

Xoma, Ltd.

(XOMA-NSDQ)

Current Recommendation

Prior Recommendation

Date of Last Change

Buy

Hold

05/12/2005

Current Price (10/24/06)

\$1.97

Six- Month Target Price

\$4.00

OUTLOOK

Xoma, Ltd. is a biopharmaceutical company that develops products to treat infectious diseases, immunological and inflammatory disorders, and cancer. The company's receives royalties on worldwide sales of psoriasis drug Raptiva, as well as provides contract manufacturnig and licensing services related to its bacterial cell expression and human engineering technology. Xoma also possesses an interesting early-stage pipeline and collaborative research efforts. We look forward to several positive catalysts the remainder of 2006 to help drive the shares higher. We see fair value at \$4.00.

ZACKS SMALL-CAP FOCUS IDEA

SUMMARY DATA

52-Week High	\$2.29
52-Week Low	\$1.46
One-Year Return (%)	19.08
Beta	1.37
Average Daily Volume (sh)	647,645

Shares Outstanding (mil)	97
Market Capitalization (\$mil)	\$201
Short Interest Ratio (days)	5.39
Institutional Ownership (%)	25
Insider Ownership (%)	3

Annual Cash Dividend	\$0.00
Dividend Yield (%)	0.00

5-Yr. Historical Growth Rates	
Sales (%)	6.7
Earnings Per Share (%)	N/A
Dividend (%)	N/A

P/E using TTM EPS	N/A
P/E using 2006 Estimate	N/A
P/E using 2007 Estimate	N/A

Zacks Rank	2
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Risk Level

Above Avg.

Type of Stock

Small-Growth

Industry

Med-Biomed/Gene

Zacks Rank in Industry

15 of 155

ZACKS ESTIMATES

Revenue

(In millions of \$)

	Q1	Q2	Q3	Q4	Year
	(Mar)	(Jun)	(Sep)	(Dec)	(Dec)
2005	3.0 A	5.2 A	4.4 A	6.1 A	18.7 A
2006	5.6 A	7.5 A	10.0 E	11.1 E	34.2 E
2007					45.5 E
2008					53.3 E

Earnings per Share

(EPS is operating earnings before non-recurring items*)

	Q1	Q2	Q3	Q4	Year
	(Mar)	(Jun)	(Sep)	(Dec)	(Dec)
2005	\$0.28 A	-\$0.10 A	-\$0.10 A	-\$0.04 A	\$0.03 A
2006	-\$0.23 A	-\$0.06 A	-\$0.06 E	-\$0.05 E	-\$0.40 E
2007					-\$0.21 E
2008					-\$0.14 E

* Q1-2005 includes \$41 million gain on loan forgiveness.

* Q1-2006 includes \$8 million one-time charge for debt re-valuation.

Zacks Projected EPS Growth Rate - Next 4 Years %	N/A
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KEY POINTS

- Raptiva continues to provide meaningful royalty revenue to Xoma. Growth outside the U.S. is strong and should help drive royalties higher over the next several years. Now that Genentech's Lucentis is on the market, Xoma has begun receiving royalty on that product as well. We expect another royalty product, UCB's Cimzia, to gain approval late 2006 or early 2007, bringing the total royalty product suite to three.
- Xoma exited the second quarter 2006 with \$34.9 million in cash and investments. We believe this is enough to fund operations through 2007. Our financial model predicts that Xoma will become cash flow positive toward the beginning of 2009.
- We are pleased to see development programs outside Raptiva, for example the antibody therapeutic program with Novartis and the collaboration with Lexicon Genetics, progressing along. We believe the market is applying very little value to these programs. Although Xoma's pipeline is still very early-stage, it should help contribute to positive momentum the next several quarters.
- In late July 2006 Xoma was awarded a second exclusive \$16 million contract from the National Institute of Allergy and Infectious Disease (NIAID). This contract follows the first 18-month, \$15 million development and manufacturing contract signed last year. Both contracts will focus on the production monoclonal antibodies for the treatment of botulism to protect U.S. citizens against the harmful effects of botulinum neurotoxins used in bioterrorism. Xoma has begun to focus more and more on winning government business by placing founder, Patrick J. Scannon M.D., Ph.D. in charge of government operations. This should open the door to additional contract business at Xoma.
- The company recently signed its first Human Engineering ("HE") technology licensing deal with privately held AVEO Pharmaceuticals. Xoma's HE technology offers upfront payments, development milestones, and potential royalties on sales of HE derived products. In late May 2006 Xoma formed a broad research collaboration agreement with Schering-Plough worth \$25 to \$75 million in upfront payments. We expect another high-profile collaboration with a large pharmaceutical company to be announced before year-end.
- With the shares trading below \$2.00, Xoma is a very volatile stock. However, valuation is attractive based on our 2006 total revenue forecast of \$33 million. We believe the shares are well supported in the \$1.60 range given the new profitability of the Raptiva alliance and the collaborations with Lexicon, Novartis, and Schering-Plough. Although highly speculative, Xoma may offer aggressive shareholders an impressive return. Our price target is \$4.00.

OVERVIEW



Xoma, Ltd. (XOMA) develops and manufactures – either on its own or in collaboration with its partners – antibody and protein-derived biopharmaceuticals for treating various diseases. Core focus for research and development are in the areas oncology, immunology and inflammatory disorders. The company's business strategy includes establishing alliances with pharmaceutical companies to facilitate and finance internally developed compounds or those of the partner company. The key proprietary and collaborative products include Raptiva for psoriasis (with Genentech), Neuprex for anti-infective and anti-inflammatory indications, a multiple antibody product development program with Novartis AG cancer treatment, and research collaborations with Schering-Plough. The company derives its revenue primarily from government contracts, collaborative agreements, royalty payments on sales of Raptiva and Lucentis, and technology licensing. The company recently received a second \$16 million contract from the National Institute of Allergy and Infectious Diseases (NIAID) to produce monoclonal antibodies that will help fight bioterrorism in July 2006. This is the second NIAID contract win following the \$15 million award in 2005. The government business offers a new opportunity of growth for the company. Xoma was founded in 1981 and went public on 1986. The company is based in Berkeley, CA and employs more than 230 people worldwide.

Xoma has several value drivers that we believe will all work to send the shares higher over the next few years. The company has extensive human antibody capabilities including both commercial and custom phage libraries, as well as humanization expertise and optimization technologies. Xoma also has a fully integrated development infrastructure with discovery through manufacturing capabilities in both mammalian and bacterial production. Xoma is well positioned to take advantage of the growing demand for monoclonal antibody solutions. Management is focused on creating value through a number of business operations such as contract manufacturing expertise, licensing of innovative technology, collaborating with larger partners, and internally developing its own product candidates. Licensing and collaborating with larger partners has allowed Xoma the opportunity to receive royalty on product sales for two drugs, Raptiva and Lucentis.

Royalties:

Raptiva (efalizumab) is a humanized therapeutic antibody designed to selectively and reversibly block the activation, reactivation and trafficking of T-cells that lead to the development of psoriasis. Raptiva received U.S. approval in October 2003 (September 2004 in the E.U.) for the treatment of chronic moderate-to-severe plaque psoriasis in adults. The drug can be self-administered via once-weekly subcutaneous injections by the patient at home. It is Xoma's first therapeutic candidate to achieve commercial status.

Raptiva has good sales potential given the very large psoriasis market. There are an estimated 4.5 million Americans with psoriasis – 1.5 million considered to have moderate-to-severe disease. Given the drug's convenient in home dosing, safety profile, and rapid onset of action it should gain a good niche position in the psoriasis market behind Amgen's Enbrel or Abbott's Humira. Raptiva is marketed by Genentech in the U.S. and by Serono in the international market. We estimate peak global sales of roughly \$250 million, although with an improved marketing effort by Genentech in the U.S., Raptiva could approach sales beyond that figure. In the second quarter of 2006, worldwide sales of Raptiva were \$39.2 million, comprised of \$22.3 million in U.S. sales at Genentech and \$16.9 million in international sales booked by Serono. Genentech reported U.S. sales in the third quarter were \$23 million. Based on previous quarterly financial information, we estimate the worldwide royalty on sales of Raptiva is 5 – 5.5%. International Raptiva sales offer the greatest opportunity to expand the Raptiva royalty line, as the product is now approved in roughly 50 countries outside the U.S.

Lucentis (ranibizumab) is an antibody fragment to Vascular Endothelial Growth Factor (VEGF), a protein that plays a role in angiogenesis (the formation of new blood vessels). Genentech received approval for Lucentis on June 30, 2006 for the treatment of neovascular (wet) age-related macular degeneration (AMD). FDA approval was based on data demonstrating nearly all patients (approximately 95%) treated with Lucentis (0.5 mg) maintained (defined as the loss of less than 15 letters in visual acuity) and up to 40 percent improved (defined as the gain of 15 letters or more in visual acuity) vision at one year, as measured on the Early Treatment of Diabetic Retinopathy (ETDRS) eye chart. On average, patients treated with experienced an improvement from baseline at both one and two years compared to a loss in vision with photodynamic therapy (PDT) or placebo. Up to 40% of patients treated with Lucentis achieved vision of 20/40 or better. Xoma receives a royalty on worldwide sales of Lucentis through its Bacterial Cell Expression (BCE) technology license. Lucentis sales were \$153 million in the third quarter of 2006. We estimate the royalty rate on sales of Lucentis is approximately 0.75%. Peak sales are \$750 million in our view.

Cimzia (certolizumab) is a PEGylated Fab' anti-TNF alpha antibody fragment in phase III trials for Crohn's disease (CD) and rheumatoid arthritis (RA) and UCB Pharma. UCB submitted requests for regulatory approval for Cimzia to the U.S. (in February 2006) and European (in April 2006) regulatory authorities for the treatment of Crohn's disease. Ongoing phase III studies are investigating the efficacy and tolerability in the treatment of rheumatoid arthritis. Xoma is set to receive a royalty on worldwide sales of Cimzia upon approval. We estimate the royalty rate on sales of Cimzia is approximately 1.0%. Peak sales are in the area of \$1 billion in our view.

Innovative Technology Licensing:

Future royalties on sales of Lucentis and Cimzia are the result of Xoma's licensing of its **Bacterial Cell Expression (BCE) technology**. BCE is an enabling technology used to develop and manufacture recombinant proteins expressed in *E. coli* for commercial purposes. Xoma's BCE allows for optimal production levels through tight gene expression control. Components of the platform include an expression vector, a companion plasmid, and a proprietary production strain. The benefits of BCE to licensing partners are tight gene expression control and high production of accurate and effective product.

To date, over 45 companies including Genentech, Merck, Wyeth, Eli Lilly, Sanofi-Aventis, and UCB have licensed this technology. BCE provides Xoma with upfront licensing fees and milestone payments, as well as a royalty on sales of BCE-developed product candidates. The royalty rate on BCE products varied between 0.5% and 3.0%. Xoma does not disclose the upfront fees or royalty rate on BCE products due to competitive reasons and negotiating leverage.

Management has begun licensing its **Human Engineering (HE)** Technology platform. HE technology is a patented, clinically validated humanization technology for modifying non-human antibodies to make them suitable for medical purposes in humans. It technology is distinct from other humanization techniques and is independent of CDR grafting. Xoma's technology is based on the conserved structure-function relationships among antibodies and defines which amino acid residues in a non-human antibody variable region are candidates for substitution. The result is a 93%-95% human antibody generated in approximately three months with preserved antigen binding, structure, and function. This process compares favorably to other similar humanization procedures at PDL Biopharma or Abgenix (now Amgen). We believe that HE licensing is more attractive than BCE licensing because along with the upfront milestone, Xoma has the opportunity to receive development work milestones and greater royalties on sales of HE-derived products.

In April 2006, privately held AVEO Pharmaceuticals was the first to license this technology. Xoma human engineered **AV-299**, a highly potent antagonist of hepatocyte growth factor / scatter factor (HGF/SF). HGF is frequently deregulated in cancer and is believed to play an important role in tumor growth, invasion and metastasis. Xoma will now create an AV-299 production cell line, conduct process and assay development, and initiate cGMP manufacturing activities in support of AVEO's IND filing and early clinical trials. AVEO will pay Xoma \$6 million as part of the agreement, and Xoma is in-turn responsible for production and manufacturing of AV-299. In October 2006 **Attenuon**, LLC became the second to announce an agreement for Xoma to utilize its HE technology to humanize a monoclonal antibody targeting the urokinase plasminogen activator (uPA) system for the treatment of cancer. The uPA system plays a central role in multiple pathways and processes related to tumor growth, metastasis, and angiogenesis (the growth of new blood vessels that feed tumors). As like AVEO, Attenuon will pay XOMA an up-front fee, development milestones, and royalties. We are excited about the potential for more HE deals because we believe the AVEO and Attenuon deals are highly profitable to Xoma. We expect the announcement of several more HE technology contracts over the near-term.

Through cross-licensing of its BCE technology to several biotechnology companies, Xoma has amassed the world's premier **Antibody Phage Display** program with seven distinct and proprietary libraries. The libraries are constructed by infecting bacteria with a virus (bacteriophage, or "phage") that is engineered to express antibody fragments. The phage replicates, and the antibody fragment is displayed on the bacteria wall surface. A large number – approximately 10 billion – of these fragments can be expressed in any one of the seven libraries, creating an enormous number of molecular targets ready for rapid screening. Xoma may use these targets to identify therapeutic antibodies with specific properties for *in vitro* testing. Access to the phage display library significantly enhances the preclinical research effort and shortens the time to IND filing for clinical evaluation. Xoma's phage display capabilities are a significant competitive advantage in our view.

Collaborative Research:

In May 2006 Xoma formed a broad research collaboration with **Schering-Plough**. The collaboration is intended to capitalize on Xoma's comprehensive antibody discovery, development and production technologies and expertise. Under the agreement, Schering-Plough will make up-front and milestone payments to Xoma, fund Xoma's R&D activities related to the agreement, and pay royalties to Xoma on sales of products resulting from the collaboration. Xoma has not disclosed the upfront milestone fees captured from this collaboration, just that the front-end load of the deal is between \$25 and \$75 million. This does not include potential back-end royalties on co-developed products. Using its extensive collection of phage display libraries and optimization technologies, Xoma will discover therapeutic antibodies against one or more targets selected by Schering-Plough. Xoma may also utilize its proprietary Human Engineering technology to humanize antibody candidates generated by hybridoma techniques.

In April 2005, Xoma and Chiron (now **Novartis**) initiated a phase I trial of HCD122 (formerly CHIR-12.12) in chronic lymphocytic leukemia (CLL). In October 2005, the companies initiated another similar phase I trial in multiple myeloma (MM). The candidate is being developed under the Therapeutic Antibody Program in collaboration with Novartis. Under a worldwide, exclusive, multiple product agreement announced in March of 2004, the companies are jointly researching and developing multiple antibody product candidates, sharing expenses and revenues, generally on a 70-30 basis, with Xoma's share being 30%. HCD122 is the first of these potential products to reach clinical stage development.

The candidate is a fully human antagonist antibody that targets the CD40 antigen. HCD122 binds to tumor cells that express CD40 and antagonizes (prevents) CD40 ligand-mediated growth and survival of malignant B cells. Based on preclinical data, HCD122 also induces antibody-dependent cellular cytotoxicity (ADCC) killing CD40 expressing tumor cells by immune effector cells. This dual mechanism of action makes HCD122 a drug candidate with potential for the treatment of B-cell malignancies such as leukemia, myeloma, and lymphoma. We hope to see preliminary data by the end of the year at the American Society of Hematology (ASH) meeting in December.

Xoma believes that HCD122 may also provide a clinical benefit in autoimmune diseases. With Chiron, research efforts were specifically focused on oncology. However, Novartis has research desires – and capabilities – far beyond oncology. We believe that Xoma and Novartis are in the process of re-negotiating their existing relationship from a cost and profit sharing (70-30 mix) to a more broad licensing and collaboration one that would include upfront payments and potential developmental milestones to Xoma. Xoma may also receive a royalty on worldwide sales of HCD122 upon commercialization.

We are excited about the possibilities for HCD122. Novartis probably has plans for a significant clinical program with the antibody including multiple oncology trials in leukemia, myeloma, and lymphoma, as well as autoimmune trials outside of oncology. A cost sharing model no longer makes sense for such a large program. We believe that Xoma would benefit greatly from Novartis taking over development of HCD122. The relationship would then move to a “profit now / profit later” type for Xoma. This announcement could come shortly.

In June 2005 Xoma and **Lexicon Genetics** announced a broad-based research collaboration in the area of metabolic disorders. The three-year collaboration combines Lexicon's biotherapeutics target discovery capabilities with Xoma's antibody generation platform. Lexicon will select targets from its Genome 5000 program in which Lexicon uses its gene “knockout technology” to determine the physiological functions of 5,000 potential drug targets. Xoma will generate and engineer antibody candidates for further development using its phage display libraries and Human Engineering technology. Xoma will also be principally responsible for manufacturing antibodies for clinical trials and commercialization, along with 35% of the costs. The companies have already selected an initial target, a secreted protein involved in metabolic functions such as weight gain in response to diet and insulin sensitivity. Antibodies to this target may be therapeutically useful in the treatment of obesity and Type-II diabetes. This apart, Lexicon has agreed to additionally provide two drug targets during the three-year collaboration period. Xoma will receive 35% of any profits should a collaborative product reach commercialization.

In September of 2004, XOMA and **Aphtron Corporation** announced a worldwide collaboration to develop treatments for gastrointestinal (GI) and other gastrin-sensitive cancers using anti-gastrin monoclonal antibodies. Gastrin is a circulating peptide hormone responsible for stimulation of gastric acid secretion. In addition, it acts as a potent growth factor promoting the growth of normal gastric mucosa as well as a variety of GI cancers (gastric, pancreatic, colorectal). Gastrin expression and the appearance of gastrin receptors have been associated with increasing malignant characteristics of GI tumors and with poorer prognostic outcomes. Specifically, gastrin is known to be involved in the progression of colorectal, stomach, liver and pancreatic cancers and inhibiting gastrin may inhibit such growth. XOMA and Aphtron were previously working together to develop therapeutic grade inhibitory Mabs to block the pathological functions of gastrin as a novel treatment for GI cancers in preclinical development. However, Aphtron has filed for bankruptcy in May 2006 and this program is currently on hold.

We recently met with management and had a discussion on the potential for additional licensing and collaborations. We believe there are several deals in the works, one of which could be with another large pharmaceutical partnership similar to the Schering-Plough deal. This would be a very positive development for Xoma.

Contact Services:

In March 2005, the company received a \$15 million / 18-month contract with the National Institute of Allergy and Infectious Disease (**NIAID**), a division of the National Institutes of Health, to develop three anti-botulinum neurotoxin monoclonal antibody vaccines as part of the war on bioterrorism. In July 2006 the NIAID awarded Xoma a second \$16 million / 36-month contract XOMA will create and produce an innovative injectable product comprised of three anti-type A-botulinum neurotoxin monoclonal antibodies to support entry into phase I safety human clinical trials. The NIAID contracts are 100% funded and should help expand Xoma's future development programs in this area. We believe that this manufacturing contract will open the door to additional contract development and manufacture work, either with the government or with pharmaceutical or biotechnology companies, in the future. Xoma has placed founder Patrick J. Scannon M.D., Ph.D. in charge of government operations.

The company has been working to expand manufacturing greatly over the past several quarters. All of the NIAID work is being handled in Xoma's pilot plant that contains two 500L bioreactors. In the second quarter 2006, a brand new cGMP full range facility containing three 2,750L bioreactors will be ready for operations. Management should be aggressive in pursuing new contract manufacturing agreements throughout the rest of 2006 to take advantage of the enormous capacity. This is evidenced by the recent expansion of the AVEO deal to now include production and manufacturing for pre-IND activities and early-stage clinical trials. We expect a significant ramp in contract service revenues over the next several quarters.

Internal R&D:

BPI/Neuprex is an injectable formulation of rBPI21, a modified recombinant fragment of BPI (bactericidal / permeability-increasing protein). BPI is a human host-defense protein made by PMN (polymorphonuclear) leukocytes - a type of white blood cell important in the body's defense against microbial infections. BPI kills gram-negative bacteria, enhances the activity of antibiotics, neutralizes gram-negative endotoxin and inhibits angiogenesis (blood vessel growth). More than 2000 patients have taken part in Neuprex clinical studies without any apparent safety concerns. Xoma's current strategy in the U.S. is to support Investigator Sponsored Trials (IST's) to gather additional clinical data in a variety of disease indications.

These data will provide the basis for a decision to continue development with Neuprex and advance into larger clinical studies. Outside the U.S., Neuprex was recently granted Orphan-Drug status by the EMEA in early September 2006. Xoma is evaluating the possibility of filing a Marketing Authorization Application (MAA) in Europe for approval in meningococemia under the EMEA's "exceptional circumstances" approval mechanism. This would be very exciting and could bring Xoma's first product to the market by 2008. The "exceptional circumstances" path to approval is a full approval with no marketing restriction or no conditional terms. The path is instituted when a large scale confirmatory trial is not feasible but previous data has demonstrated clinical relevant efficacy and safety. We believe the market has yet to factor in any product sales for Neuprex in the E.U. We think investors will start to realize the potential of this revenue line after the application has been filed. By 2010, Neuprex product sales could account for the biggest percent of Xoma's top-line.

There are currently two IST's ongoing with Neuprex, including one initiated in March 2006 at the Southwestern Medical Center in Dallas for severe burns. The first IST began in October 2003 for open heart surgery. Management expects another IST to initiate later this year in allogeneic hematopoietic stem cell transplant (HSCT). The outcome of this trial may open the possibility to Neuprex use in acute radiation syndrome, potentially funded by the government's bioterrorism bill.

Xoma's internally developed preclinical pipeline looks promising as well, with human-engineered **XOMA 052**. XOMA 052 is a proprietary monoclonal antibody being developed as an anti-inflammatory molecule that would be appropriate for use in a variety of auto-immune and inflammatory diseases. This candidate is a high-affinity binder to inflammatory targets. This could lead to clinical studies in osteoarthritis or rheumatoid arthritis in 2007. Management expects to file an Investigation New Drug (IND) application before year-end 2006.

XOMA 629 is a synthetic peptide compound derived from bactericidal/permeability-increasing protein (BPI), a human host-defense protein that is one of the body's early lines of defense against invading microorganisms. Xoma scientists evaluated antibacterial activity of XOMA 629 against *Propionibacterium acnes* and other skin flora in preclinical studies and found that the compound, in a proprietary formulation buffer, showed bactericidal activity against strains resistant to other antibiotics such as erythromycin or clindamycin. Xoma recently announced a successful reformulation of XOMA 629 in pre-clinical trials using a proprietary gel or cream. Management's goal is to initiate a phase I program in acne before year-end 2007.

INDUSTRY POSITION

We are excited about the potential that Xoma offers with its newly initiated Human Engineering Technology licensing. This is an excellent way to monetize some of the company's antibody technology advantage. Biologic drugs are quickly becoming some of the largest products in the pharmaceutical market with blockbusters such as Enbrel, Humira, Rituxan, and Avastin. Pharmaceutical companies are starting to spend more R&D dollars on developing antibody targets for diseases in inflammation and oncology indications. We believe this should play out well for Xoma given the recently expanded biologic manufacturing capacity, and its ability to capture upfront and development milestones on Human Engineering projects.

The company possesses a significant research competitive advantage with the Antibody Phage Display library. The ability to quickly create and analyze antibody fragments could dramatically speed the pre-clinical research effort and shorten the time to IND (investigational new drug) application. Xoma enables discovery and development through a more direct and focused effort opposed to large-cap pharma's shotgun approach. We think companies such as Schering-Plough and Novartis will benefit from this expertise, and more companies will seek to partner with Xoma in the future. Each collaboration Xoma signs moves the company closer to cash-flow positive.

Xoma reminds us of other antibody development companies such as PDL BioPharma, Abgenix, and Cambridge Antibody Technology (CAT) several years ago. We remind investors that both Abgenix and CAT have been acquired in 2006. Yet, Xoma's future is not tied closely with any one partner. The small-cap stature of Xoma should allow for the company to continue signing licensing and manufacturing deals throughout the year. Dr. Scannon has recently been promoted to Chief Biotechnology Officer and will lead the company's effort to win more government business either through the NIAID or other programs.

RECENT NEWS

October 3, 2006: XOMA Ltd. and Attenuon, LLC announced an agreement for XOMA to utilize its Human Engineering (HE) technology to humanize a monoclonal antibody targeting the urokinase plasminogen activator (uPA) system for the treatment of cancer. The uPA system plays a central role in multiple pathways and processes related to tumor growth, metastasis, and angiogenesis (the growth of new blood vessels that feed tumors). Attenuon will pay XOMA an up-front fee, development milestones, and royalties. Attenuon will retain all development and commercialization rights to the antibody. Additional financial terms were not disclosed.

October 2, 2006: XOMA Ltd. and Affimed Therapeutics AG announced that they have signed a cross-license and collaboration agreement for antibody-related technologies. The agreement provides XOMA with a license under Affimed's antibody library patents for antibody discovery purposes, as well as for the development and commercialization of antibodies. In addition, Affimed has agreed to build two customized patient-derived human antibody phage display libraries according to XOMA specifications. The agreement provides Affimed with a license to use XOMA's Bacterial Cell Expression (BCE) technology for research purposes, with an option to acquire a BCE license for production and commercialization of antibodies, in particular for Affimed's proprietary TandAb and Flexibody technologies. XOMA also has agreed to provide Affimed with cell line development and process development services specific to a TandAb therapeutic product candidate that Affimed is currently developing.

September 28, 2006: XOMA Ltd. and AVEO Pharmaceuticals, Inc. (AVEO) announced a \$6 million agreement under which XOMA will manufacture and supply AV-299, AVEO's novel anti-HGF antibody, in support of early clinical trials. The companies also announced that XOMA has successfully completed the Human Engineering (HE) of AV-299.

September 7, 2006: XOMA Ltd. announced successful results with a research formulation of XOMA 629 (formerly XMP.629). XOMA has initiated a development program with the goal of reentering clinical trials of the topically-applied reformulated drug in mild to moderate acne in 2007. XOMA 629 is a novel synthetic peptide compound derived from bactericidal/permeability-increasing protein (BPI) -- a human host-defense protein that is part of the body's early lines of defense against invading microorganisms. In preclinical studies, XOMA 629 has shown potent anti-bacterial activity against *P. acnes*, believed to be the major causative agent in acne. XOMA 629 also has shown similar activity against antibiotic-resistant strains of *P. acnes*, including strains resistant to other antibiotics such as erythromycin or clindamycin.

September 6, 2006: XOMA Ltd. announced that the European Commission has granted an orphan medicinal product designation to NEUPREX (opebacan) in meningococcal disease, a potentially life-threatening bacterial infection predominantly affecting young children. Xoma is currently completing the regulatory assessment for NEUPREX under the European Medicines Agency's (EMA) exceptional circumstances mechanism and plans to base its application on existing phase III clinical trial data for NEUPREX.

Source: Xoma, Ltd.

VALUATION

We upgraded our recommendation on Xoma to a Buy in May 2005 shortly after the restructuring of the Genentech deal on Raptiva. We believe this transaction was a positive event given that Raptiva is now profitable for Xoma and Genentech forgave a \$41 million loan to the company. This now allows Xoma to focus on technology licensing, contract manufacturing, and its own internal pipeline.

The recent NIAID contract win and the progressing collaborations with Lexicon, Novartis, and Schering-Plough are all helping to drive value forward at Xoma. Finally, Xoma's internally developed pipeline is also moving forward with an IND on XOMA 052 expected before year end. We have increased our 2006 through 2010 total revenues given the increased licensing and the expected royalties on Lucentis and Cimzia. We have also increased our 2009 and 2010 figures based on the launch of Neuprex in the E.U. We are also optimistic on the company's ability to sign licensing collaborations with the HE technology – see the recent deal with Aveo and Attenuon.

There has been little improvement in the overall debt position given the replacement of \$41 million debt with the new \$65 million convertible debt. There has been some convert of the debt already so the total of \$59.5 at the end of the second quarter is lower than the original balance. However, this debt is being converted into equity so shareholder dilution is a concern. That said, the company's cash position has definitely improved, and the convertible debt is not due until 2012. Management will be aggressively converting the debt into equity at the allowable rate over the next several years. The interest is payable at 6.5%.

We believe future royalty payments on Raptiva, Lucentis and Cimzia are worth roughly \$2.00/share based on projected discounted flow analysis. Currently investors are assigning little value to Xoma's collaborations and internal research efforts. If investors assign any value to ongoing programs such as the NIAID grants, the HCD122 antibody program, the BPI/Neuprex product, the Lexicon deal, and the potential for royalties on Lucentis and Cimzia, then Xoma should be an excellent play at this level. Longer term we are excited about the ability of the company to continue to sign up manufacturing contracts and Human Engineering technology licenses. We think another big collaboration similar to the Schering-Plough deal is coming shortly.

The company has one of the more diverse revenue streams in small-cap biotech. In five years a number of products could be paying royalties to Xoma. This should help fund development of the internal pipeline.

Industry Comparables – Top competitors

	P/E (2006 E)	EPS Gr. 4-Yr Est.	Price / Sales
Xoma Ltd.	N/A	N/A	5.1x
Biotech Mean	28.3x	22%	9.7x
S&P 500	16.4x	6%	3.0x
Medarex, Inc.	N/A	N/A	25.5x
PDL BioPharma	45.3x	40%	11.4x
Cambridge Antibody	N/A	N/A	N/A

MANAGEMENT PROFILE

John L. (Jack) Castello became Chairman of the Board, President and Chief Executive Officer in March of 1993. From April of 1992 to March of 1993, Mr. Castello was President, Chief Executive Officer and a director. Mr. Castello was President and Chief Operating Officer of the Ares Serono Group from 1988 to 1991 and prior to that was President of the Serono Diagnostics Division from 1986 to 1988. Mr. Castello previously held senior management positions at Amersham International PLC and Abbott Laboratories. Mr. Castello is also a director of Cholestech Corporation, which is engaged in the business of developing products for the diagnostic measurement of cholesterol and other blood components.

Patrick J. Scannon, M.D., Ph.D. is Xoma's Company Founder, Executive Vice President, Chief Biotechnology Officer, and a member of the Board of Directors. Since 1980, Dr. Scannon has directed the Company's product identification, evaluation, and clinical testing programs. As Chief Biotechnology Officer, he heads the clinical and preclinical research programs, evaluating several classes of biologic compounds, and conducting clinical studies for infectious, oncologic, and immunologic indications. Dr. Scannon holds a Ph.D. in organic chemistry from the University of California, Berkeley and a medical degree from the Medical College of Georgia. He completed his medical internship and residency at the Letterman Army Medical Center in San Francisco.

J. David Boyle II was appointed Vice President, Finance and Chief Financial Officer in July 2005 after joining Xoma in January 2005 as Vice President, Financial Operations. From 2002 to 2005 he was with Polycom, Inc., a worldwide high technology communications company, most recently as its Vice President of Finance. From 1996 to 1999, he was Executive Vice President and Chief Financial Officer at Salix Pharmaceuticals, Ltd. Mr. Boyle holds a bachelor of arts degree from Catholic University.

Robert H. Gundel, Ph.D. was appointed Vice President, Scientific Corporate Development in November 2005 after joining Xoma in 2002 as Vice President, Preclinical Research. In his new role, Dr. Gundel will provide corporate leadership to key areas of Xoma's business, including corporate messaging, business development and specialized projects. Dr. Gundel joined Xoma from Emeryville, CA-based Chiron Corporation where he served as Vice President of Pharmacology and Preclinical Research from 2000 to 2002. Dr. Gundel holds a Ph.D. and M.S. degree in Physiology from New York Medical College and a BA degree in Biology from S.U.N.Y. Purchase.

Mary Haak-Frendscho, Ph.D. is Vice President, Preclinical Research and Development. She joined the company in 2003 as Senior Director, Cell & Analytical Biology. In addition to directing the antibody discovery and preclinical development of Xoma's drug candidates, Dr. Haak-Frendscho has primary responsibility for leadership of the Antibody Platform enhancement effort. Prior to joining Xoma, she held positions of increasing responsibility at Abgenix, Quantum Dot Corporation, and Promega Corporation. Dr. Haak-Frendscho received her Ph.D. in Immunology from the University of Wisconsin-Madison, M.A. in Immunology from SUNY-Stony Brook, M.L.A. in Liberal Arts from Washington University in St. Louis, and B.S. in Biology from the University of Michigan, Ann Arbor.

INSIDER TRADING AND OWNERSHIP

Institutional owners control 25% of the shares outstanding. The largest reported holders of XOMA Ltd. shares, as of the end of the quarter, were Smith Barney Asset Management, Primecap Mgmt Co., Orbimed Advisors, and Barclay Global Investors, all of which hold over 2% of the total shares outstanding. Insiders control 3% of the total shares outstanding.

PROJECTED FINANCIALS

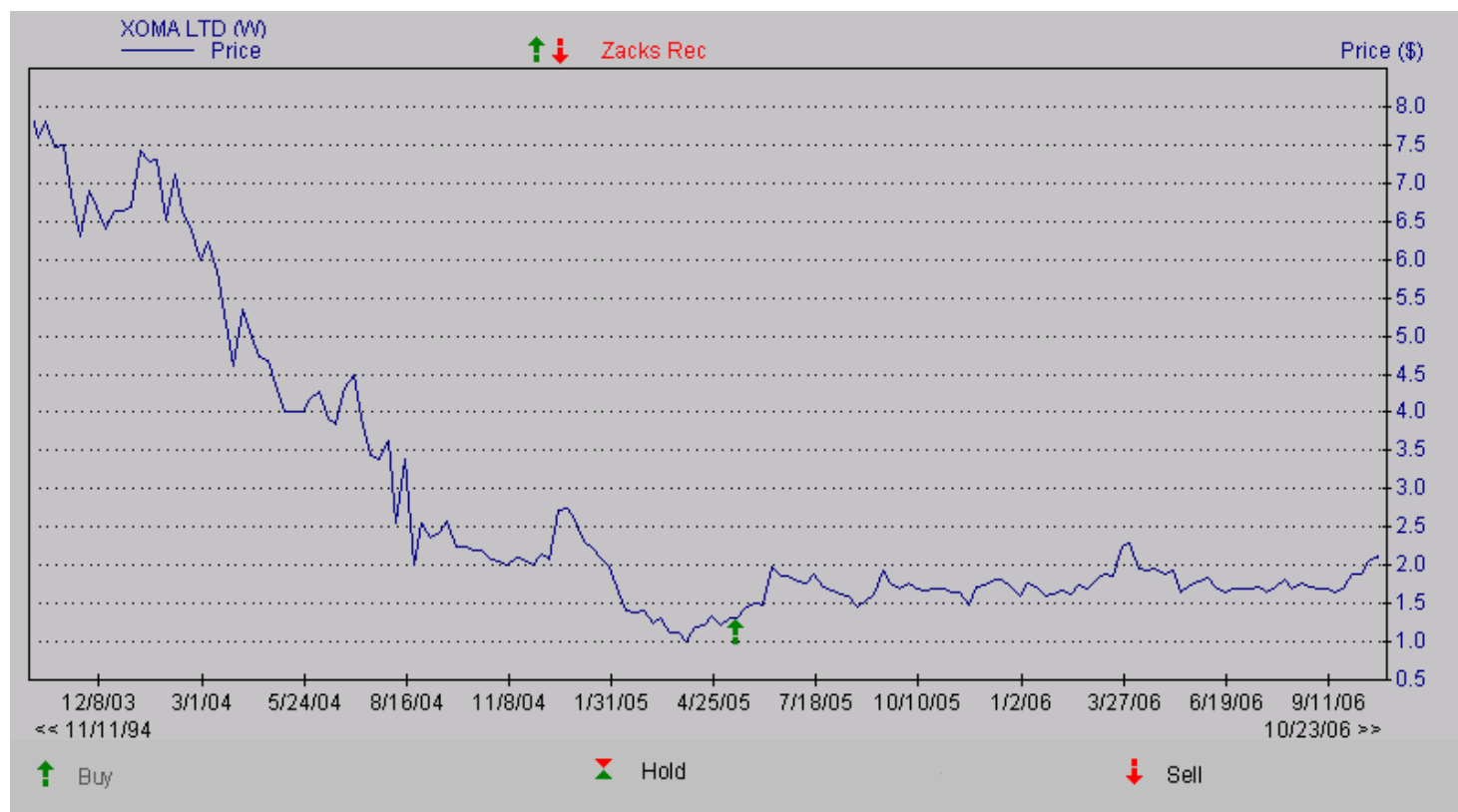
Xoma Ltd Income Statement

	2005 A	Q1 A	Q2 A	Q3 E	Q4 E	2006 E	2007 E	2008 E	2009 E	2010 E
Contracts Services	\$7.4	\$3.1	\$4.7	\$5.8	\$6.7	\$20.3	\$23.5	\$24.0	\$24.5	\$25.0
YoY Growth	-	145.8%	401.7%	212.2%	100.5%	174.3%	15.9%	2.1%	2.1%	2.0%
Licensing & Collaborative	\$5.1	\$0.7	\$0.7	\$1.0	\$1.2	\$3.6	\$7.5	\$11.5	\$16.5	\$22.0
YoY Growth	-	24.6%	-72.5%	16.8%	17.1%	-29.2%	109.2%	53.3%	43.5%	33.3%
Total Royalties	\$6.2	\$1.9	\$2.1	\$3.2	\$3.2	\$10.4	\$14.5	\$17.8	\$21.1	\$24.0
YoY Growth	-	53.4%	33.8%	89.5%	87.5%	67.9%	39.1%	22.7%	18.4%	13.6%
Neuprex (E.U. sales)	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$15.0	\$35.0
YoY Growth	-	-	-	-	-	-	-	-	-	133.3%
Total Revenues	\$18.7	\$5.6	\$7.5	\$10.0	\$11.1	\$34.3	\$45.5	\$53.3	\$77.1	\$106.0
YoY Growth	-	87.2%	45.6%	126.9%	82.8%	83.7%	32.7%	17.1%	44.6%	37.4%
Cost of Goods Sold	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$2.1	\$4.6
Gross Income	\$18.7	\$5.6	\$7.5	\$10.0	\$11.1	\$34.3	\$45.5	\$53.3	\$75.0	\$101.4
Gross Margin	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	97.3%	95.7%
SG&A	\$14.8	\$5.1	\$4.4	\$4.4	\$4.4	\$18.2	\$18.0	\$18.6	\$19.8	\$21.3
% SG&A	79.3%	90.2%	58.4%	43.8%	39.5%	53.2%	39.5%	34.9%	25.7%	20.1%
R&D	\$39.9	\$12.2	\$12.1	\$12.0	\$12.1	\$48.4	\$49.5	\$50.5	\$51.5	\$52.5
% R&D	213.7%	217.4%	161.1%	119.5%	108.7%	141.1%	108.8%	94.7%	66.8%	49.5%
Operating Income	(\$36.0)	(\$11.6)	(\$9.0)	(\$6.4)	(\$5.4)	(\$32.3)	(\$22.0)	(\$15.8)	\$3.7	\$27.6
Operating Margin	-193.0%	-207.5%	-119.5%	-63.3%	-48.2%	-94.3%	-48.3%	-29.6%	4.8%	26.1%
Interest & Other Income	\$38.8	(\$9.0)	\$3.1	\$0.4	\$0.3	(\$5.2)	\$1.2	\$1.1	\$1.3	\$1.6
Pre-Tax Income	\$2.8	(\$20.6)	(\$5.9)	(\$6.0)	(\$5.1)	(\$37.5)	(\$20.8)	(\$14.7)	\$5.0	\$29.2
Taxes	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Tax Rate	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Net Income	\$2.8	(\$20.6)	(\$5.9)	(\$6.0)	(\$5.1)	(\$37.5)	(\$20.8)	(\$14.7)	\$5.0	\$29.2
YoY Growth	-	-168.5%	-31.1%	-33.8%	-47.9%	-1450.9%	-44.6%	-29.4%	-134.0%	485.4%
Net Margin	14.9%	-367.6%	-78.7%	-59.3%	-45.5%	-109.5%	-45.7%	-27.5%	6.5%	27.6%
Reported EPS	\$0.03	(\$0.23)	(\$0.06)	(\$0.06)	(\$0.05)	(\$0.40)	(\$0.21)	(\$0.14)	\$0.05	\$0.27
YoY Growth	-	-184.5%	-38.5%	-41.0%	22.0%	-1385.4%	-47.4%	-31.3%	-133.0%	471.8%
FAS-123R	\$0.0	\$0.39	\$0.25	\$0.25	\$0.25	\$1.14	\$1.20	\$1.20	\$1.20	\$1.20
EPS Impact of FAS-123R	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.01	\$0.01	\$0.01	\$0.01	\$0.01
Fully Diluted Shares	90.1	87.9	96.7	96.9	97.1	94.7	99.6	102.4	105.3	107.8

Source: Zacks Investment Research, Inc.

Jason Napodano, CFA

HISTORICAL ZACKS RECOMMENDATIONS



DISCLOSURES

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