FINAL TRANSCRIPT

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MDZ - Q2 2008 MDS Inc. Earnings Conference Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen, welcome to the MDS second quarter results conference call.

I would like to turn the meeting over to Kim Lee, Director of Investor Relations. Please go ahead Ms. Lee.

Kim Lee - *MDS Inc. - Director of IR*

Thank you, good morning everyone, and thank you for joining us today. Our second quarter results were issued this morning along with our MD&A and financial statement. If you have not received a copy of the documents, they are posted on our web site at MDSInc.com. We are also webcasting this event live on our web site, where you will find a PowerPoint presentation highlighting the details of the call. The archive version will remain on our web site after the call today. Joining me this morning are Stephen DeFalco, President and CEO of MDS and Doug Prince, Executive Vice President of Finance and CFO. Stephen will begin the call with his perspective on the quarter, and Doug will follow with his comments on Q2 financials. Prior to our Q&A session, we will turn it back to Stephen for a few closing comments.

During the call, we will make forward-looking statements about MDS's business. These statements are not a guarantee of future performance and are subject to risks and uncertainties that could cause actual results to differ materially. Some of these risks

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are disclosed in the reports and other documents filed with the relevant Canadian and U.S. Securities Regulators and are available on our web site. Let me remind everyone that all financial data today is shown on a U.S. GAAP basis and in U.S. dollars unless otherwise indicated. In addition to standard GAAP measures, we make reference to select non-GAAP financial measures that we believe provide meaningful information to investors. Both GAAP and non-GAAP measures referenced here are used by management to assess the performance of the business and as a basis for management compensation.

To help our investors gain a clear understanding of our non-GAAP measures, such as net revenue, adjusted EBITDA and adjusted earnings per share, we provide detailed reconciliations between GAAP and non-GAAP measures in the MD&A of our April 30, 2008 interim financial report and our 2007 annual report, which are available on our web site.

With that, I'll turn it over to Stephen DeFalco.

Stephen DeFalco - *MDS Inc. - President - CEO*

Good morning, everyone, and thank you for joining us. Q2 was a challenging quarter for MDS, while we continue to make progress executing our strategy, we have seen some softening in demand for high-end instruments, particularly in the North American pharmaceutical market. We are also not yet seeing the benefits of Pharma Services repositioning flow to the bottom line. Although there are positive highlights, I am not satisfied with our overall progress this quarter, and am focused on accelerating our initiatives.

Now for the specifics. For the quarter, MDS reported net revenues of 326 million, up 24%, and adjusted EBITDA of 34 million, up 10% from last year. Customers continue to come back and are driving a positive trajectory of new business wins at MDS Pharma Services, and this quarter reflects a reversal in our backlog trends. We are beginning to see some revenue acceleration, but have yet to see that translate to the bottom line. We are still working through the two previous quarters with exceptionally high cancellations and expect things to pick up in the second half of the year. Following a tough Q1, MDS Nordion delivered solid performance in Q2, both on the top and bottom line. MDS analytical technologies had a tougher go this quarter, with pharmaceutical companies, particularly in North America tightening capital budgets, we are seeing a shift in our revenue mix from high-end instruments to low-end instruments. The decline in end customer sales of higher margin, high-end instruments had a significant impact on MDS's analytical technologies profitability this quarter. For the quarter, adjusted earnings per share was $0.06 compared to $0.11 last year.

Now I would like to take a minute to provide a brief summary of events concerning the Maple project. Subsequent to the quarter, on May 16, Atomic Energy of Canada, Limited, AECL and the Federal Government announced their intention to discontinue the Maple project. AECL did not consult us on this decision or announcement, as would be expected under our contract. Until this announcement, at meetings with AECL, we were reassured they were working on solutions to technical issues and would complete the project. Importantly, in the announcement, AECL indicated its commitment to providing an ongoing supply of medical isotopes and the Canadian Government has asked AECL to pursue the extension of the NRU operation beyond its currently license. Based on the best information that we have from AECL, The NRU remains very reliable, and we are expecting its relicensing. For medical's isotopes, our current assessment of the situation is that depending on resolution with AECL, this is about managing long-term supply, not near-term or mid-term supply. Let me remind everyone, that MDS Nordion is more than medical isotopes. Medical isotopes represent about a third of MDS Nordion's revenue and less than half of the profits. We intend to pursue appropriate steps to protect the interest of patients, customers and shareholders, and are currently evaluating all our options. The information that we have is still very fresh, and we will provide updates on the fluid situation as they become available.

Now let's get back to discussing the quarter. During the quarter, we made a number of exciting announcements. We continue to upgrade our customer facing leadership team. This quarter we added Jim Miskel, Teresa Winslow and Dr. Peter Covitz. Peter comes to us from the National Cancer Institute. He leads the global effort for developing and implementing new technology strategies and identifying new business opportunities to support growth at MDS Nordion. We create a new global business

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development role to drive revenue growth at MDS Pharma Services and Teresa will spear head these efforts. Previously, Teresa was with Dendrite International and she brings with her a proven track record as a leader of business development in the health care industry. Jim will focus on building strategic partnerships at MDS Pharma Services to further strengthen our position in the CRO industry. His prior experience includes senior roles at Wyeth Pharmaceuticals and Mckenzie and Company.

To drive innovation and growth, we launched a next-generation Arcturus XT, system for laser capture microdissection. The new Arcturus XT provides researchers greater speed, precision and flexibility. After the close of the quarter, we completed the previously announced divestiture of two non-core product lines at Nordion. These assets are slower-growth product lines with relatively low margins. The first step in executing our growth strategy to position Nordion as the leading innovator in molecular medicine. Earlier this week, at the American Society of Mass spectrometry, we showcased a number of exciting new products. We focused our announcements on software, which strengthens our leadership in the mass spectrometry market by providing customers improved ease-of-use to expand the total addressable market for mass spectrometry based solutions.

iMethod for Cliquid Software, these are downloadable methods that our customers can access to get turnkey solutions for routine food and beverage testing. Analyst 1.5 software. This software runs our systems and allows researchers to screen more analytes with even greater accuracy and precision. This capability will best serve the food and environmental industries, as they will now be able to screen for more than 600 possible contaminant in one run for the first time ever.

DiscoveryQuant Software. This, tool improves the speed and efficiency in analyzing drug candidates in high through-put early ADME studies and LightSight Software which offers our customers automated metabolite identification method creation, to help them screen drug candidates more quickly and accurately. I will now turn it over to Doug Prince, our CFO to provide the financial details for the quarter.

Doug Prince - *MDS Inc. - EVP - CFO*

Thank you, Stephen. Before I get into the financial results, I would like to remind everyone that in addition the GAAP financial results included in the press release, we also provide commentary on the items that impact the comparability of our results. For the second quarter, adjusted financial results exclude charges related to restructuring initiatives, acquisitions and divestitures, provisions for FDA settlements and asset back commercial paper. Where appropriate, for year-over-year comparability, I will describe the impact of foreign exchange, acquisitions and divestitures. In addition, when I refer to revenue growth figures and margin percentages, these are based on net revenues, that is revenues for products and services excluding reimbursement revenue. For our consolidated MDS results for Q2, our total revenue was 350 million, including 24 million of reimbursement revenue. Net revenues were 326 million, up 24% from 263 million last year.

Molecular devices contributed 55 million to Q2 revenues, compared to 29 million in the post-acquisition period end last year. Excluding molecular devices, and 25 million of favorable impact from foreign exchange, revenues increased 5% over prior year with growth across all businesses. GAAP operating income was 11 million for the quarter, versus a loss of 55 million reported last year. Adjusted EBITDA was 34 million compared to 31 million in 2007, up 10%.

Both Analytical Technologies in Nordion contributed to adjusted EBITDA growth while Pharma Services reported a loss of 1 million compared to break-even last year. In addition to depreciation and amortization, the major adjusting items for 2008 included a $10 million benefit from revised estimates for reimbursing clients FDA expense and a 3 million loss related to additional write-down on asset back commercial paper. The major prior-year adjustments include the $61 million provision for client FDA expense, a $25 million restructuring charge, and a $6 million valuation provision on MDS Capital Corp. Our adjusted EBITDA margin declined to 10% from 12% in the prior year primarily driven by analytical technologies' performance. Our reported gross margin, which is net revenues less associated cost of revenues, dropped nearly 100 basis points versus prior year, driven by declines at Pharma Services and Nordion.

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SG&A for the quarter was 75 million, compared to 61 million last year, as a percent of net revenues, SG&A was level at 23%. In the quarter we spent 22 million or 7% of revenues on R&D activities, compared to 16 million or 6% spent last year. The majority of the year-over-year increase in SG&A and R&D is attributed to foreign exchange in a full quarter with molecular devices. Our effective tax rate for the quarter was 31%. Adjusting for investment tax credits and taxes on asset backed commercial paper provision, our tax rate for the quarter would have been approximately 34%. On a reported basis, our GAAP earnings per share from continuing operations were $0.09 in Q2 2008 versus a loss of $0.40 last year. Following the adjustments mentioned earlier and $0.04 of higher intangible amortization related to the acquisition of molecular devices, our adjusted earnings per share was $0.06 in 2008 compared to $0.11 last year.

Now let me discuss business unit results. For the quarter, Pharma Services reported net revenues of 128 million, up $0.11--- or 11% over the same quarter last year. These revenues reflect a favorable impact from foreign exchange of approximately $11 million. Adjusted for foreign exchange, both early-stage and late-stage services had slightly higher revenue in the quarter. The late-stage increase was mainly due to increases in the Central Lab business. The early-stage increase was primarily due to increased Phase 1 activity. Q2 continued to demonstrate a high level of new business wins, with 165 million in new orders, up 60% over last year. Based on the strength of these new orders, our quarter-end backlog increased 36 million sequentially or 9% to 431 million, our highest level since Q1 2007.

On a GAAP basis, Pharma Services reported break-even operating income for the quarter compared to a loss of 98 million last year when we recorded the FDA provision in a major restructuring charge. Adjusted EBITDA was a 1 million loss this year compared to break-even last year. This decrease was primarily the result of higher-margin services reported in our late-stage business last year, increased investments in growth, and the impact of previously announced contract cancellations, all of which helped to offset the savings achieved from restructuring activities announced last year. Relative to the $61 million FDA provision we took last year, we have now reimbursed clients for $19 million of audit or study rerun costs. Although we believe that almost all clients site audits have been completed, we still await final reimbursement requests from our customers. Based on our experience to date, we now estimate that a provision of 33 million is sufficient to cover all future costs. As a result, we have benefited from a $10 million reduction of the provision this quarter.

Now onto MDS Nordion. Nordion reported revenues of $80 million, up 13% from $71 million last year. During the quarter, Nordion's revenues benefited from 6 million in foreign exchange impact. The remaining 3 million increase was due to revenue growth across most product lines, particularly in sterilization technologies. GAAP operating income was 21 million, compared to 20 million last year, and adjusted EBITDA was 24 million versus 22 million last year. In 2008, we realized a $3 million non-cash benefit related to foreign exchange on long-term supply agreements. In 2007, we realized a $4 million benefit from higher isotope sales related to supply disruption at a competitor. Excluding these items, improvement and profitability was driven by growth and productivity. Subsequent to the quarter and effective May 1, 2008, we completed the sale of two product lines to Best Medical. The operating results for these product lines are included in our Q2 results. We recorded the expected loss of $4 million on the sale of these product lines in Q1.

Stephen has already commented on the AECL situation. The primary financial reporting implication is a possible impairment of the Maple Supply agreement, a $342 million intangible asset. Given the fluid nature of this situation, it is too early for us to make this call. We will continue to evaluate this situation, and we'll communicate any change in status when it occurs. Now, on Analytical Technologies. Analytical Technologies recorded revenue of 118 million in Q2, up from 77 million last year. Adjusted for acquisitions and foreign exchange, revenues increased 15%. Analytical Technologies reported a GAAP operating loss of $4 million in Q2, compared to a $3 million loss last year. Adjusted EBITDA was 17 million in Q2 compared to 17 million last year. Adjusted EBITDA was 17 million in Q2 compared to 17 million last year. To help you understand the AT story, I need to take a minute to describe U.S. GAAP accounting for our Sciex JVs. This is also included in our MD&A. Sciex revenues represent billings to the JVs for products manufactured and R&D services performed for the JVs. They are not a direct indication of end customer revenue, which is the real driver of JV profitability. With that said, Sciex revenues to the joint venture grew by 15 million or 31%, excluding 8 million of positive impact of foreign exchange, Sciex revenues increased 15%. Including the impact of foreign exchange, reported end user revenues for Sciex products grew by 6% versus the prior year. Compared to the same period last

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year, unit volume declined as pharmaceutical customers deferred purchases of high-end instruments. Sciex delivered 8 million of adjusted EBITDA in the second quarter, flat with a weak prior year, including the decline in sales of high-end instruments.

For the quarter, Molecular Devices delivered 55 million in revenues, compared to 29 million in the post-acquisition period last year. Compared to the same three-month period in 2007, Molecular Device revenues grew by 8%. Molecular Devices contributed 9 million of adjusted EBITDA in Q2 versus 7 million in the post-acquisition period last year. Profitability of Molecular Devices was also impacted by the decline in demand for high-end, high-margin instruments, plus increased transition expense associated with moving manufacturing to Asia.

Now turning to the balance sheet and cash flow, we ended Q2 with 139 million in cash and short-term investments, down from 144 million in Q1. During the quarter, 5 million of net cash was used. Our businesses had net operating cash out flows of 14 million in Q2. For the remainder of fiscal 2008, we expect to have net operating cash inflows. Our Q2 capital expenditures totaled 15 million, compared to 7 million last year. During the quarter, we repurchased and canceled over 600,000 common shares for $12 million, under our normal course issuer bid. We believe that cash on hand, cash generated from operations and our financing sources will provide sufficient liquidity to fund ongoing to operations, capital expenditures, R&D, restructuring costs and potential acquisitions. We continue to see a bright future for MDS as we drive our strategy for profitable growth.

At MDS Pharma Services , our initiatives are taking hold. New business wins are on the rise, and the higher backlog is expected to drive revenue growth in the second half of 2008. Following a tough Q1, Nordion delivered a solid Q2, and we expect Nordion to be a strong performer in the second half. The acquisition of Molecular Devices met or exceeded our first-year targets, with a strong pipeline of innovation, and the continued shift of manufacturing to Asia, we are excited about the future of Analytical Technologies.

While we remain committed to executing our strategy and have made significant progress on all fronts, we are disappointed with our Q2 performance in two areas. First, the impact from the shortfall and demand in Analytical Technologies, and second, the delayed improvement in Pharma Services profitability. As a result, we are reducing our annual guidance for 2008. A primary driver of lower guidance is the softening of demand for high-end instruments by pharmaceutical customers. Because the majority of this impact is seen through the Sciex JVs, we have reduced the high-end of our net revenue guidance by $10 million to $1.29 billion.

With a corresponding impact on JV profitability and the delay in the improved profitability at Pharma Services, we are reducing our guidance for EBITDA to the range of 160 to 170 million. This reduction in adjusted EBITDA the partially offset by the $10 million benefit for lower client FDA expense, less the $3 million charge to asset-backed commercial paper. We have reduced our full-year adjusted earnings per share by $0.10 to between $0.27 to $0.33, basic earnings per share should be within the $0.37 to $0.45 range. We expect income from continuing operations to be in the 45 to $55 million range, and we plan to spend 5 million less on capital expenditures this year.

Finally, we have adjusted our effective tax rate upwards to the 10 to 20% range, due to changes in earnings and a lower than expected gain on the reduction of future Canadian tax rates. That concludes my financial comments for the quarter; and with that, I'll turn it back to Stephen for closing remarks.

Stephen DeFalco - *MDS Inc. - President - CEO*

Thank you, Doug. Despite some challenges in Q2, MDS was able to grow both revenue and adjusted EBITDA. We remain focused on executing our strategy with a view on balancing investments for growth with productivity actions to improve overall performance. The investments we have made to rebuild the customer facing front end at MDS Pharma Services are beginning to show benefits. New business wins are ramping nicely, and this benefit needs to be driven to the bottom line. We are taking actions targeted to drive operational improvements and accelerate the profit expansion. While we expect the softness in the high-end instrument segment to persist throughout 2008, we have a strong pipeline of products at MDS Analytical Technologies.

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Recently we introduced a suite of software products to help our customers increase productivity and improve the ease of use of our offerings. We expect to make significant hardware announcements over the next 12 months. We plan to continue investments to ship manufacturing to Asia, and accelerate synergies from the transition. Our fundamental markets remain strong and I am encouraged by the demand that we see for our products and services.

I'll now turn it over to Kim for Q&A.

Kim Lee - *MDS Inc. - Director of IR*

Thanks, Stephen. Before I ask the operator to open the lines up for Q&A, I would like to ask you to limit yourself to one primary and one follow-up question before you queue up again for follow-up questions. Mark, would you please open the line for questions.

QUESTIONS AND ANSWERS

Operator

Certainly. (OPERATOR INSTRUCTIONS). Our first question is from Lennox Gibbs from TD Securities. Please go ahead.

Lennox Gibbs - *TD Securities - Analyst*

Good morning. Thank you. Mass Spect. You've seen declines currently in terms of unit growth, but on top of that this week, there's three to four new compete and triple quads on the market. Your press release, I notice you're evaluating a number of options to manage the market environment. Can you share what options you see as being available to you and also comment on whether or not you may need to compromise on price over the common quarters?

Stephen DeFalco - *MDS Inc. - President - CEO*

Yes. Good morning. Thanks. In the mass spec market, what I think we are really seeing here this quarter is the North American pharmaceutical customers pushing out their purchase decisions as they face a number of issues in their businesses. As you know, our franchise is -- we have a very, very strong position in that market, and so I don't think it's -- we're losing sales to competitors in that market. I think they're not buying from anyone right now, and we expect that to continue for a little while, and we've been in this business long enough to have seen this in other times in the past. Whenever we announce new products, we reposition the product line by price, right, and that's kind of typical so that older-generation stuff becomes more accessible to more -- people with more moderate budgets, and quite frankly, the newer generation stuff, able to capture a big premium on. I don't see anything we're going to do that's going to change that dramatically from what we've done over the past ten years, and so we'll -- we'll keep doing that, and keep-- bringing our innovations to market, and that market -- outside of North American Pharma, that market continues to be exciting and robust for us.

Lennox Gibbs - *TD Securities - Analyst*

Does that mean prices are essentially stable until we see new instruments being launched by you?

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Stephen DeFalco - *MDS Inc. - President - CEO*

We tactically look at price, as any company does from period to period, but basically what we look at mostly is the value that we provide our customers above and beyond in terms of performance. And so, typical ongoing efforts I would say on that front no big shift in direction.

Lennox Gibbs - *TD Securities - Analyst*

Okay. But what other levers do you have outside of price, then? Because the press release alludes to you looking at a number of options.

Stephen DeFalco - *MDS Inc. - President - CEO*

Well, we're transitioning a bunch of products to Asia. That gives us a margin expansion. We're looking at places we can accelerate that. We're looking at places where we might have costs in both locations, and we can make some adjustments on those fronts. We're looking at activities in terms of more and more product in Asia, what can we do on the supply chain side and purchase materials at better costs? So, there's a range of stuff, and then there's certainly marketing activities, making sure that particularly the new software offerings are very exciting, that the industry is shifting more towards software-based enhancements, so a little -- maybe a good analogy is the PC market there with the I-Mack in terms of just making the PC insanely easy to use so that you can access broader number of users, and we're seeing that. And so we're seeing that, we have best-in-class hardware in most categories, and we think that this software really makes this incredible platform a lot easier to use and a lot more accessible, particularly to novice users. So a number of actions underway, and as I said, we're seeing good growth in Asia, still seeing big growth in applied markets. So, by and large the mass spec market continues to be a pretty frothy arena for innovation.

Lennox Gibbs - *TD Securities - Analyst*

Thanks very much.

Operator

Thank you. The next question is from Maher Yaghi from Desjardins Securities. Please go ahead.

Maher Yaghi - *Desjardins Securities - Analyst*

Thanks for taking my questions. Stephen, I just wanted to ask you about Maple. You mentioned in your financial statements that you are looking for long-term -- and you mentioned earlier in your comments. You are looking for actions you would like to take to secure a long-term supplier of isotopes beyond what might come up with the Maple decision. Can you maybe share with us what that entails in terms of potential CapEx requirements that you might take? I know this is still new, but we're just interested in knowing what other options you have on the table, if the Maple reactor decision is not returned to its prior decision, and eventually, then, are you -- will have to be -- a decision has to be made there. So what is your thinking on it right now?

Stephen DeFalco - *MDS Inc. - President - CEO*

Yes. So, as you said, Maher, the situation is a little fresh, and quite frankly, a tad fluid, as we learn more every 24 hours. To frame -- let's frame this issue correctly, right? So isotopes is an important business at Nordion, but it's not Nordion. It about a 1/3 of revenues and less than a half of profits at Nordion. Nordion has a number of other strong businesses, and second the NRU is licensed through 2011. They'll look to extend the license. Based on all of the information from the experts we talk to, that's a very likely event. So we're probably really talking -- the issue is really year 6 through 40. Probably not something here that's in

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the first couple of years. And then, that will get refined a little bit as we know a little more about it. I think it's way too premature without talking about CapEx or anything else. We need to learn more of the information. We are hoping more rational minds prevail here in the government, and are trying to have that dialogue. But I would say all of this is kind of fresh, right? We had an exclusive arrangement with AECL that appears like it is, certainly from their point of view, in jeopardy. So I think we'll reach out in assessing all the technical options to fill in that supply issue that will be out a couple years in the future. So we'll let you know more as we know, but I think, right now, it's too early to tell.

Maher Yaghi - *Desjardins Securities - Analyst*

Just on the decision not to take the write-down on your intangible assets, do you really think that the government is -- by not taking the intangible asset write-down, your thinking is they may come back and change their view, do you really think that could be an option here?

Stephen DeFalco - *MDS Inc. - President - CEO*

Yes. I think, again, as we said, we're early days here; but we have a position on a number of matters, including the strength of our contracts, and we need to go and have those conversations and pursue that before we think it's prudent to take any write-downs on any assets. So we'll go ahead and do that. We want to -- in good disclosure, we signal that out there. But I think, in our minds, that decision is far from completed.

Maher Yaghi - *Desjardins Securities - Analyst*

Okay. That's fair. And just a final question on MDS Pharma Services, I always have a question on that. The revenue is quite nice. You report good revenues, but can you guide us into understanding how long this productivity issue or profitability issue due to the cancellations of the projects you had in Q1 and Q4 might continue to impact profitability? I know you lowered your guidance due to that, and you're saying that the second half might be impacted, but are we talking only second half, or could that extend beyond that time?

Stephen DeFalco - *MDS Inc. - President - CEO*

We're expecting that to begin accelerating here in the second half.

Maher Yaghi - *Desjardins Securities - Analyst*

No, no. But I'm talking about the profitability of MDS Pharma and the impact of the cancellations, specifically the cancellations. How long will these cancellations continue to impact profitability?

Stephen DeFalco - *MDS Inc. - President - CEO*

We're balancing a number of trend lines. As you said, the new business wins have been very strong for us. We have room to continue improving them, because we're not yet records in the industry for book-to-bill, gross book-to-bill, but certainly up take a lot. We're starting to see that flow into revenue, and we expect it to be able to flow into profitability here in the back end of the year. So I'd say stay tuned on that.

Maher Yaghi - *Desjardins Securities - Analyst*

Okay. Thank you.

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Operator

Thank you. The next question is from John Maletic from Scotia Capital. Please go ahead.

John Maletic - *Scotia Capital - Analyst*

Hi. Good morning. My questions will be somewhat similar, just phrased slightly differently. On the Pharma Services profitability, is it strictly a volume issue at this point, or are there still efficiency says that need to be extracted from your restructuring plan, or is it a business mix issue, where some of the higher profitability contracts are still in the backlog and not yet impacting the bottom line?

Stephen DeFalco - *MDS Inc. - President - CEO*

I would say, John, it is a good question. Of course, in a business that large, it's a little of all three of what you said, right? So you have some mix issues, and you have some -- a couple areas, we think, where we can get still more efficiency. But I would say that, the big driver of profitability here is getting the volume back in those facilities; and it's a pretty -- it's a relatively fixed cost business, and so driving up the utilization of the facilities, particularly in the early-stage business and the central labs business, is probably your biggest lever, right. I think the other things are important, but the driving up that utilization with volume with the new business wins is probably the biggest lever here to accelerate.

John Maletic - *Scotia Capital - Analyst*

Okay. And then on the Maple situation, not to beat this to death, but is there a scenario within the structure of your contracts where you could potentially recover some of the investment that you made prior to 2006, even if the decision is not reversed?

Stephen DeFalco - *MDS Inc. - President - CEO*

I would say that, again, that issue is quite fluid, and we have a perspective on our legal position in our contracts, and I think we need a couple more discussions here, and then we're going to have to take action to protect our rights on that. So I wouldn't rule out anything that you said.

John Maletic - *Scotia Capital - Analyst*

Okay.

Stephen DeFalco - *MDS Inc. - President - CEO*

But, as I said, let's give this a couple more days.

John Maletic - *Scotia Capital - Analyst*

Would you say that the position of, say, the Federal Government in a sale, given the new management, is more accommodating than would have been the case a year ago, given the supply disruption?

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Stephen DeFalco - *MDS Inc. - President - CEO*

Yes. I don't think it's helpful for me to characterize my view of their management.

John Maletic - *Scotia Capital - Analyst*

Okay. Fair enough.

Operator

Thank you. The next question is from Randall Stanicky from Goldman Sachs. Please go ahead.

Randall Stanicky - *Goldman Sachs - Analyst*

Great. Thanks for the question. I'll keep it to two. First, on Pharma Services, Stephen, what's changed over the last couple of months from what you thought the business would be and where it ended in terms of profitability? And secondly, you introduced long-term targets in February. Is it fair to say that all of those targets across those divisions still hold at current levels?

Stephen DeFalco - *MDS Inc. - President - CEO*

In Pharma Services, again, we're managing a couple different trend lines, and, all things, Pete, being equal, we probably thought we could turn a new business trend into revenue a little quicker than we were able to operationalize that. And at the same time, the impact of the cancellations were coming through, and we probably were a little off on the timing a little bit. On the longer-term outlook for the three businesses, yes, I remain very confident. I mean, these are three really, really robust end markets. Medical imaging and sterilization. It's, mass spectrometry, cellular analysis, and then contract research services, these are really good strong end markets, and I think, every quarter, our businesses are improving. As I would say, I was disappointed in our results this quarter; but when I look in the context of the trend lines I feel good about those long-term targets.

Randall Stanicky - *Goldman Sachs - Analyst*

The investments in growth that you referred to in your release, can you characterize that as hiring, that infrastructure build? What specifically is that? Is that any different than what you thought it would be three months ago?

Stephen DeFalco - *MDS Inc. - President - CEO*

No. I would say that across the portfolio, we have a lot of investments in growth. People like Peter Covitz coming in at Nordion and accelerating the partnership activities we have that. Things like the Phoenix site that we announced in previous quarters. I think one big thing I would spike out is hiring of Teresa Winslow. I mean, this is the first time we've had a single head of all of our business development efforts, globally across all of the business lines and across the geographies; and she's a fabulous talent. And so I think having that coordinated customers facing activity is showing for us some real good results. So yeah, I generally -- I feel good about those. I think these are all things we knew we had to make, and we were timing them kind of properly here as we got ourselves away from the FDA issues, got ourselves back out to our customers, and now those investments are having a pretty quick turn in terms of benefit.

Randall Stanicky - *Goldman Sachs - Analyst*

Great. Thanks.

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Operator

Thank you. The next question is from David Martin from Dundee Securities. Please go ahead.

David Martin - *Dundee Securities - Analyst*

Hi. Thanks for taking my questions. You mentioned weakness in the premium mass spec market and increasing competition for high sensitivity instruments. I'm wondering, do you foresee a next major innovation that will allow you to capture a high-end premium as the competition increases for your existing high-end mass specs?

Stephen DeFalco - *MDS Inc. - President - CEO*

Yes. I would say just, a tad of a clarification. I think we are seeing softening in the large pharmaceutical -- it's usually referred to as the small molecule market. It's sort of quantitative triple quad. We're not seeing increased competition in that market, quite frankly. We're seeing customers deferring their purchases, so that's one set of events. And I think that will have a little bit of a cycle to it, and probably last about six months. They can't defer the purchases forever. They need the equipment in order to do their drug development work.

On the other issue of competition, we do see -- I would describe it as healthy competition out in the marketplace, and as it has been for the past ten years in mass spec, and the way that you win there is to innovate, right? We were very excited about this new software we've brought out, which again, brings a tremendous ease of use to what is a very, very sophisticated set of hardware platforms. And those markets that are opening for us mass spec, food and beverage markets, we didn't even talk about 35 months ago. Now they're meaningful drivers of our revenue, and certainly as we develop across Asia, and those -- to be competitive in those markets, you're going to need best in class hardware, but going to need, insanely easy to use software that helps a novice user get in there and really be able to get great results, quite quickly as opposed to even five years ago, it was also a Ph.D. operator working on a mass spec. So yes, we'll keep innovating and keep making them easy to use, keep pushing the performance envelope. And, I don't -- I don't know that any of that is new, news, quite frankly. I've been involved in the mass spec market since 1999. It's been almost ten years. It's every year. I mean, this is how the market is characterized, and why we like it, because we think that we do those things better than anyone in the world.

David Martin - *Dundee Securities - Analyst*

Okay. Moving over to Pharma Services, as far as the prior quarter compound failures in the clinic, is this more Phase 2 instead of Phase 3 and 4 and our you taking steps to reduce cancellations, for example, reducing fees to exposure if that's where the cancellation problem is; and are you seeing an impact of these steps as far as the content of the backlog?

Stephen DeFalco - *MDS Inc. - President - CEO*

Yes. So just to be clear, the cancellations over the past six months were Phase 2 through 4 work, which is -- Phase 2 through 4 development work.

David Martin - *Dundee Securities - Analyst*

Was it more Phase 2 or all across the board?

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Stephen DeFalco - *MDS Inc. - President - CEO*

It was across the board.

David Martin - *Dundee Securities - Analyst*

Okay.

Stephen DeFalco - *MDS Inc. - President - CEO*

And I think that -- you asked a specific question, are we doing things to control the cancellations? The truth is not really, right? Because they're a function of the work we do. They're the function of the industry as we try to help our clients with good data and projects, make decisions on drugs; and as we know, most drugs don't make it to the market, and so it's a question of when get them the right data so they can make the decision that they're not going to go forward on it. I think quite frankly your best protection against cancellations is to have a stronger new business development pipeline so that when you have a cancellation, you can slide in another customer and another project.

David Martin - *Dundee Securities - Analyst*

Is there a way you can measure some metrics for measuring the quality of your backlog, and are those metrics trending positively? I know the backlog is building now in size, but is there anything to say it's getting better quality on average, or staying stable or reducing?

Stephen DeFalco - *MDS Inc. - President - CEO*

Yes. When we would say quality of backlog, we would be referring to looking at the margin of work that's in backlog. If you're implying can we priority decide which drugs might be likely to fail, not really, because quite frankly, the best minds in the world make that decision every time that they hit a milestone in drug development. The truth is, in every phase, you hit a new stage. So we have very little ability to predict the, quote, "quality of the compound." I think --

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David Martin - *Dundee Securities - Analyst*

Phase 2.

Stephen DeFalco - *MDS Inc. - President - CEO*

Patterns there.

David Martin - *Dundee Securities - Analyst*

Phase 2 is risky, and I was just wondering if the content of phase 2 is up or down. Just one last question. How much money have you paid into Maple that you've not been recome penced for at this point? I know you have some compensation back, and are you in a contractual position to receive payment for that amount that you haven't been paid back?

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Stephen DeFalco - *MDS Inc. - President - CEO*

Again, it's early days on that, and obviously there is a series of call it reading of the contract. We feel very comfortable with our position. The numbers are all in our disclosure, and you can go kind of look at them. Basically, there was historically about 300 million invested in the project, and there's some more of compounded interest in there. So on the balance sheet, that supply contract is in the neighborhood of 350 million. I think it's 346 million. And, we'll be doing what we believe are the right steps to protect that asset for our shareholders.

David Martin - *Dundee Securities - Analyst*

Okay. Thank you.

Stephen DeFalco - *MDS Inc. - President - CEO*

Thank you.

Operator

The next question is from Dave Windley from Jefferies & Company. Please go ahead.

Dave Windley - *Jefferies & Company - Analyst*

Good morning. Thanks for taking the questions. I wanted to start, Steven, on the Analytical Technologies business and drilling down a little bit. I'm wanting to understand the shift in mix a little better. I'm looking at product revenue that was up sequentially, service revenue that was up sequentially and obviously margins down quite a bit. So could you be -- could you add a little more color around what the shift in mix was? I guess, within each of those two buckets, that drives margins down as far as they did go?

Stephen DeFalco - *MDS Inc. - President - CEO*

Right. Okay. So Dave, there's two forces at work there. Let me try to work them one at a time. The first one is, a pretty big mix shift. So essentially our high-end mass specs, our high-end platforms and cellular screening and whatnot, the devices that sell for over $250,000 each, as you can imagine, have a whole lot more margin in them than a $15,000 plate reader, and so when we are growing what we're seeing softness in the high-end, that means we had a pretty quick shift here in mix from high-end to low-end products, and quite frankly, the lower-ticket priced products have lower margins.

Dave Windley - *Jefferies & Company - Analyst*

Yes.

Stephen DeFalco - *MDS Inc. - President - CEO*

And certainly lower gross margin dollars per unit, right, which, is going to flow through your manufacturing overheads and other things.

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Dave Windley - *Jefferies & Company - Analyst*

Okay.

Stephen DeFalco - *MDS Inc. - President - CEO*

I think the second thing is, we have very goodies closure about how we account for the joint venture, and so the Sciex revenue and the joint venture, I would say that reported revenue reflects our sales to the joint venture, not sales out to the end user market. We provide that disclosure; but if you go quickly through that, you might think that Sciex had huge revenue growth this quarter, and that's not really the case. That has to do more with some of the joint venture accounting, and so we look more at the end user sales for that indicator.

Dave Windley - *Jefferies & Company - Analyst*

Okay. So maybe that second piece answers this question; but if I look within products and think about a reduction in sales of the high-end products, it would take a big jump in the sales of the low-end products to still get us to a revenue number that was up sequentially, so what's the driver of that? Do you follow the question? What's the driver of small -- of low-end demand?

Stephen DeFalco - *MDS Inc. - President - CEO*

Yes. We might want to -- oh, the driver of low-end demand, I think, is the markets across the life science sector are quite strong and robust. We have a number of really nice new products out there. So we're seeing good growth in Asia, good growth -- certainly solid growth in Europe, good growth in biotech, good growth in a lot of the extra applications, like the applied markets. What really has gone soft for us here -- in a nutshell what's gone soft for us here is pharmaceutical North America, which again is a disproportionate amount of our high-end products.

Dave Windley - *Jefferies & Company - Analyst*

Right. Fair enough. Quickly on Pharma Services -- and I'll jump out -- first of all, a similar question there. Sequentially revenue did improve, backlog conversion was decent. So 8 million increase in revenue, 7 million decrease in EBITDA. Where were the cost increases in that business sequentially, and what were the reasons for those -- those cost increases?

Doug Prince - *MDS Inc. - EVP - CFO*

Sure. Dave, this is Doug Prince.

Dave Windley - *Jefferies & Company - Analyst*

Hi, Doug.

Doug Prince - *MDS Inc. - EVP - CFO*

The first-half profitability overall, again, Stephen has already commented, is again largely related to the late-stage order cancellations, but we had some pretty big swing items between the quarters that are, again -- if you go back and look at our Q1 release and our Q2, there was about a $4 million swing in foreign exchange. In Q1 we got a balance sheet gain and in Q2, a $1 million charge. We also saw a $2 million credit in the first quarter from stock-based compensation, and we also do salary increases at the first of the year. So Q1 had one month of increase, and Q2 had two. So when you adjust for those things, I think

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it will be more clear as to what some of the quarter-over-quarter variances are. But again, as Stephen said, the real key is getting the revenue to accelerate and the backlog increase is going to drive that, and that will leverage the stream-line cost structure we put in place as a result of the restructuring actions taken in the past year.

Dave Windley - *Jefferies & Company - Analyst*

Okay. And then, lastly, to follow up on Randall's earlier question, you said at your investor day pretty specifically that you expected to exit fiscal 2009 and industry-average EBITDA margins. Is that still a realistic expectation?

Stephen DeFalco - *MDS Inc. - President - CEO*

I believe it is, and we're still driving pretty hard on that plan.

Dave Windley - *Jefferies & Company - Analyst*

Okay. Thank you.

Operator

Thank you. The next question is from Max Paris from CIBC World Markets. Please go ahead.

Max Paris - *CIBC World Markets - Analyst*

Yes. Good morning. Getting back to Analytical Technologies. Many of your competitors are talking about the strength of demand in Asia and so were you a few seconds ago. How are you trying to capitalize on this trend, and just if you can highlight your tactics or general strategies there?

Stephen DeFalco - *MDS Inc. - President - CEO*

Sure. We do see great strength in Asia. We have a direct sales force in the China region. We recently added a VP of sales at AT for all of the Asia regions. So previous to this, the individual countries, whatever, Australia, Singapore, Korea, Taiwan, China, would sort of report up, and now we've put in a VP for the region, and I think have a lot more marketing attention on that area. And so it's quite frankly, been a very robust set of investments. On the Pharma Services side, we had the big expansion of our Beijing lab, been in China for over ten years with our Central Lab, got a strong presence in Taiwan, got a strong presence in Singapore, and then investing in our two factories in Shanghai and Singapore. All up across MDS we have quite a lot going there, and I think Asia is -- it's a very exciting market for us, but it's interesting because we're seeing customers notice the factory presence; and of course, that gives you more of a halo effect of someone there to stay and building a lot of capability there. So it's -- it's generally pretty good times in terms of market demand.

Max Paris - *CIBC World Markets - Analyst*

Okay. Are you selling any high-end instruments in Asia, and can you give us an idea of sort of the proportion of revenues in terms of the instruments coming from Asia, and then for the manufacturing that you're transferring to Asia, what proportion of manufacturing is now carried out in Asia, and when should we start to see, like, the margin expansion results from that? Thanks.

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Stephen DeFalco - *MDS Inc. - President - CEO*

So I think some of that we'll have to get back to you with. I would say we are selling a lot of high-end instruments across Asia; and again, there's not a Q2 event. This is something we've been doing for a couple of years. We can get you more of kind of a breakout there by revenue; but it's -- it's, at this point, a healthy portion of our revenue. It's certainly been the fastest growing region we have for probably multiple quarters here, and so we can follow up with that information.

Max Paris - *CIBC World Markets - Analyst*

And for the manufacturing?

Stephen DeFalco - *MDS Inc. - President - CEO*

I'm sorry. The questions on the manufacturing?

Max Paris - *CIBC World Markets - Analyst*

Well, you're transferring some manufacturing to Asia, and we should be expecting some margin expansion, and when are the real, like, results out of the margin expansion expected?

Stephen DeFalco - *MDS Inc. - President - CEO*

Yes. We've gotten them -- gotten a good amount of that, already, although, some of that has certainly been eaten up with foreign exchange, kind of back and forth. And so you're making that decision on a long-term basis. The foreign exchange has been moving against us on that front. I think we'll see an acceleration of that in the back end of this year and certainly for the first half of '09 as we complete those moves. I mean, we have a reasonable size amount of our revenue being produced there. But the big benefit comes when you can fully localize the supply base, and in some cases where we have the product being produced there, we have some of the supply base in North America as we are very careful on particularly, high-precision devices making sure the Asian supplier is up to speed before we transfer it over. An ongoing process quarter to quarter.

Max Paris - *CIBC World Markets - Analyst*

Thank you.

Stephen DeFalco - *MDS Inc. - President - CEO*

Thank you.

Operator

The next question from Doug Miehm from RBC Capital Markets. Please go ahead.

Doug Miehm - *RBC Capital Markets - Analyst*

Thank you. Good morning. I guess just a simple question on Nordion. You keep telling us it's fluid, and that's completely understandable, but can you just comment on this: Is there any chance that Maple comes back, or is this complete dead without any potential CapEx from MDS?

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Stephen DeFalco - *MDS Inc. - President - CEO*

Those are two questions. We don't view that decision as dead, and two, we don't view the completion of Maple as something that's going to require CapEx from MDS. That was decided in the 2005 mediation, and don't see that in our scenarios going forward.

Doug Miehm - *RBC Capital Markets - Analyst*

Okay. So we're still confused as to why they even made this announcement, then.

Stephen DeFalco - *MDS Inc. - President - CEO*

Well, the contract we signed with them in 2005 was something that we published, and so you can get access to it and read it and make your own interpretation, but we were surprised why they made this announcement also.

Doug Miehm - *RBC Capital Markets - Analyst*

I agree. And I think you should get something out of this at the very least. The second thing, Stephen, as I look back to Q1 and you highlight on the Pharma Services side, three items why things were weaker this quarter. One was you had a very strong '07, two you had investments growth in 2008 and finally had the contract cancellations. I think -- I could be wrong, but I think we knew all those things when we came out with the guidance around Q1. Can you exactly tell me what happened in terms of the shortfall relative to the three items?

Stephen DeFalco - *MDS Inc. - President - CEO*

Yes, I guess. Doug, let me start off by saying that we're disappointed with the performance of Pharma in Q2. I want to start there. We need to see the bottom line accelerating. We understand that. We understand that's a commitment to our shareholders. So let me put the exclamation point around that, which is kind of the most important part of the communication. On the other part, we did know certain things. We did not fully anticipate how the cancellations would kind of flow through. We thought we would be able to turn some of the new business wins into higher utilization and higher profits quicker. We probably had that timing off by a quarter. And so I -- and we have a couple things moving around on us, like foreign exchange and other things; but at the end of the day we need to have a good strong trajectory there in terms of profit improvement, and we understand that.

Doug Miehm - *RBC Capital Markets - Analyst*

Okay. I think that's fair. Just finally, I'm just trying to figure this out myself. I know other people have been trying to do this. Basically you said Analytical Technologies is revenue strong, but margin is weak due to high end instrumentation mix issues, but did you also say -- and I could be wrong here that unit sales were down?

Stephen DeFalco - *MDS Inc. - President - CEO*

Yes.

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Doug Miehm - *RBC Capital Markets - Analyst*

So I'm just trying to reconcile that. If unit sales are down and you're selling more of the low end stuff, how does that work?

Doug Prince - *MDS Inc. - EVP - CFO*

Doug, this is Doug Prince.

Doug Miehm - *RBC Capital Markets - Analyst*

Hi Doug.

Doug Prince - *MDS Inc. - EVP - CFO*

We said that unit sales are down through the joint ventures, which is on the mass spec products. So the unit sales are up on the MD side overall; but again, we're selling a lot more of the lower end instruments on the MD side. Even there, they've got some big ticket instruments there as well in the 2 to $500,000 range, and they're also seeing some push-out there. So MD is seeing a bit of hit on their gross margin on the mix between the higher growth low margin or higher growth low-end instruments while both Sciex and MD are seeing the decline in the high-end. But the unit volume is only down on the mass spec products.

Doug Miehm - *RBC Capital Markets - Analyst*

O kay. That makes a lot of sense. Thank you very much.

Operator

The next question is from Lennox Gibbs from TD Securities. Yes. Please go ahead.

Lennox Gibbs - *TD Securities - Analyst*

Thanks again. Still struggling with the trend in financial services. Can you provide more of the mechanics on the product cancellations, how much of it was in process business and when did the activities wind down, and what exposure do you currently have to products that may have been canceled, but where there's still billable activity going on and still needing to go through the wind-down process?

Doug Prince - *MDS Inc. - EVP - CFO*

Yes. Lennox, this is Doug. What happens when a cancellation comes in is we've got a variety of resources ramped up, and some of the ones that we saw canceled in the last couple of quarters were ones that were already underway. So it takes a while to redeploy the resources, and they may not be the same resources you need for the next project. They may not be in the right country and the right area, and then as we get the new business wins in, we have to ramp up. What happened is we were not able to get the new wins started up as quickly. So we've got under -- we've got overcapacity both in people in some areas and resources and facilities in others. So we've got a gap, and as he said, if anticipated, we'd be able to shorten the gap.

It's taken a little longer to recognize the revenue increases, but we're taking actions underway to again accelerate the revenue growth, and we're looking at costs, again, as well, and ways to clamp down there where needed. But it's an interesting mix,

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because we are seeing growth. We have to continue to invest in growth while we have to continually resize our capacity in this business.

Lennox Gibbs - *TD Securities - Analyst*

So are all of the canceled projects now wound up, or is there still some residual activity going on with some of the projects that have already been canceled?

Doug Prince - *MDS Inc. - EVP - CFO*

Mostly wound up.

Lennox Gibbs - *TD Securities - Analyst*

Wound up. Okay. And finally, how did the Phoenix Clinic feature into the numbers on the quarter?

Stephen DeFalco - *MDS Inc. - President - CEO*

Demand there is ramping up nicely and so we continue to see a strong pull from customers for that facility, particularly for the thorough QTC studies, which is really the hallmark of that facility. And so we're seeing that ramp up nicely.

Lennox Gibbs - *TD Securities - Analyst*

Profitability?

Stephen DeFalco - *MDS Inc. - President - CEO*

Well, within our expectations, and maybe a little bit ahead of plan here.

Lennox Gibbs - *TD Securities - Analyst*

So it's positive?

Stephen DeFalco - *MDS Inc. - President - CEO*

Yes.

Lennox Gibbs - *TD Securities - Analyst*

Good. Excellent. Thank you.

Stephen DeFalco - *MDS Inc. - President - CEO*

Thank you, Lynn.

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Operator

Thank you. This concludes our question period. I would now like to turn the meeting back over to Ms. Lee.

Kim Lee - *MDS Inc. - Director of IR*

Thank you for joining us this morning. If you have additional questions, please do feel free to give me a call. Good-bye.

Operator

Thank you. The conference has now ended. Please disconnect your lines at this time. We thank you for your participation.

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