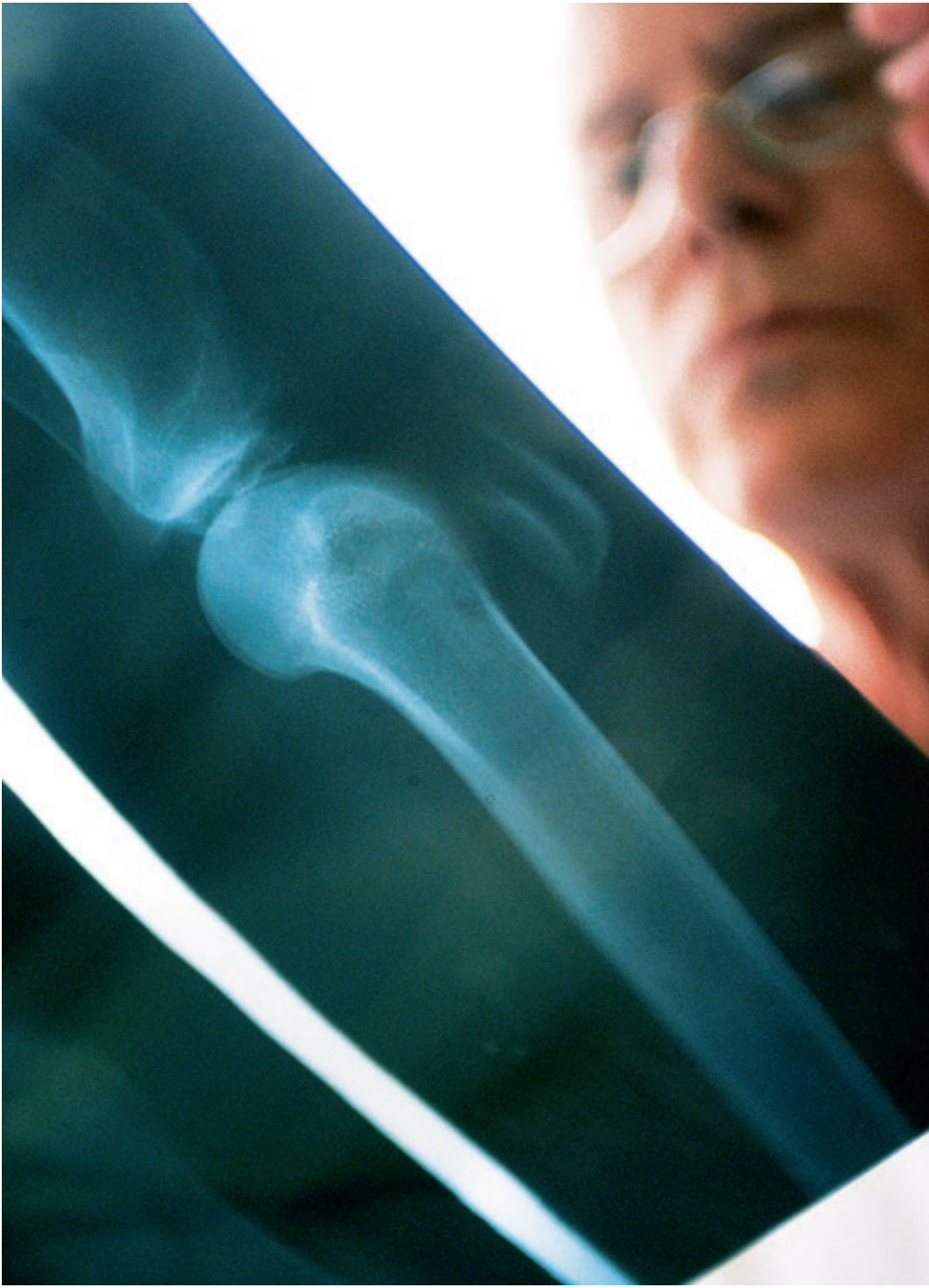
Mereo BioPharma

Identifying real healthcare potential

Mereo BioPharma Group plc

Interim report 2016



Targeting transformation of patient quality of life and improvement of human health.

Mereo is a UK-based speciality biopharmaceutical company focused on the acquisition and rapid development of innovative medicines.

Mereo's management team is highly experienced in identifying and selecting new product opportunities, managing clinical development pipelines, capital raising and structuring in- and out-licensing transactions.

www.mereobiopharma.com

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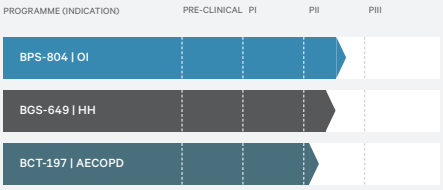
Mereo is building a strong pipeline of innovative medicines.

Focused in rare and specialist disease areas, through the acquisition of validated, mid-stage development programmes from large biopharmaceutical companies.



Operational highlights

- Commenced a Phase 2 dose-ranging study with its oral anti-inflammatory agent BCT-197 for treatment of the underlying inflammation in patients with acute exacerbation of COPD (AECOPD) in Q1 2016, in line with expectations, with data expected in H2 2017
  - Opened a US Investigational New Drug (IND) application for AECOPD
  - Recruitment underway for a global, multi-centre clinical study assessing the impact of two different dosing regimens compared to placebo on top of standard of care in 255 patients
- Initiated a global Phase 2b dose-confirmation study with its oral, once-weekly aromatase inhibitor BGS-649 for the treatment of hypogonadal hypogonadism (HH) in obese men in Q2 2016, with data expected in H2 2017
  - Recruitment underway for a global, multi-centre clinical study assessing the ability of three different doses of BGS-649 to restore testosterone levels and to positively impact clinical outcomes in 260 patients
  - Established a blinded interim review, to be conducted once approximately 50% of the patients have received a month of treatment, to assess whether any of the active dose arms are ineffective
  - Established a follow-up study to be carried out with 50% of the patients in the Phase 2b study to confirm safety of long-term treatment with BGS-649
- Progressed the orphan disease treatment BPS-804 towards a Phase 2b/3 study in patients with osteogenesis imperfecta (OI, also known as brittle bone disease)
  - Obtained Orphan Drug Designation in the US and EU for BPS-804 as a treatment for OI
  - Following our submission to the regulator in H1 2016 we expect to begin the trial during H1 2017 pending feedback from the regulator
- Strengthened intellectual property protection across the portfolio, with new patent applications being pursued, and allowance and grant of additional patents for BPS-804, BCT-197 and BGS-649 in the US, EU and elsewhere
- Shares admitted to the AIM market of the London Stock Exchange on 9 June 2016

Financial highlights

- Raised a further £14.8 million of capital through a private placement of new ordinary shares raising gross proceeds of £11.3 million and a cash investment by existing shareholder Novartis by way of a convertible loan in the amount of £3.5 million
  - Supplements the £76.5 million private placement completed in July 2015
- Loss after tax for the period of £14.7 million (2015: £nil) or 59 pence per ordinary share (2015: nil pence per ordinary share)
- Net cash inflow from financing activities during the period of £68.5 million (2015: £nil) and net cash outflow from operating activities during the period of £10.5 million (2015: £nil), with cash and cash equivalents as at 30 June 2016 of £70.2 million (2015: £nil)

Chairman and CEO's statement

Laying the foundations for success

Business overview

Mereo was founded in early 2015 to finance and develop clinical-stage products which pharmaceutical companies cannot resource due to prioritisation of their rich development pipelines and P&L pressures. Although this is a recognised opportunity within the pharmaceutical industry, it has often proven challenging for companies to agree and establish an appropriate business structure once such assets have been identified. With a focus on rare and speciality diseases and a clear set of product selection criteria, Mereo was able to identify three Phase 2 programmes from Novartis appropriate for external financing and development. In parallel, we negotiated a transaction structure with an equity-for-product swap that aligns the interests of both companies based on the success of the pipeline products.

In July 2015 we completed a £76.5 million private financing round and secured our initial product portfolio from Novartis. In June 2016, with the continued support of Invesco, Woodford Investment Management and Novartis, we completed a private placement, raising an additional £14.8 million through the issue of new equity and a convertible loan, and completed our admission to the AIM market of the London Stock Exchange.

We believe we are now well positioned to leverage our early mover advantage with a novel business model that aligns our interests with the drug development needs of pharmaceutical companies. Our long-term goal is to increase the number of products in the portfolio and we are confident that we possess the right ingredients and experience to build a scalable and sustainable speciality pharmaceutical business.

The initial portfolio

The selection of product candidates from Novartis was based on strong scientific rationale, clinically meaningful data and a clear path to significant value-generating inflection points through further clinical development or commercialisation.

BCT-197 is being developed to treat the inflammation in patients experiencing an acute exacerbation of chronic obstructive pulmonary disease (AECOPD). COPD patients are currently treated with corticosteroids to control inflammation. Despite this treatment AECOPDs still occur frequently. As no therapies treating the underlying AECOPD itself have been approved for use in the US or EU, we believe that novel therapeutics to treat and reduce exacerbations have the potential to improve quality of life, slow the progression of the disease and significantly reduce direct healthcare costs. BCT-197 aims to increase lung function and quality of life for patients, and reduce hospital stays. Furthermore, it offers the possibility of reducing the risk of re-exacerbations and re-hospitalisations.

BCT-197 has been studied in 260 individuals and has already demonstrated a therapeutically meaningful increase in the amount of air forcibly exhaled by an AECOPD patient in one second (forced expiratory volume in one second, or FEV1), a clinically relevant endpoint in COPD. BCT-197 has also demonstrated a statistically significant reduction in the inflammatory marker TNFα in clinical studies. In studies to date, BCT-197 has been shown to be safe and well tolerated in the target patient population.

We commenced a Phase 2 dose-ranging study in 255 AECOPD patients during the first half of 2016 assessing the impact of two different dose levels versus placebo on top of existing standard of care and expect data from this study in the second half of 2017. The aim of the study is to demonstrate the most biologically active dose regimen of BCT-197 based on a primary endpoint of FEV1. Patients will be followed for 26 weeks to explore recurrence rates of AECOPD and number of hospitalisations.

We have filed a number of new patent applications relating to BCT-197 and a patent application covering the use of BCT-197 in the treatment of AECOPD has recently been granted in the US and allowed in Europe and other territories where it will shortly proceed to grant.

BGS-649 is being developed for hypogonadal hypogonadism (HH) in obese men, a clinical syndrome that results from inadequate levels of testosterone. Symptoms that are most commonly associated with testosterone deficiency include impaired libido and sexual dysfunction (including infertility) as well as tiredness, fatigue and mood disturbance. Current treatment for HH is testosterone replacement therapy by intramuscular injection, gel or patches. Testosterone replacement is associated with significant side effects, including excessively high levels of testosterone, which the FDA and health professionals associate with a possible higher risk of stroke and heart attack. We believe that there is a significant market opportunity for a treatment of HH that can be administered in a convenient manner and that restores normal levels of testosterone without causing excessively high testosterone levels.

BGS-649 is a once-weekly pill that is designed to be more convenient, and have additional therapeutic benefits and potential safety advantages, compared to testosterone replacement therapies. BGS-649 has been received by 130 individuals in Novartis' clinical studies. Novartis' Phase 2 data established proof of concept in obese men with HH because it restored testosterone levels to a normal range without causing excessively high levels, and boosted luteinising hormone (LH) and follicle stimulating hormone (FSH) implying maintenance of the normal negative feedback loop, which controls the normal testosterone level. BGS-649 was well tolerated in all clinical studies with no BGS-649-related serious adverse events.

We commenced a Phase 2b study with BGS-649 in 260 patients with HH during the first half of 2016, assessing three different dose levels compared to placebo, and expect data from this study in the second half of 2017. The primary objective of this trial will be to demonstrate the normalisation of testosterone in a significantly greater percentage of patients receiving BGS-649 (compared to those receiving placebo) and to establish the lowest effective dose of BGS-649. Further endpoints will include assessment of patient-reported outcomes and the impact on fertility. There will be an interim analysis, expected before the end of 2016, that aims to identify any dose that has not normalised testosterone and this dosing arm will then be stopped. A subset of patients will be offered to enter into a six-month extension study, to gain long-term data on both efficacy and safety.

We have significantly extended the patent coverage for BGS-649: notably, following an accelerated prosecution, we have patent applications covering the dosing regimen and formulation that have been granted in the US and other territories in 2016 and have been allowed and will shortly proceed to grant in Europe.

Business overview continued

The initial portfolio continued

BPS-804 is being developed for osteogenesis imperfecta (OI, also known as brittle bone disease), a rare genetic condition that results in bones that can break easily. In severe cases, patients may experience hundreds of fractures in a lifetime. Current treatment of OI focuses on treatment of fractures as they occur, maintaining mobility and managing pain. There are no currently available treatments that address the underlying bone weakness. BPS-804 is a fully human antibody that blocks the action of the protein sclerostin, which inhibits the activity of bone-forming cells. By blocking sclerostin, BPS-804 is therefore expected to increase bone formation and reduce bone resorption, thereby reducing fractures in OI patients. There is a significant unmet need for drugs to treat OI, as there is no pharmacological agent approved for the reduction in fractures for children or adults with OI and no treatment or cure is available. We received Orphan Drug Designation for BPS-804 in the US in March 2016 and in the EU in June 2016, which provides significant benefits including a period of market exclusivity and eligibility for incentives.

Novartis' Phase 2 data in osteogenesis imperfecta patients has demonstrated statistically significant proof of concept data in bone biomarkers and bone mineral density. In total, 83 patients and volunteers have received BPS-804 in the clinical studies undertaken by Novartis; in these studies BPS-804 has been shown to be safe and well tolerated.

In our proposed placebo-controlled Phase 2b/3 pivotal study, which is the first major placebo-controlled study to be conducted in OI, we are aiming to demonstrate a benefit in terms of a reduction in the incidence of fractures, since recurrent fractures are the key clinical issue in these patients. We expect the study to be in two parts. The initial part will deliver interim data based on an imaging biomarker and bone mineral density (BMD) in 120 patients following twelve months of treatment and will be used to confirm the dose for the second part of the study. The second part of the study will be event driven, with time to first fracture (TTFF) as the primary endpoint TTFF is inversely related to incidence of fractures. Approximately 300 patients will be treated with BPS-804 or placebo for the greater of one year or TTFF. Patients on placebo will then be converted to active treatment. Patients in the study will be followed for a total of three years. We believe this innovative design has the benefits of being a scientifically robust placebo-controlled study that is attractive to patients as they are likely to receive therapy, and having the potential for early data at an interim analysis. Following our submission to the regulator in H1 2016, we anticipate beginning the trial during H1 2017, pending detailed feedback from the regulator arising from ongoing multidisciplinary review of our submission.

BPS-804 has strong patent protection through granted composition of matter claims. New patent applications are being pursued and a divisional patent application in Europe has recently been allowed and will shortly proceed to grant.

Building the infrastructure

We are fortunate to have had an experienced Board in place from the early stages of Mereo, comprising individuals with significant operating and clinical development experience in successful pharmaceutical and biotechnology companies. Since completion of the private financing in July 2015 we have built the Company infrastructure and added resources for effective execution of the clinical development plans for the initial three products, and for the future acquisition of additional products. We have attracted highly talented individuals in clinical development, clinical operations, manufacturing and intellectual property to support the high calibre and experienced management team and Board of Directors. In the short term we plan to execute on the clinical studies which represent the next value inflection points for each of the three pipeline products. In the longer term our goal is to have between five and seven products under development. To achieve this we are planning to leverage our internal resource with appropriate and selective use of external resource, such as clinical research organisations, in such a way that we will only need to minimally increase internal personnel for each additional product.

Development of our portfolio

Our portfolio is designed to have diversified risk as each product has a different mechanism of action, involves different regulatory frameworks, and has different pricing and reimbursement considerations.

We will continue to review opportunities to expand our initial portfolio by acquiring additional product candidates with strong scientific rationale and a clear path to significant value generating inflection points. We are actively developing a deal pipeline with large pharmaceutical companies with a history of robust product development and a reputation for product data quality. We believe that our scalable business model allows Mereo to be involved in a range of different therapeutic areas, enabling further diversification of our product portfolio and successfully creating sustainable value through intelligent growth with a preference for rare and specialist diseases with high unmet medical need that may be developed through to product approval.

Another key feature of our business model is that Mereo has complete commercial flexibility. As we consider the strategic options for each of our pipeline products we are now in a position to dictate the balance between out-licensing products at the stage which it is appropriate to do so and retaining the commercial rights to select products where we believe Mereo can best manage the value creation.

Financial review

Following the formation of the Company on 10 March 2015 there were minimal financial transactions prior to the private financing that completed on 29 July 2015 other than the issuance of founders' equity. Accordingly, there is no relevant comparative information for the consolidated financial statements.

On 9 June 2016 the Company's shares were admitted to the AIM market of the London Stock Exchange under the symbol "MPH". Immediately prior to this, the Company was re-registered as a public limited company.

The loss for the six-month period ended 30 June 2016 (the "Period") was £14.7 million (2015: £nil). The reported loss includes a non-cash share-based payment charge and associated provision for social security payments totalling £5.3 million (2015: £nil) and a tax credit of £2.2 million, representing the estimated amount receivable under the UK Research & Development SME scheme in respect of the activities conducted during the Period.

Research and development expenses for the Period were £11.1 million (2015: £nil), including a non-cash share-based payment charge and associated provision for social security payments totalling £1.1 million. The majority of these expenses comprise payments to contract research organisations (CROs) in respect of the set up and running of the clinical trials for the Group's three programmes, along with payments to contract manufacturing organisations (CMOs) relating to manufacturing and distribution of clinical trial materials.

General and administrative expenses for the Period were £5.8 million (2015: £nil), including a non-cash share-based payment charge and associated provision for social security payments totalling £4.2 million and an exchange gain of £1.2 million (see below). General and administrative expenses include staff costs for executive management and administration functions, facilities costs and professional advisors as well as the costs of filing and maintaining the Group's intellectual property.

Financial review continued

The Group strengthened its balance sheet significantly during the Period. At completion of the £76.5 million private financing in July 2015 the Group drew down an initial £20.0 million. During June 2016 the Group drew down the remaining £56.5 million gross proceeds and, in addition, completed a further private placement raising total gross proceeds of £14.8 million, comprising £11.3 million through the issue of new ordinary shares and £3.5 million through the issue of a convertible loan note to Novartis. The net cash inflow from financing activities during the period was £68.5 million (2015: £nil) and the net cash outflow from operating activities during the Period was £10.5 million (2015: £nil), resulting in cash and short-term deposits as at 30 June 2016 of £70.2 million (2015: £nil).

A significant component of the Group's current clinical trial expenditure is denominated in US Dollars. In the period before the vote in the UK to leave the European Union on 23 June 2016 ("Brexit") the Group purchased sufficient US Dollars to meet its near-term commitments, providing a hedge against a potential vote to leave the European Union. Following the vote to leave the European Union, Sterling weakened significantly against both the US Dollar and the Euro. Accordingly, administrative expenses for the Period include a £1.2 million exchange gain on the US Dollar deposits. In addition, the Group has reviewed the assumptions underlying its valuation of the intangible assets and has concluded that there is no impairment as a result of the economic consequences of the Brexit vote or other internal or external factors since the last impairment review as at 31 December 2015.

Outlook

Following the recent private placement and admission of its shares to AIM, the Group believes it is well positioned to deliver key value inflection points on all three of its initial portfolio programmes. The Group will seek further opportunities to accelerate growth and development with the aim of becoming a leading player in the development and commercialisation of novel therapies for rare and speciality diseases with a high unmet medical need.

Dr Peter Fellner
Chairman
16 September 2016

Dr Denise Scots-Knight
Chief Executive Officer

Independent review report

to Mereo BioPharma Group plc

Introduction

We have been engaged by the Company to review the condensed set of consolidated financial statements in the half-yearly financial report for the six months ended 30 June 2016, which comprises the consolidated statement of comprehensive loss, consolidated balance sheet, consolidated statement of cash flows, consolidated statement of changes in equity and the related notes 1 to 10. We have read the other information contained in the half-yearly financial report and considered whether it contains any apparent misstatements or material inconsistencies with the information in the condensed set of consolidated financial statements.

This report is made solely to the Company in accordance with guidance contained in International Standard on Review Engagements 2410 (UK and Ireland) "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" issued by the Auditing Practices Board. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company, for our work, for this report, or for the conclusions we have formed.

Directors' responsibilities

The half-yearly financial report is the responsibility of, and has been approved by, the Directors. The Directors are responsible for preparing the half-yearly financial report in accordance with International Accounting Standard 34 *Interim Financial Reporting* as adopted by the European Union.

As disclosed in note 1, the annual consolidated financial statements of the Company are prepared in accordance with IFRSs as adopted by the European Union. The condensed set of consolidated financial statements included in this half-yearly financial report has been prepared in accordance with International Accounting Standard 34 *Interim Financial Reporting* as adopted by the European Union.

Our responsibility

Our responsibility is to express to the Company a conclusion on the condensed set of consolidated financial statements in the half-yearly financial report based on our review.

Scope of review

We conducted our review in accordance with International Standard on Review Engagements (UK and Ireland) 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" issued by the Auditing Practices Board for use in the United Kingdom. A review of interim financial information consists of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing (UK and Ireland) and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the condensed set of consolidated financial statements in the half-yearly financial report for the six months ended 30 June 2016 is not prepared, in all material respects, in accordance with International Accounting Standard 34 as adopted by the European Union.

Ernst & Young LLP
Reading
16 September 2016

Consolidated statement of comprehensive loss

for the six months ended 30 June 2016

	Notes	Six months ended 30 June 2016 Unaudited £	10 March 2015 to 30 June 2015 Unaudited £	10 March 2015 to 31 December 2015 Audited £
Research and development expenses		**(11,121,516)**	—	(5,445,015)
Administrative expenses		**(5,784,548)**	(2)	(7,716,344)
Operating loss		**(16,906,064)**	(2)	(13,161,359)
Net finance income		**8,794**	—	25,717
Loss before tax		**(16,897,270)**	(2)	(13,135,642)
Taxation	5	**2,170,849**	—	946,681
Loss for the period, attributable to equity holders of the parent		**(14,726,421)**	(2)	(12,188,961)
Other comprehensive income/(loss) for the period, net of tax		**—**	—	—
Total comprehensive (loss) for the period, net of tax and attributable to the equity holders of the parent		**(14,726,421)**	(2)	(12,188,961)
Basic and diluted loss per share for the period	6	**(0.59)**	—	(1.01)

Consolidated balance sheet

as at 30 June 2016

	Notes	30 June 2016 Unaudited £	30 June 2015 Unaudited £	31 December 2015 Audited £
Assets				
Non-current assets				
Property, plant and equipment		**189,191**	—	204,517
Intangible assets		**25,812,941**	—	25,812,941
		26,002,132	—	26,017,458
Current assets				
Prepayments		**749,377**	—	253,926
R&D tax credits	5	**3,117,530**	—	946,681
Other receivables		**713,791**	—	396,022
Cash and short-term deposits		**70,177,639**	4,998	12,247,986
		74,758,337	4,998	13,844,615
Total assets		**100,760,469**	4,998	39,862,073
Equity and liabilities				
Equity				
Issued capital	9	**193,022**	5,000	59,221
Share premium	9	**100,073,792**	—	26,212,880
Other capital reserves	9	**10,534,362**	—	21,660,105
Accumulated losses		**(19,915,382)**	(2)	(12,188,961)
Total equity		**90,885,794**	4,998	35,743,245
Non-current liabilities				
Provisions		**1,102,836**	—	141,311
Convertible loan	7	**2,957,009**	—	—
		4,059,845	—	141,311
Current liabilities				
Trade and other payables		**5,814,830**	—	3,977,517
Total liabilities		**9,874,675**	—	4,118,828
Total equity and liabilities		**100,760,469**	4,998	39,862,073

Consolidated statement of cash flows

for the six months ended 30 June 2016

	Notes	Six months ended 30 June 2016 Unaudited £	10 March 2015 to 30 June 2015 Unaudited £	10 March 2015 to 31 December 2015 Audited £
Operating activities				
Loss before tax		**(16,897,270)**	(2)	(13,135,642)
Adjustments to reconcile loss before tax to net cash flows:				
– Depreciation and impairment of property, plant and equipment		**16,651**	—	11,361
– Share-based payment expense		**4,360,818**	—	2,982,265
– Provision for social security contributions on employee share options		**961,525**	—	141,311
– Finance income		**(19,042)**	—	(25,717)
– Interest on convertible loan		**10,248**	—	—
Working capital adjustments:				
– Increase in receivables		**(813,220)**	—	(649,948)
– Increase in payables		**1,837,313**	—	3,977,517
Net cash flows from operating activities		**(10,542,977)**	(2)	(6,698,853)
Investing activities				
Purchase of property, plant and equipment		**(1,325)**	—	(215,878)
Interest received		**19,042**	—	25,717
Net cash flows received /(used) in investing activities		**17,717**	—	(190,161)
Financing activities				
Proceeds from issue of ordinary shares	9	**67,888,820**	5,000	20,005,000
Transaction costs on issue of shares		**(2,897,470)**	—	(868,000)
Proceeds from issue of convertible loan	7	**3,463,563**	—	—
Net cash flows from financing activities		**68,454,913**	5,000	19,137,000
Net increase in cash and cash equivalents		**57,929,653**	4,998	12,247,986
Cash and cash equivalents at the beginning of the period		**12,247,986**	—	—
Cash and cash equivalents at the end of the period		**70,177,639**	4,998	12,247,986

Consolidated statement of changes in equity

for the period ended 30 June 2016

	Issued capital (note 9) £	Share premium (note 9) £	Other capital reserves (note 9) £	Accumulated losses £	Total equity £
As at 10 March 2015	—	—	—	—	—
Loss for the period	—	—	—	(2)	(2)
Issue of share capital	5,000	—	—	—	5,000
At 30 June 2015	5,000	—	—	(2)	4,998
Loss for the period	—	—	—	(12,188,959)	(12,188,959)
Issue of share capital	14,740	27,067,420	—	—	27,082,160
Issue of bonus share capital	39,481	(39,481)	—	—	—
Share-based payments	—	—	2,982,265	—	2,982,265
Shares to be issued	—	—	18,677,840	—	18,677,840
Profit on transfer of loan notes for equity	—	52,941	—	—	52,941
Transaction costs on issuance of share capital	—	(868,000)	—	—	(868,000)
At 31 December 2015 – audited	59,221	26,212,880	21,660,105	(12,188,961)	35,743,245
Loss for the period	—	—	—	(14,726,421)	(14,726,421)
Issue of share capital (note 9)	133,801	83,758,382	—	—	83,892,183
Share-based payments	—	—	4,360,818	—	4,360,818
Redemption of shares to be issued	—	—	(16,003,363)	—	(16,003,363)
Equity element of convertible loan (note 7)	—	—	516,802	—	516,802
Share capital reduction (note 9)	—	(7,000,000)	—	7,000,000	—
Transaction costs on issuance of share capital (note 3)	—	(2,897,470)	—	—	(2,897,470)
At 30 June 2016 – unaudited	**193,022**	**100,073,792**	**10,534,362**	**(19,915,382)**	**90,885,794**

Notes to the interim report

1. Corporate information

The interim condensed consolidated financial statements of Mereo BioPharma Group plc and its subsidiaries (collectively, the "Group") for the six months ended 30 June 2016 were authorised for issue in accordance with a resolution of the Directors on 14 September 2016. Mereo BioPharma Group plc (the "Company" or the "parent") is a public limited company incorporated and domiciled in the United Kingdom and whose shares are publicly traded on the AIM Market of the London Stock Exchange. The registered office is located at Fourth Floor, 1 Cavendish Place, London W1G 0QF.

The Group is principally engaged in the research and development of novel pharmaceuticals.

2. Basis of preparation

The interim condensed consolidated financial statements for the six month period ended 30 June 2016 have been prepared in accordance with IAS 34 *Interim Financial Reporting*.

The interim condensed consolidated financial statements do not include all the information and disclosures required in the statutory financial statements, and should be read in conjunction with the Group's financial statements as at 31 December 2015.

The accounting policies adopted in the preparation of the interim condensed consolidated financial statements are consistent with those followed in the preparation of the Group's consolidated financial statements for the period ended 31 December 2015, except for the new accounting policies described in note 3 below. The financial information is presented in Sterling.

These condensed half-yearly financial statements are unaudited and do not constitute statutory accounts of the Group as defined in section 434 of the Companies Act 2006. The auditor, Ernst & Young LLP, has carried out a review of the financial information in accordance with the guidance contained in International Standard on Review Engagements (UK and Ireland) 2410 "Review of Interim Financial Information Performed by the Independent Auditor of the Entity", and their review report is set out at the beginning of this report.

The financial information for the period ended 31 December 2015 has been extracted from the Group's published financial statements for that year, and a copy of the statutory accounts for that financial year has been delivered to the Registrar of Companies. The auditors reported on those accounts and their report was unqualified, did not draw attention to any matters by way of emphasis and did not contain a statement under section 498(2) or (3) of the Companies Act 2006.

3. Summary of changes or new significant accounting policies

3.1 Costs of issuing capital

The Group deducts directly attributable costs of issuing capital from the proceeds in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*.

3.2 Long term incentive plan

In accordance with IFRS 2 *Share-Based Payment*, employee services received in exchange for the grant of any share-based compensation are measured at their fair values. These are indirectly determined by reference to the share option or shares awarded. Their value is appraised at the grant date and excludes the impact of any non-market vesting conditions. The fair value of LTIP shares, which have market conditions attached, includes an adjustment based on the probability of the shares vesting at the end of the vesting period.

Details of the LTIP scheme and the conditions applying to each scheme are disclosed in note 8.

3. Summary of changes or new significant accounting policies continued

3.3 Convertible loan instrument

Convertible loan notes are regarded as compound instruments consisting of a liability component and an equity component. At the date of issue the fair value of the liability component is estimated using a discount rate for an equivalent liability without the conversion feature. The difference between the proceeds of issue of the convertible loan note and the fair value assigned to the liability component, representing the embedded option to convert the liability into equity of the Group, is included in equity.

3.4 Share-based compensation – cancellation of options

In accordance with IFRS 2 *Share-Based Payment*, the cancellation of share options is accounted for as an acceleration of the vesting period and therefore any amount unrecognised that would otherwise have been charged in future accounting periods is recognised immediately.

4. Segment information

For management purposes, the Group is organised into business units based on its products and has three reportable segments, as follows:

- Respiratory Unit, which develops drugs to treat respiratory diseases
- Endocrinology Disorders Unit, which develops drugs to treat endocrine disorders
- Orphan Diseases Unit, which develops drugs to treat various orphan diseases

Period ended 30 June 2016	Respiratory Unit £	Endocrinology Disorders Unit £	Orphan Diseases Unit £	Total segments £	Unallocated £	Consolidated £
Expenses						
Research and development	(4,241,623)	(4,116,677)	(2,449,412)	(10,807,712)	(313,804)	(11,121,516)
Administrative	(1,543,854)	(1,591,431)	(1,656,843)	(4,792,128)	(992,420)	(5,784,548)
Segment operating loss	(5,785,477)	(5,708,108)	(4,106,255)	(15,599,840)	(1,306,224)	(16,906,064)
Assets						
Tax credit	867,486	844,539	458,824	2,170,849	—	2,170,849
Intangible assets	4,310,761	9,886,356	11,615,824	25,812,941	—	25,812,941

5. Income tax

The Group is entitled to claim tax credits in the United Kingdom under the UK research and development (R&D) small or medium-sized enterprise scheme, which provides additional taxation relief for qualifying expenditure on R&D activities, and includes an option to surrender a portion of tax losses arising from qualifying activities in return for a cash payment from HM Revenue & Customs (HMRC). The amount included in the statement of comprehensive loss for the period ended 30 June 2016 represents the credit receivable by the Group for the six months to 30 June 2016. The amounts have not yet been agreed with HMRC.

	Six months ended 30 June 2016 £
Group	
United Kingdom corporation tax R&D credit	2,170,849
Income tax credit	2,170,849

6. Loss per share

Basic loss per share is calculated by dividing the loss attributable for the period to ordinary equity holders of the parent by the weighted average number of ordinary shares outstanding during the period.

As net losses from continuing operations were recorded in the period, the dilutive potential shares are anti-dilutive for the earnings per share calculation.

	Six months ended 30 June 2016
Group	
Loss from continuing operations attributable to ordinary equity holders of the parent	**(£14,726,421)**
Weighted average number of ordinary shares in issue	**24,914,940**
Basic and diluted loss per share	**(£0.59)**

The Company operates share option schemes which could potentially dilute basic earnings per share in the future. In addition, there exist within equity 1,453,520 shares to be issued which also have the potential to dilute basic earnings per share in the future (see note 7). There have been no other transactions involving ordinary shares or potential ordinary shares between the reporting date and the date of this interim report.

7. Convertible loan note

On 3 June 2016, the Company created 3,463,563 £1 unsecured convertible loan notes ("Notes"). The Notes attract an interest rate of 4% per annum payable annually and accruing daily and constitute direct, unsecured obligations of the Company ranking ahead of any other unsecured obligations of the Company.

The noteholder shall be entitled, at any time within 36 months of the date of the instrument ("Maturity Date"), to serve a conversion notice on the Company to convert all or some only of the outstanding Notes into fully paid ordinary shares at a conversion price of £2.21 per share. To the extent the Notes are not converted at the Maturity Date, the outstanding principal amount of the Notes, together with any accrued interest, is redeemable. Upon conversion of any Notes, in addition to the relevant number of conversion shares, the noteholder is entitled to receive an additional number of ordinary shares in the Company equal to the number of conversion shares into which such Notes are to convert, multiplied by 0.93, up to a maximum aggregate number of 1,453,520 such bonus shares.

The value of the debt component of the Notes at 30 June 2016 was calculated as £2,946,761. The cash flows attached to the Note up to the Maturity Date were calculated and discounted at an appropriate venture debt rate of 10%.

The value of the equity component of the Notes at 30 June 2016 was calculated as £516,802.

8. Long Term Incentive Plan

Incentive plan

Under the Mereo BioPharma Group plc Long Term Incentive Plan (the "LTIP Plan"), the Group, at its discretion, may grant nil cost options to acquire shares to employees. Under the LTIP Plan rules, vesting of 75% of the options issued to nil cost is subject to a share price performance condition (the "Share Price Element") and vesting of 25% of the options is subject to achievement of strategic operational targets (the "Strategic Element"). Share options vest over a maximum of five years, dependent upon achievement of these targets.

The fair value of the LTIP Share Price Element is estimated at the date of grant using a Monte Carlo pricing model, taking into account the terms and conditions upon which the share options were granted.

The fair value of the LTIP Strategic Element is estimated at the date of grant using a Black Scholes pricing model, taking into account the terms and conditions upon which the share options were granted, and the expected level of achievement of strategic targets.

The fair value calculations do not include any allowance for dividends as the Company has no available profits for distribution.

The contractual term of the LTIP options is five years.

The expense recognised for employee services received during the period to 30 June 2016 was £17,728 (30 June 2015: £nil).

There were no cancellations or modifications to the awards in the period to 30 June 2016.

Movements during the period

The following table illustrates the number of, and movements in, LTIP options during the period:

	Awards
Granted during the period	1,199,658
Outstanding at 30 June	**1,199,658**
Exercisable at 30 June	**—**

The weighted average remaining contractual life for the LTIP options outstanding as at 30 June 2016 was 4.1 years.

The weighted average fair value of options granted during the period was £1.21.

The following tables list the weighted average inputs to the models used for the fair value of LTIP options granted during the period ended 30 June 2016:

LTIP share price element

	Period ended 30 June 2016
Expected volatility	**48.9%**
Risk-free interest rate	**0.48–0.74%**
Expected life of share options	**3–5 years**
Market price of ordinary shares	**£2.21**
Model used	**Monte Carlo**

8. Long term incentive plan continued

LTIP strategic element

	Period ended 30 June 2016
Expected volatility	**48.9%**
Risk-free interest rate	**0.74%**
Expected life of share options	**5 years**
Market price of ordinary shares	**£2.21**
Model used	**Black Scholes**

Since there is no historical data in relation to the expected life of the LTIP options, the contractual life of the options has been used in calculating the expense for the period.

Volatility is estimated by reference to the share price volatility of a group of comparable companies over a retrospective period equal to the expected life of the LTIP options.

9. Issued capital and reserves

	£
Ordinary share capital	
Ordinary share capital at 1 January 2016	59,221
Issuances in the period	133,801
Nominal share capital as at 30 June 2016	**193,022**
Ordinary shares issued and fully paid (post ordinary share split)	
At 1 January 2016	19,740,296
Issued on 9 June 2016 for private financing round	39,464,540
Issued on 9 June for private placement	5,135,962
At 30 June 2016	**64,340,798**
Nominal value at 30 June 2016	**0.003**
Issued capital at 30 June 2016	**193,022**

Since 1 January 2016, the following alterations to the Company's share capital have been made:

- under the subscription agreement dated 28 July 2015, as amended by an agreement dated 1 June 2016, the issue and allotment of 39,464,540 ordinary shares of £0.003 in nominal value in the capital of the Company on 9 June 2016 at a price of £1.84 per share. 39,699 of these ordinary shares were issued to WG Partners LLP, for no cash consideration, as payment for financial advisory services;
- on 21 March 2016 the Directors of the Company signed a solvency statement with the agreement of all shareholders and undertook a capital reduction, reducing the share premium account by £7,000,000 and reducing the accumulated losses by the same amount;
- under a private placement dated 9 June 2016, the issue and allotment of 5,135,962 ordinary shares of £0.003 in nominal value in the capital of the Company on 9 June 2016 at a price of £2.21 per share; and
- on 9 June 2016, the Company's ordinary shares were admitted to trading on the AIM market of the London Stock Exchange.

9. Issued capital and reserves continued

	£
Share premium	
At 1 January 2016	26,212,880
Issuance of share capital for private financing round on 9 June 2016	72,423,314
Issuance of share capital for private placement on 9 June 2016	11,335,068
Transaction costs for issued share capital	(2,897,470)
Share capital reduction on 21 March 2016	(7,000,000)
At 30 June 2016	**100,073,792**

Share option schemes

The Group has a share option scheme under which options to subscribe for the Company's shares have been granted to certain Executives, Non-Executive Directors and employees.

Other capital reserves

	£
At 1 January 2016	21,660,105
Share-based payments expense during the period	4,360,818
Shares to be issued – reduction due to shares released on 9 June 2016	(16,003,363)
Equity component of convertible loan instrument	516,802
At 30 June 2016	**10,534,362**

Share-based payments

The share-based payment reserve is used to recognise the value of equity-settled share-based payments provided to employees, including key management personnel, as part of their remuneration. Of the £4,360,818 share-based payment expense in the period, £298,836 is an accelerated charge relating to 500,000 share options which were cancelled on 9 June 2016.

Shares to be issued

Of the 44,600,502 ordinary shares issued on 9 June 2016, 8,697,480 shares were issued to Novartis Pharma AG ("Novartis").

10. Related party disclosures

Transactions between the parent and its subsidiaries, which are related parties, have been eliminated on consolidation and are not disclosed in this note.

Novartis holds shares in the Company at 30 June 2016. On 3 June 2016, the Group issued 3,463,563 £1 unsecured convertible loan notes ("Notes") to Novartis and received £3,463,563 from Novartis in consideration (note 7).

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