

XILLIX TECHNOLOGIES CORP.

(XLX, \$0.64, TSX)

Recommendation: Overweight; 12-Month Target: \$1.30

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March 2, 2005

All values in C\$ unless otherwise noted.

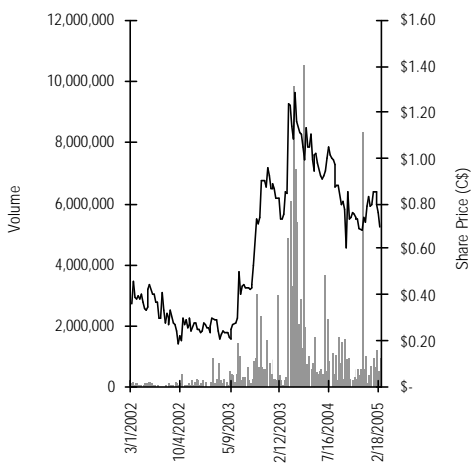
Closing Price:	\$0.64
Target Price:	\$1.30
Potential Return:	103%
12-Month High-Low:	\$1.19 - \$0.55
Previous Volume:	351,140
Shares O/S	
Basic:	126.9 million
F.D.:	148.8 million
Market Cap:	\$81.2 million
Float:	126.5 million
Float Value:	\$81.0 million
Full Report Issued:	September 10, 2004

What's Changed

	Previous	New
EPS (2004E)	(\$0.06)	Unchanged
EPS (2005E)	(\$0.04)	Unchanged
EPS (2006E)	\$0.00	Unchanged
Rating	Overweight	Unchanged
Target	\$1.50	\$1.30

Company Profile

Xillix Technologies is a medical device company focused on the development and commercialization of its lead product, Onco-LIFE, for the detection of cancer. The first indication for Onco-LIFE is in the detection of lung cancer; Xillix intends to follow this with approval for the GI cancer indication. Onco-LIFE is a fluorescence imaging system for use with fibre-optic endoscopes.

Xillix Technologies Corp. – Trading History**On Track but the Road Is Getting Bumpy; Q4 Preview and Update**

- **Q4 results will likely be a non-event.** We expect weak Q4 sales of Onco-LIFE in the E.U., but we believe that this is largely priced into the stock and the near-term FDA decision and subsequent U.S. launch will lead to a recovery in the stock.
- **FDA approval and clinical trial results will be the main catalysts for the stock.** The FDA decision on U.S. approval of Onco-LIFE Lung is expected by month-end. Data from the pilot GI and pivotal Lung trials are scheduled for Q2/05 and H2/05, respectively.
- **We are reducing our target to \$1.30 (from \$1.50), but we remain Overweight on the stock.** We increased our discount rate to 27% (from 22%) to reflect added risk of competition and expected technology shift in the GI endoscopy space. Our long-term view remains positive.

Financial Summary

YE Dec 31 (C\$000s)	2003A	2004E	2005E	2006E
Revenues	\$39	\$940	\$5,184	\$17,073
EBITDA	(\$9,604)	(\$8,782)	(\$6,257)	\$799
Earnings	(\$10,142)	(\$9,295)	(\$6,619)	\$628
Shares O/S FD (000s)	127,942	148,365	155,865	155,865
EPS FD	(\$0.08)	(\$0.06)	(\$0.04)	\$0.00
Cash & Equivalents	\$8,283	\$13,862	\$19,858	\$19,692
Cash/FD Share	\$0.06	\$0.09	\$0.13	\$0.13

Milestone Summary

Q1/05	FDA approval of Onco-LIFE PMA supplement.
Q1/05	North American launch of Onco-LIFE in lung cancer.
Q1/05	Initiation of Onco-LIFE clinical trial in GI cancer.
Q2/05	Pilot GI data at DDW (May 2005).
H2/05	Pivotal data from Lung trial.

Please see important disclaimers at the end of this report.

Summary & Investment Outlook

Xillix will report its Q4 and 2004 results later this week, but we do not believe these should be a big focus for investors since they are not likely indicative of future performance and are largely discounted at current levels. We are focusing on the upcoming FDA decision to approve the Onco-LIFE Lung PMA supplement (expected by month-end) as a key near-term catalyst for the stock. We have adjusted our model, increasing our discount rate for Xillix to 27% (from 22%) based on increased competition and an expected longer-term platform shift to disposable endoscopes in the GI space. Combined with rolling forward of our model by six months, we arrive at a reduced 12-month target of \$1.30 (previously \$1.50). We maintain our Overweight recommendation in the belief that Xillix will maintain its leadership position in fluorescence endoscopy. We view the GI application of Onco-LIFE as a big near-term value driver for the company and the stock, and we look forward to the release of pilot data (Q2/05) as an early indicator of its clinical potential.

Financial Forecasts

We are forecasting modest Onco-LIFE sales in the E.U. for Q4, but we believe that these results should not be a focus for investors. We are forecasting revenue of \$0.31 million for Q4 and \$0.94 million for 2004, with a projected quarterly loss of (\$0.01/sh) for Q4, and (\$0.06/sh) for the year. We continue to believe that initial E.U. sales reflected in these results are a poor indicator of Onco-LIFE's overall market potential. European sales of Onco-LIFE are likely to continue to be choppy and disappointing over the next few quarters, until after FDA approval in the U.S. (expected in Q1/05) and the release of pivotal clinical data from Onco-LIFE Lung in H2/05. In our view, the real focus is on the long-term potential of Onco-LIFE in both the Lung and GI indications and Xillix's technological leadership in fluorescent endoscopy.

GI Endoscopy Market Is Shifting

We believe that the GI endoscopy market is likely to shift towards a disposable endoscope platform. At a recent analyst meeting, Boston Scientific (BSX: NYSE) outlined its plan to move aggressively into the GI endoscopy market. Starting with colonoscopy, the BSX 'Endovations' program centres on single-use endoscopes with disposable digital video cameras. BSX expects to conduct clinical trials in late 2005, and launch the product after obtaining 510K approval in H2/06. We believe that so long as the optics of these devices prove to be of comparable quality with the current technology, the disposable endoscope has the potential to become a new standard of care. Their main advantage over multiple-use endoscopes will be higher patient throughput and the reduction in time and expense currently allocated to cleaning endoscopes between procedures. As a result, we expect that there will be a platform shift towards disposable systems, initially in the GI space where digital endoscopy is already becoming the standard of care. Faced with increased competition, current players in the field will likely seek to differentiate their product offerings with additional value-added features, such as autofluorescence.

In our view, Xillix is very well positioned to meet the challenges of the changing endoscopy landscape. The Onco-LIFE Lung product for bronchoscopy is not likely to be immediately affected, since digital video is not yet applicable to bronchoscopy (the reduction of endoscope diameter is currently limited by the size of the charge coupled device [CCD] camera chip). While we do not expect an immediate conversion to disposable endoscopes for GI, there will likely be a substantial shift over time, which would place the Xillix product in its current form (compatible with fiberoptic, but not white light digital video endoscopes) at a competitive disadvantage. We believe that the two recently awarded patents (described below) claiming basis for transferring autofluorescence to a digital platform are an indication that Xillix is in the lead to meet this challenge. To our knowledge, none of the endoscopy players currently have products with digital fluorescence capability in clinical development. However, Xillix is not alone in this space – at least one other company, Newton Laboratories, Inc. (private), has been granted a U.S. patent for imaging tissue autofluorescence through a video endoscope. Exhibit 1 describes a number of approved patents and patent applications in this area (for Xillix and its competitors) currently listed with the U.S. Patent and Trademark Office. Importantly, none of the big endoscopy players (Olympus, BSX, JNJ, Pentax, Fuji, or Conmed) appear to hold patents for this technology switch. **We believe that patent protection and other steps that Xillix appears to have taken towards developing a digital version of Onco-LIFE could make it an attractive acquisition target for one of these main endoscopy players, as they rush to differentiate and innovate under competitive pressure from BSX.**

Exhibit 1. A Selection of Patents Protecting Digital Fluorescence Endoscopy Technologies

Patent Number	Assignee	Title	Description
6,821,245	Xillix Technologies	Compact Fluorescence Endoscopy Video System	Protects a device with a compact camera that receives light from the image guide of an endoscope or directly from the tissue by virtue of being located in the insertion portion of the endoscope. It is capable of operating in multiple imaging modes to acquire colour or multichannel fluorescence and reflectance images.
Allowed	Xillix Technologies	Fluorescence Endoscopy Video Systems with No Moving Parts in the Camera	Suggest that Xillix may be on the path to developing a "chip on the tip" or digital design of its current fibre optic system.
Application	Xillix Technologies	Imaging System with Automatic Gain Control for Reflectance and Fluorescence Endoscopy	An imaging system for white light and fluorescence endoscopy that includes an automatic gain control circuit 30 that adjusts the brightness of an image produced based on distribution of pixel intensities in one or more video frames. The magnitude of the image signals produced by a pair of high sensitivity imaging devices such as intensified CCD transducers is compared with a number of reference thresholds.
Application	Xillix Technologies	Compact Fluorescent Endoscopy Video System	A fluorescence endoscopy video system includes a multimode light source that produces light for color and fluorescence imaging modes. Light from the light source is transmitted through an endoscope to the tissue under observation. The system also includes a compact camera for colour and fluorescence imaging.
6,364,829	Newton Laboratories	Autofluorescence Imaging System for Endoscopy	Describes a system and method for imaging tissue autofluorescence through a video endoscope, comprising a light source, an optical system, and a means for digitally acquiring the resulting, visible fluorescence images using a digital video camera at the distal tip of the endoscope. This system can either be added on to an existing video endoscope or integrated into its structure. The combined system can be electronically switched between normal white light imaging and fluorescence imaging.
Application	Newton Laboratories	Autofluorescence Imaging System for Endoscopy	A system and method for imaging tissue autofluorescence through a video endoscope is described.
Application	Korea Electrotechnology Research Institute	Fluorescence Endoscope Apparatus and Method for Imaging Tissue Within a Body Using the Same	Describes a system and method for imaging using a fluorescence endoscope, developed for diagnosing a tumor-inflamed region. The fluorescence light endoscope apparatus is comprised of an endoscope probe; a multiple light source that provides illumination light or excitation light of short wavelength onto a diagnostic region; a colour CCD camera and a high sensitive monochromatic CCD camera placed on the back of an endoscope ocular lens; a reference test sample; a computer; and a monitor.
Application	Massachusetts Institute of Technology	Fluorescence Imaging Endoscope	Describes a fluorescence imaging colonoscope using a dual channel electronic endoscope that employs a CCD chip or other solid state imaging device mounted on its distal tip to collect the white light image. Of particular significance for the present invention is that this chip can also collect the fluorescence image, displaying it on the endoscope's video monitor with much larger signal size than that obtained using the optics module and intensified CID camera.

Source: U.S. Patent and Trademark Office, Orion Securities

Valuation

We have adjusted our discount rate to reflect the higher expected level of competition in the GI endoscopy field. As outlined above, we believe that Xillix has already taken steps to prepare for transferring its autofluorescence capability onto a digital platform. This should help it compete in the new landscape; however, it adds an additional level of uncertainty about the adoption and long-term success of Onco-LIFE for GI. As a result, we have increased our discount rate to 27% (from 22%), leaving all other forecasts unchanged. Combined with a six-month rolling forward of our model, this results in our new 12-month target of \$1.30. **We maintain our Overweight rating for Xillix, focusing on its strong patent position, expected U.S. approval, and upcoming clinical data releases as main sources of upside for the stock and our view.**

Disclaimers

Orion Securities Inc. has acted as a financial agent for Xillix Technologies Corp. within the past two years.

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Industry Rating	Definition
Overweight	Analyst expects performance of their industry coverage universe to beat the TSX benchmark** over the next 12 to 18 months.
Equal Weight	Analyst expects performance of their industry coverage universe to be in line with TSX benchmark over the next 12 to 18 months.
Underweight	Analyst expects performance of their industry coverage universe to lag the TSX benchmark over the next 12 to 18 months.
Stock Rating	
Overweight	The stock's total return is expected to exceed the average total return of the analyst's (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12 to 18 months.
Equal Weight	The stock's total return is expected to be in line with the average total return of the analyst's (or industry team's) coverage universe on a risk-adjusted basis, over the next 12 to 18 months.
Underweight	The stock's total return is expected to be below the average total return of the analyst's (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12 to 18 months.
Speculative Rating	Analysts will use a speculative risk rating where the company faces unusually high business or financial risk.

Note: All ratings assume equal-weighted stocks in a portfolio.
TSX benchmark total return is assumed at annualized rate of 8% to 10%.