights the need for Pharma companies to bolster their R&D activities through external innovation.

SECURE FINANCIAL POSITION

Significant deal income anticipated

We issued our Appendix 4C for the quarter ending 30 June 2012 on 10 July 2012. The reported cash income for the fourth quarter was \$0.5 million and for the full year, we received \$1.7 million. We acknowledge that this income figure is below our previous FY2012 revenue guidance, but this can be understood in the context of a timing issue. We had anticipated signing two new discovery alliances in the fourth quarter, but in both cases the timing of closing these deals has been extended, for reasons that were unexpected at the time of giving our guidance.

Importantly, our financial position remains secure. We reported a net cash position as at 30 June 2012 of \$2.8 million, which should support ongoing operational activities until our revenue streams accelerate from progress on existing deals and from finalising negotiations with new partners.

BENEFITTING FROM THE NEW R&D TAX CREDIT LEGISLATION

Significant cash rebate anticipated

In addition to anticipated deal income, Phylogica is well positioned to benefit significantly from the new R&D Tax Credit legislation, which takes effect from 1 July 2011 being for financial years ending on or after 30 June 2012. The intention of the bill is to give a boost to small innovative, research-orientated companies, such as Phylogica.

Under the previous R&D Tax Concession legislation, eligible entities were entitled to a tax deduction on a company's taxable income based on R&D expenditure. However, such a concession was only beneficial to companies that had a sizable tax debt and, hence, was of no immediate benefit to Phylogica during our loss-making phase. Whilst the previous program did offer a sizable refundable component for companies making a loss, Phylogica was unable to access this refund based on the eligibility criteria at the time.

The new R&D Tax Credit legislation offers a tangible near-term benefit to Phylogica. Under the legislation, we can claim a tax credit and receive a refund from the government for up to 45 per cent of our eligible R&D spend. We are working with the R&D specialists at PwC to prepare our application for an R&D tax credit and we anticipate claiming a cash refund of up to \$2 million for the 2012 financial year. We aim to submit our application to the ATO within a couple months, potentially leading to receipt of a cash rebate before the end of this calendar year.

PROGRESS WITH PFIZER VACCINE COLLABORATION

First step towards exercise of commercial licence

At the end of May 2012, we announced the achievement of a significant research milestone in our Collaboration and License agreement with Pfizer to discover novel peptide-based vaccines. This milestone followed the successful completion of the first stage of the collaboration, which was announced in December 2010. Under the terms of the agreement, the recent milestone achievement triggered an undisclosed financial payment, which was received in July 2012.

We are particularly excited to have reached this research milestone in our collaboration with Pfizer because it represents the first step towards our partner potentially exercising its option to a commercial licence within the coming months. Our Phylomer platform has unique capabilities to identify candidate antigens for therapeutic vaccines and we have identified multiple novel Phylomers that meet the criteria required for further evaluation by Pfizer. Hence, we are looking forward to the outcome of Pfizer's ongoing evaluation

of these Phylomers and hopefully advancing a candidate towards development.

RESEARCH ACTIVITIES UNDERWAY WITH JANSSEN

First multi-product partnership

Our research activities with Janssen Biotech are well underway and have progressed well since signing the partnership, which was announced on 3 January 2012. The start of research activities triggered an undisclosed payment to Phylogica, which was received in the final quarter of the 2012 financial year.

In the initial stage of our Janssen collaboration, Phylogica is responsible for identifying cell-penetrating Phylomer peptides for delivery to a specific cell type. In this collaboration, Janssen could develop multiple Phylomer-based drug candidates and may later expand the scope of the partnership to include additional cell-specific Phylomers for the development of further candidates.

We have established a strong relationship with our newest partner and are exploring opportunities to build on our existing alliance.



Phylogica CEO Dr Paul Watt at the Janssen booth at the 2012 BIO International Convention in Boston, Massachusetts.



Janssen deal validates Phylogica's unique cell-penetrating peptide discovery capabilities

Our Phylomer platform has unique capabilities to identify tissue-specific, cell-penetrating peptides that can carry biological cargoes into cells. Furthermore, we have already demonstrated that we can identify novel cell-penetrating peptides with exquisite cell specificity. Since Phylomers derive from bacterial and viral proteins, Phylogica is uniquely positioned to capture natural mechanisms, which have evolved in these microorganisms for cell uptake. We have multiple discussions with other prospective Pharma companies that are interested in alliances to discover cell-penetrating Phylomers for specific cell types, particularly for crossing the blood-brain barrier.

We are pleased with the initial progress of our research activities with our newest partner, Janssen, to discover novel therapies that can access the intracellular landscape. Since the vast majority of known therapeutic targets reside within cells, but have generally proved inaccessible to drugs, our collaboration with Janssen could lead to new treatment approaches for some of the world's major unmet medical needs.

The first research payment from our partner, Janssen, is disclosed in our Appendix 4C for the fourth quarter. As I'm sure our shareholders understand, for commercial reasons, we must maintain confidentiality on the financial aspects of our Janssen agreement. However, what we can say is that the terms are commensurate with other multi-product drug discovery deals of this size and scope. We look forward to announcing further news from this collaboration as the program progresses.

SUMMARY

We have added several new Pharma leads to our list of prospective partners and advanced on numerous fronts since our previous newsletter in March 2012. While we have not finalised any new deals in recent months, the reasons as described above have been outside of our control.

Our ongoing deal discussions include some broad-ranging collaborations, which in some cases are associated with substantially larger deal economics than we have achieved in our deals to date. Coupled with the potential for our existing partnerships to reach key value inflection points over the next six months, we expect to have some exciting potential news flow to look forward to.

The Company is now a firmly recognised entity in the international world of peptide drug discovery. In addition, there is increasing interest from international specialist biotech investors in the Phylogica story. The management team has been on four investor road shows in Europe and the USA already this year. Some of these overseas funds have undertaken detailed due diligence on the Company and have indicated an interest in investing, which we hope will translate to increased on-market buying of our stock.

In summary, I would like to thank our loyal shareholders for their continued support. I believe that Phylogica is well positioned for a re-rating of its share price over the coming months as we ultimately deliver on our stated goals.

Please register for electronic communication by emailing your name to farzanak@phylogica.com with REGISTER in the subject line.

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