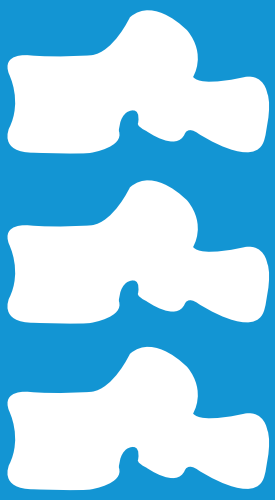
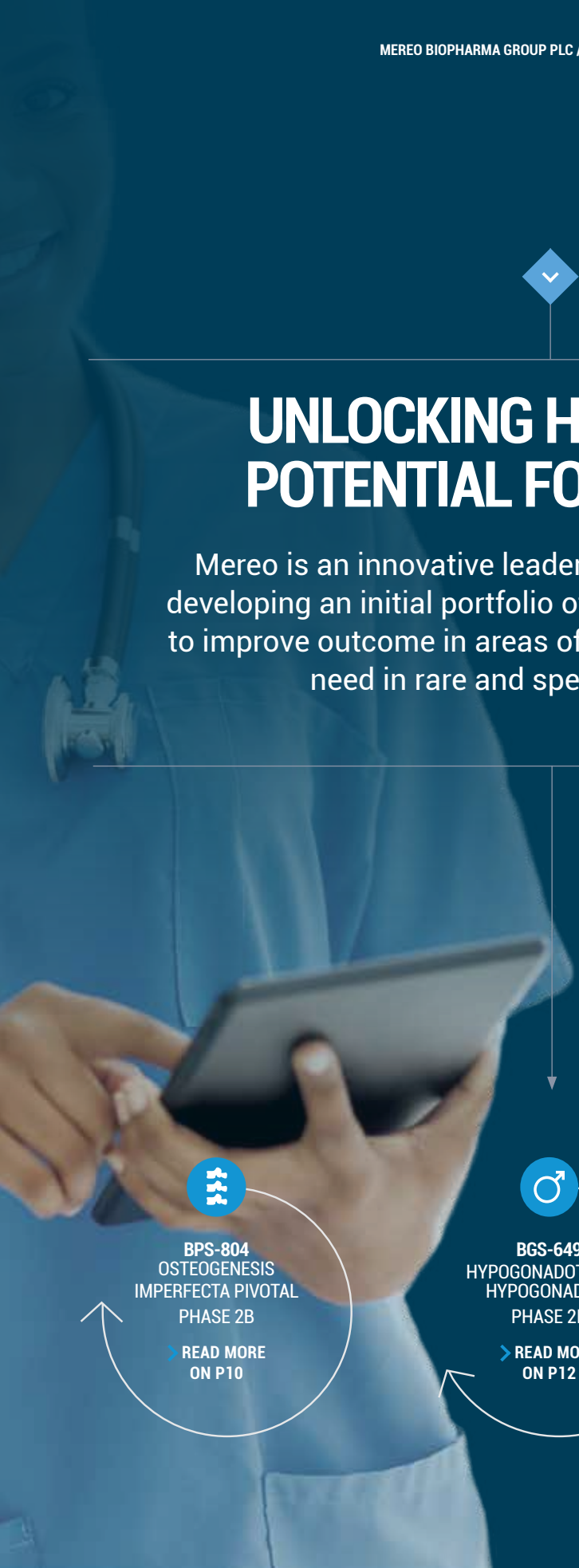
Mereo BioPharma



# UNLOCKING POTENTIAL

**MEREO BIOPHARMA GROUP PLC**
ANNUAL REPORT 2016



# UNLOCKING HEALTHCARE POTENTIAL FOR PATIENTS

Mereo is an innovative leader in the biopharma sector developing an initial portfolio of three medicines designed to improve outcome in areas of significant unmet medical need in rare and speciality diseases.

**BPS-804**
OSTEOGENESIS IMPERFECTA PIVOTAL
PHASE 2B

READ MORE ON P10

**BGS-649**
HYPOGONADOTROPIC HYPOGONADISM
PHASE 2B

READ MORE ON P12

**ACUMAPIMOD**
ACUTE EXACERBATIONS OF CHRONIC OBSTRUCTIVE PULMONARY DISEASE
PHASE 2

READ MORE ON P14

## 2016 HIGHLIGHTS

- A Phase 2 dose-ranging study initiated with acumapimod for treatment of the underlying inflammation in patients with acute exacerbations of COPD in H1 2016
- Initiated a Phase 2b dose confirmation study with BGS-649 for the treatment of hypogonadotropic hypogonadism in obese men in H1 2016 and a six month safety extension study was initiated in Q4 2016. On track to report interim analysis in March 2017
- Obtained Orphan Drug Designation in the US and the EU for BPS-804 as a treatment for osteogenesis imperfecta
- Positive Phase 1 drug-drug interactions study with BCT-197 (acumapimod) and azithromycin
- Strengthened intellectual property across the portfolio
- Shares admitted to the AIM market of the London Stock Exchange on 9 June 2016 following a private placement raising a further £14.8 million of capital, in addition to the £56.5 million drawdown earlier in the year from the previous financing round bringing the total raised since July 2015 to £91.3 million
- Balance sheet remains strong, with cash and cash equivalent balance at 31st December 2016 of £53.6 million

## POST PERIOD HIGHLIGHTS

- Three abstracts have been accepted for presentation as posters at the American Thoracic Society in May 2017
- BPS-804 accepted for EMA Adaptive Pathways programme, potentially enabling earlier patient access
- Richard Jones appointed as Chief Financial Officer, Jerome Dauvergne appointed as Head of Pharmaceutical Development

### GROSS CASH PROCEEDS FROM FINANCING

£71.3m

| | |
|---|---|
| 16 | £71.3m |
| 15 | £20.0m |

### YEAR-END CASH AND CASH EQUIVALENTS

£53.6m

| | |
|---|---|
| 16 | £53.6m |
| 15 | £12.2m |

### INVESTMENT IN R&D

£22.8m

(1) Excludes share based payments.

| | |
|---|---|
| 16 | £22.8m(1) |
| 15 | £5.0m |

### LOSS PER SHARE

63p

(2) Adjusted loss per share 51p (see note 10).

| | |
|---|---|
| 16 | 63p(2) |
| 15 | 101p |

## STRATEGIC REPORT*



## CORPORATE GOVERNANCE



## FINANCIAL STATEMENTS



* The Strategic Report, which has been prepared in accordance with the CA 2006 has been approved and signed by order of the Board on 24 February 2017

**Charles Sermon**
Company Secretary

FOR MORE INFORMATION VISIT OUR WEBSITE

**WWW.MEREOBIOPHARMA.COM**

## AT A GLANCE

# Unlocking potential in R&D pipelines

Mereo was established to address the R&D and financial challenges faced by an increasing number of pharmaceutical companies and thereby deliver novel medicines to patients that may not otherwise have been developed.

## OUR VISION

Mereo's vision is to become the partner of choice for pharmaceutical companies for the development of novel, clinically validated pipeline products that have the potential to address significant unmet medical needs.

## OUR STRATEGY

Mereo's strategy is to leverage its innovative business model and resources to develop novel medicines for patients that otherwise may not be developed and become a leader in speciality biopharma.

## OUR PRODUCTS

### BPS-804

BPS-804 is a fully humanised monoclonal antibody targeting sclerostin, which is being developed to improve bone quality and thereby reduce fractures in the orphan disease osteogenesis imperfecta (OI).

READ MORE ON P10

### BGS-649

BGS-649 is a novel once-weekly oral aromatase inhibitor being developed as a first-line therapy for the treatment of obese men with hypogonadotropic hypogonadism (HH).

READ MORE ON P12

### ACUMAPIMOD

Acumapimod (BCT-197) is an oral p38 MAP kinase inhibitor being developed as a first-line therapy for acute exacerbations of chronic obstructive pulmonary disease (AECOPD).

READ MORE ON P14

# OUR STRENGTHS

## Strategy

READ MORE ON P4

**Leverage our innovative model to develop novel medicines for patients and become a leader in speciality biopharma**

Large companies' pipelines are full of promising new drugs, but P&L pressures and competition for R&D resources mean it is difficult for all of these drug candidates to be advanced. Mereo was established to overcome these hurdles, optimise drug development and ensure that promising drug candidates are made available to patients and fulfil their potential.

## Business model

READ MORE ON P5

**Acquire innovative products and deliver to patients in areas of high unmet medical need**

Mereo combines the efficiency of a small company combined with the financial strength to conduct comprehensive clinical studies, enabling us to rapidly develop promising drug candidates into marketable products and to capitalise on this value through partnership, sale or direct commercialisation. Our substantial internal expertise is complemented by an agreement with the global Contract Research Organisation (CRO) ICON.

## Pipeline

READ MORE ON P9

**Build a pipeline of novel products focused on rare and speciality diseases with unmet needs**

Mereo has developed a clear set of selection criteria for new product candidates which reflects the expertise and experience of its founders. The Group has acquired an initial portfolio of three pipeline products from Novartis, each with a comprehensive and robust package of Phase 2 clinically meaningful data. Longer term, the Group aims to build a diversified portfolio of five to seven products.

## Governance

READ MORE ON P20

**Highly experienced Board and management team**

Our leadership team is highly experienced in clinical development, identifying new product opportunities, capital raising and structuring transactions. Our Board comprises individuals with significant general operating and clinical development experience in successful biotechnology and pharmaceutical companies.

## Financial

READ MORE ON P18

**Well financed to support achievement of key value inflection points**

In 2016 Mereo drew down £56.5 million from the private financing round in 2015 with two leading investors, Woodford and Invesco, and completed a further financing round of £14.8 million from investors, including Novartis, in June 2016, following which it joined the London Stock Exchange's AIM market.

# BUSINESS MODEL

## Acquire innovative products and deliver to patients in areas of high unmet need.

### HELPING TRANSFORM THE LIVES OF PATIENTS

#### Current portfolio – Developing our drugs

- Strong internal development expertise
- ICON relationship to facilitate clinical development
- Leverage global thought leaders to optimise development strategies
- Well diversified risk profile across multiple drug types and clinical indications

#### Identifying new products

Leverage relationships with large pharmaceutical companies

#### Acquisition of new products

Aligned interests with pharmaceutical companies allow for alternative transaction structures

#### New products

Target rare and speciality indications with unmet medical needs and compelling market potential

# A flexible and scalable business model.

## 1 DEVELOP EXISTING PORTFOLIO

- We are focused in specialist-treated disease areas where there are often few or no treatment options for patients and hence a high level of unmet medical need.
- We consult broadly with patient organisations and global thought leaders to shape our clinical development plans to meet the needs of patients, physicians and payers as well as regulators.
- Our studies are robust and statistically well powered to build on and expand the high quality packages we acquire from our large pharmaceutical company product providers.

## 2 OPTIMISE THE VALUE

- We seek to acquire global rights for all products, providing control over the future development and commercialisation of each programme. Mereo intends to develop, register and commercialise products in orphan diseases, whereas it will seek a partner for speciality disease products at the most appropriate stage.
- Mereo has been structured to provide flexibility for value realisation through multiple avenues.
- We are intentionally pursuing a diversified portfolio – in terms of disease areas, mechanisms of action and types of molecule – to ensure a balanced risk profile.

## 3 EXPAND THE PORTFOLIO

- Our lean internal infrastructure covers clinical development, manufacturing and IP management. This is further complemented by key partners, in particular the global CRO, ICON for clinical development and operators. Furthermore, this structure is readily scalable for future product acquisitions with only modest increases in headcount for new products.
- Our focus is on product candidates with strong intellectual property, compelling market potential, comprehensive preclinical, clinical and manufacturing data packages and a clear path to a significant and timely value inflection point.
- For each additional product candidate we will seek to secure funding to reach the next value inflection point at the time of acquisition.

READ MORE ON P6

# CHAIRMAN AND CEO'S STATEMENT

## Mereo had a strong year in 2016.

*"This year we have made significant progress on all three of our programmes with two now well advanced in the clinic and the third set to enter a pivotal study. We remain focused on executing against our strategy, delivering data on our current programmes and continuing to build our portfolio of differentiated, late stage products over time."*

**DR DENISE SCOTS-KNIGHT**
CHIEF EXECUTIVE OFFICER

*"Our strategy of unlocking the potential of products from pharmaceutical pipelines in areas of high unmet medical need brings significant benefits and value to all investors. The Group's progress means it is well on the way to making medicines available to patients that otherwise may not have been developed."*

**DR PETER FELLNER**
CHAIRMAN

Mereo is a biopharmaceutical group developing innovative medicines for patients with rare and/or speciality diseases that are not adequately treated by current drug products.

### Introduction

The Group's strategy is to generate shareholder value by acquiring clinical stage products according to our exacting criteria, as an increasing number of pharmaceutical and biotechnology companies face R&D and financial challenges. We then seek to finance and develop such products to an optimum value inflection point. Patients benefit from this approach by having access to medicines that otherwise may remain underdeveloped by larger pharmaceutical companies.

The Group plans to build a broad and diverse portfolio of acquired orphan disease products and develop them through clinical studies to regulatory approval and then plans to commercialise them directly. Orphan disease products are an attractive opportunity for smaller companies to commercialise. Due to the lack of existing treatments, orphan drugs can be fast-tracked to the market and can involve smaller clinical trials, with lower development costs. The development of these products often involves close co-ordination with patient organisations and a limited number of treatment sites

allowing for relatively easy identification of the patient population and therefore a small sales infrastructure.

For speciality products the Group plans to partner or sell the product upon completion of additional clinical studies which may be for dose-ranging optimisation or, in certain cases, the Phase 3 studies required for product approval and registration.

By acquiring products with clinical efficacy and safety data the Group aims to reduce some of the development risks involved and to accelerate the availability of these drugs for patients. Such well characterised clinical-stage products will have received significant investment whilst being developed by major pharmaceutical companies.

Our product selection process has a clear set of criteria and typically means that we acquire products that already have compelling proof of concept data or a well-established scientific proof of mechanism in the disease indication we plan to pursue.

This is the case for the Group's initial portfolio, comprising of three products acquired from Novartis in 2015; acumapimod (BCT-197) for acute exacerbations of chronic obstructive pulmonary disease (AECOPD), BGS-649 for hypogonadotropic hypogonadism (HH) and BPS-804 for osteogenesis imperfecta (OI, also known as brittle bone disease). Each of these products was acquired with proof of concept data in the target clinical indication we intend to pursue.

## 2016 YEAR IN REVIEW

Mereo had a strong year in 2016, advancing all of our three clinical stage products towards the goal of delivering novel medicines to patients. In 2016 we:

### Acumapimod

In Q2 2016 we initiated a Phase 2 dose-ranging clinical trial for acumapimod in 270 AECOPD patients in the US and the EU to explore two different dosing regimens versus placebo (on top of standard of care). The study aims to demonstrate the most biologically active dose regime of acumapimod based on a primary end point of forced expiratory volume in one second (FEV1). Patients will be followed for 26 weeks after treatment to explore recurrence rates of AECOPD and number of hospitalisations. We also initiated and successfully completed a drug-drug interaction study for acumapimod with the antibiotic azithromycin in 16 healthy volunteers. This will allow acumapimod to be dosed in patients already being treated with azithromycin, an antibiotic routinely employed in this clinical indication.

### BGS-649

In Q1 2016 we initiated a Phase 2b clinical study for BGS-649 in 260 hypogonadotropic hypogonadism (HH) patients to determine the lowest effective dose of the once-weekly pill. This study is comparing three doses of BGS-649 with placebo. The primary objective of this study is to demonstrate the efficacy of BGS-649 to normalise total testosterone levels in greater than 75% of subjects after 24 weeks of treatment. We are also assessing patient recorded outcomes and determining the impact of BGS-649 on luteinising hormone (LH), follicle stimulating hormone (FSH) and semen parameters. In Q4 2016 we initiated a six-month Phase 2b extension study for BGS-649 to confirm the safety of long-term treatment. This study aims to enrol up to 50% of the patients (130) from the first BGS-649 study and will include monitoring of the testosterone levels and any changes in bone mineral density. The Group has announced that it will release the outcome of a blinded interim analysis in the Phase 2b study of BGS-649 by the Independent Data Monitoring Committee (IDMC) in March 2017.

### BPS-804

During the year we obtained Orphan Drug Designation for BPS-804 in the US and the EU, which provides significant benefits for the product. Following submissions to and discussions with the regulators, we are progressing BPS-804 towards a potentially pivotal dose-ranging study in 120 patients with OI using a novel biomarker (HRpQCT). Post the period end, earlier this month BPS-804 was accepted to participate in the European Medicine Agency's (EMA) Adaptive Pathways programme. The adaptive pathway approach is part of the EMA's efforts to improve timely access for patients to new medicines, primarily in areas of high medical need. The pivotal Phase 2b study for BPS-804 in OI is expected to commence in H1 2017.

# CHAIRMAN AND CEO'S STATEMENT CONTINUED

## Introduction continued

Our acquisition structures are intended to align the interests of the Group and our shareholders with those of the pharmaceutical company through the use of equity and downstream payments based on success, rather than substantial upfront cash payments. Another key feature of our business model is the comprehensive nature of the clinical studies we undertake. These are designed to answer the key questions which are important to both patients and their physicians, as well as the regulators and payers.

## Our values and our people

The Group has grown significantly over the past 18 months and we now employ over 20 full-time staff in our London headquarters. We seek to attract and retain highly experienced individuals in clinical development, clinical operations, manufacturing, intellectual property and quality assurance and support them with strong leadership at the executive and Board level. This internal expertise is leveraged with external organisations such as the clinical research organisation ICON and external contract manufacturers. This combination has allowed the Group to efficiently and effectively transfer the three programmes from Novartis and to make significant progress this year with a lean internal infrastructure. The successful growth to date is a result of the hard work, enthusiasm, experience and skills of all our employees who show a strong affiliation with Mereo and our mission to deliver innovative medicines to patients.

Our Board members have significant operational experience in large and small pharmaceutical companies and in clinical research organisations. They provide valuable strategic input into our development programmes and into the overall direction of the Group.

In October 2016 Richard Bungay notified us of his intention to step down as CFO/COO and as a Board member of Mereo. Richard left the company on 13 January 2017 and we would like to thank him for his contribution to the Group during the past 18 months.

In November 2016 we announced the appointment of Richard Jones as CFO and a Board member of Mereo. Richard joined the company on 30 January 2017. Previously, Richard was the CFO of Shield Therapeutics plc from April 2011 and a board member from early 2010. Prior to that, Richard was an investment banker in the healthcare sector at Investec and Brewin Dolphin. We are also pleased to announce the appointment of Jerome Dauvergne as Head of Pharmaceutical Development. Jerome is currently Head of External Manufacturing at Ipsen Biopharm Ltd and he will join the Group on 2 May 2017.

From founding the Group only 18 months ago we have made outstanding progress, acquiring and integrating our first three programmes from Novartis and advancing them into the clinic. We would like to thank Board members and our staff for their important contributions during this successful period, and also our shareholders for their continued support.

## Recent developments and outlook

The Group is expecting to deliver a number of key clinical milestones in 2017.

The Group has announced it will release the outcome of a blinded interim analysis in the Phase 2b study of BGS-649 by the Independent Data Monitoring Committee (IDMC) in March 2017. This follows the enrolment of 93 patients out of a total of 260 patients expected in the study. They will have received at least one month's treatment at this point. Following this analysis, any doses either not expected to normalise testosterone at 24 weeks or with significant safety concerns will be dropped and the study will continue with remaining doses versus placebo until patients have received six months' treatment. Any doses that have been dropped at the interim analysis will also be dropped from the six month safety extension study. As per the trial design, the Group will continue to be completely blinded to the study, including information on dosing, until it is complete.

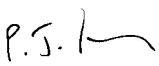
The Phase 2 study for acumapimod in AECOPD and the Phase 2b study for BGS-649 in HH are expected to read out as planned in H2 2017.

Following consultation with the regulators the BPS-804 programme for osteogenesis imperfecta was accepted into the Adaptive Pathways programme in the EU as announced earlier this month. We expect to start the pivotal Phase 2b study for BPS-804 in OI in H1 2017.

These data points are each important in demonstrating our ability to successfully transfer programmes from major pharmaceutical companies, to rapidly execute comprehensive clinical studies and also to validate our selection criteria for the product acquisitions.

The Group continues to seek further product opportunities to accelerate growth with the aim of becoming a leading player in the development and commercialisation of novel therapies for rare and speciality diseases with high unmet medical needs. Our plan is to use our first mover advantage to add additional product opportunities such that in the longer term we have between five and seven products under development. Mereo is looking to become the partner of choice for pharmaceutical and large biotechnology companies as they look to unlock the potential in their development pipelines and deliver promising drug candidates to patients. During the period, we have seen strong interest from a range of pharmaceutical companies to partner with us in respect of a significant number of specific product opportunities. We remain confident of delivering on our strategy.

**Dr Denise Scots-Knight**
Chief Executive Officer



**Dr Peter Fellner**
Non-Executive Chairman
24 February 2017

# STRONG PIPELINE PRODUCTS

Mereo acquired an initial portfolio of three strong pipeline products from Novartis, each with a comprehensive and robust package of Phase 2, clinically meaningful data.


**BPS-804**
OSTEOGENESIS IMPERFECTA

READ MORE ON P10


**BGS-649**
HYPOGONADOTROPIC HYPOGONADISM

READ MORE ON P12


**ACUMAPIMOD**
ACUTE EXACERBATIONS OF CHRONIC OBSTRUCTIVE PULMONARY DISEASE

READ MORE ON P14

## OUR PRODUCTS

# Unlocking the potential of BPS-804

### CLINICAL STUDIES TO DATE:

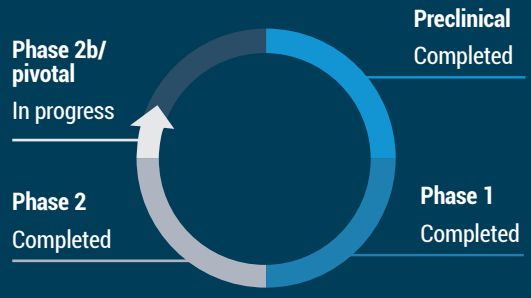
83 patients have received BPS-804, including patients with moderate OI

Statistically significant improvement on bone mineral density and bone biomarkers in OI

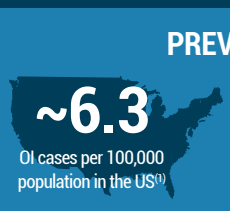
Safe and well tolerated in target population

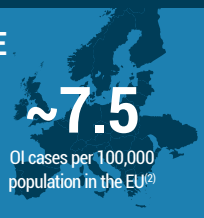
### TIMELINE

BPS-804 is expected to commence a potential pivotal Phase 2b study in H1 2017.




### PREVALENCE




**85–90%**

are linked to a gene mutation that produces abnormal type 1 collagen(1),(2)

(1) Based on Osteogenesis Imperfecta Foundation estimates.
(2) Based on Orphanet estimates.
(3) Shapiro J (2014) Osteogenesis Imperfecta: A Translational Approach to Brittle Bone Disease. Academic Press. Chapter 2: pp15–22.

## OVERVIEW

**Osteogenesis imperfecta (OI) is a rare genetic condition that affects between 20,000 and 50,000 patients in the US alone. OI is characterised by fragile bones and reduced bone mass, resulting in bones that break easily, loose joints and weakened teeth. In severe cases, patients may experience hundreds of fractures in a lifetime. The disease can be extremely debilitating and even fatal in newborn infants with a severe form of the disease.**

### WHY IT IS BEING DEVELOPED

Current treatment of OI patients focuses on reducing the number of fractures, maintaining mobility and managing pain. Currently there are no FDA or EMA licensed treatments that address the underlying bone weakness. BPS-804 is a fully human monoclonal antibody that inhibits a protein, sclerostin, which inhibits the activity of bone-forming cells. Treatment with BPS-804 will increase bone formation and reduce bone resorption, thereby strengthening the bone and potentially reducing fractures in OI patients.

OI types I, III and IV in

**72–77%**

of total OI population(3)

**Symptoms:**

- Frequent bone fractures and loose joints
- Early hearing loss
- Respiratory problems
- Brittle teeth

## MARKET OPPORTUNITY

### There is a significant unmet need for drugs to treat OI as there is no pharmacological agent approved for the reduction in the number of fractures for children or adults with OI.

Currently available therapies, which are largely surgical, reduce pain or address the complications associated with this disorder. BPS-804 represents a novel approach that will strengthen bone by building bone and reducing the resorption of bone, thereby reducing the number of fractures.

## CLINICAL DEVELOPMENT

### Novartis' Phase 2 data in OI patients established proof of concept by demonstrating a statistically significant improvement in bone formation biomarkers and bone mineral density.

In studies to date, BPS-804 has been shown to have the potential to be safe and well tolerated. Mereo intends to commence a potential pivotal trial of BPS-804 in H1 2017 that is due to report in 2018. BPS-804 has been granted Orphan Drug Designation in the US and the EU.

## OUR PRODUCTS

# Unlocking the potential of BGS-649

### CLINICAL STUDIES TO DATE:

130 patients have received BGS-649

Statistically significant rise in testosterone levels, with once-weekly dosing

Normalisation of testosterone levels was accompanied by rises in LH and FSH

Safe and well tolerated in the target population

### TIMELINE

BGS-649 is currently undergoing a global, multi-centre Phase 2b dose confirmation study in HH patients.


### PREVALENCE

**32.6%**
adult males in the US are obese(1)

**21.5%**
adult males in the EU are obese(1)

**~15.8%**
HH prevalence in obese men(2)

(1) Based on 2014 WHO estimates.
(2) Hofstra et al (2008) Netherlands J. Med, 66pp103–109.

## OVERVIEW

**Hypogonadotropic hypogonadism (HH) results from inadequate levels of testosterone. Symptoms associated with testosterone deficiency include reduced/loss of libido, erectile dysfunction, tiredness, fatigue, impaired physical endurance, loss of vitality, lack of motivation and mood disturbance. The mainstay of current therapy for HH is direct replacement of testosterone administered by gel formulations applied to the skin, which risk transference to anyone in close contact, or intramuscular injections, which can be painful and inconvenient.**

### WHY IT IS BEING DEVELOPED

BGS-649 inhibits aromatase, an enzyme that converts patients' own testosterone to oestradiol, thereby increasing testosterone levels. BGS-649 has been shown in clinical studies to normalise testosterone and increase the gonadotrophin luteinising hormones (LH) and follicle stimulating hormone (FSH), implying maintenance of the normal negative feedback loop which controls testosterone levels.

**~10 MILLION**
obese men with HH in the US and the EU

**Symptoms:**

- Reduced or loss of libido
- Erectile dysfunction
- Fatigue
- Impaired physical endurance and strength
- Loss of vitality or motivation

## MARKET OPPORTUNITY

### There are approximately six million obese men in the US and four million in the EU who suffer from HH.

Of men with clinical testosterone deficiency, over 85% are untreated despite access to care. Due to its mechanism of action, BGS-649 is expected to be safer and better tolerated as it normalises testosterone without inhibiting LH and FSH. Furthermore, as an oral drug taken once weekly, Mereo believes it is a more convenient option for patients.

## CLINICAL DEVELOPMENT

### Novartis' Phase 2 data established proof of concept for BGS-649 in obese men with HH because it showed that BGS-649 normalised testosterone levels, increased LH and FSH and was well tolerated.

Overall, BGS-649 has been well tolerated with no BGS-649-related serious adverse events. The Group has commenced a Phase 2b trial of BGS-649 and expects results in H2 2017.

## OUR PRODUCTS

# Unlocking the potential of ACUMAPIMOD

### CLINICAL STUDIES TO DATE:

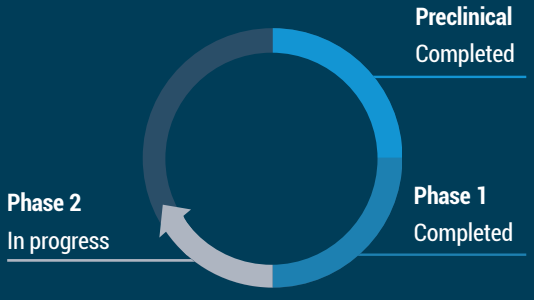
260 patients have received acumapimod

Clinically meaningful improvement in FEV1 throughout the exacerbation period

Safe and well tolerated in the target population

### TIMELINE

Acumapimod is undergoing a global, multi-centre Phase 2 dose confirmation study in patients with AECOPD.




### PREVALENCE

**12 MILLION**
COPD cases diagnosed in the US[1]

**13 MILLION**
COPD cases diagnosed in the EU[2]

**>1.5 MILLION**
hospital visits per year due to COPD[3]

(1) National Heart, Lung and Blood Institute (accessed in Feb 2016).
(2) COPD Coalition.
(3) Mannino et al (2002) MMWR Surveill Summ 51:pp1–6.
(4) Wier et al (2011) AHRQ, HCUP, Statistical Brief #106pp1–11.

## OVERVIEW

**Chronic obstructive pulmonary disease (COPD) is a non-reversible, progressive lung disease that is a leading cause of death. Smoking and air pollutants are the most common causes of the disease and lead to a chronic inflammatory response, narrowing the airways and resulting in breakdown of lung tissue. Acute exacerbations of chronic obstructive pulmonary disease (AECOPDs) occur when a patient with COPD experiences a sustained increase in coughing, sputum production or dyspnoea (shortness of breath), and may require hospitalisation. Increased inflammation is a core feature of an AECOPD.**

### WHY IT IS BEING DEVELOPED

Acumapimod is an orally dosed inhibitor of p38 MAP kinase, which is activated in COPD and AECOPDs and is inversely correlated with measures of lung function. The higher the p38 MAP kinase activation, the lower lung function is expected to be. COPD patients are treated with corticosteroids to control the inflammation. Despite this treatment, AECOPDs still occur frequently. Acumapimod offers a path to potentially controlling the inflammation.

**62.5%**
of all hospital admissions related to COPD are AECOPD patients[4]

**Symptoms:**

» AECOPDs occur when a patient with COPD experiences a sustained increase in coughing, sputum production or dyspnoea

## MARKET OPPORTUNITY

### There are currently no therapies approved in the US or the EU to treat AECOPD.

Novel therapeutics to treat and reduce exacerbations have the potential to improve quality of life, slow disease progression and significantly reduce healthcare costs. A drug that can treat and also have an anti-inflammatory effect is expected to significantly improve the quality of life of patients due to improved lung function, fewer infections, shorter hospital stays and reduced risk of rehospitalisation.

## CLINICAL DEVELOPMENT

### The studies undertaken by Novartis for acumapimod demonstrated a statistically significant reduction of the inflammatory marker TNFα and a clinically meaningful increase in forced expiratory volume in one second (FEV1), a clinically relevant endpoint in the treatment of COPD.

In studies to date, acumapimod has been shown to be safe and well tolerated in the target patient population. Mereo has commenced a Phase 2 dose-ranging trial in AECOPD patients to establish the optimal dose, with results expected to be reported in H2 2017.

# RISK FACTORS

The Group's principal activity is the acquisition, development and commercialisation of biopharmaceutical products. In common with other businesses in the biopharmaceutical sector, there are significant risks and uncertainties relevant to the Group's operations. The Board has adopted a strategy designed to identify, quantify and manage the risks it faces, whilst recognising that no risk management strategy can provide absolute assurance against loss.

The Audit and Risk Committee reviews risks at its regular meetings to oversee the management and mitigation of the principal risks faced by the Group, as set out below, and reports its findings to the Board. The Board reviews risks at its regular Board meetings, including, but not limited to, an update on progress with clinical trials and manufacturing, financial results and projections, and corporate development activities. Progress against objectives is measured by financial and non-financial key performance indicators (KPIs). The Directors consider cash runway and research and development (R&D) expenditure to be the Group's financial KPIs at its current stage of development. These are detailed in the Financial Review on pages 18 and 19.

The Directors consider that the most important non-financial KPIs relate to progress with clinical studies, manufacturing and acquisition of new products, which are discussed in the Chairman and CEO's statement and the R&D overview.

Set out below are the key risk factors that have been identified through the Group's risk management review process. Some of these risk factors are specific to the Group and others are more generally applicable to the biopharmaceutical industry in which the Group operates.

| Risk | Description | Mitigation |
|---|---|---|
| **R&D** | Mereo's research and development activities are focused on the progression of its three product candidates, BPS-804 for OI, BGS-649 for HH, and acumapimod (BCT-197) for AECOPD.<br><br>Mereo's ability to successfully develop these product candidates could be influenced by a number of factors, including the ability to demonstrate satisfactory safety and efficacy in clinical trials; delays in completing clinical trials which may cause the Group to incur additional costs; delays or difficulties in the enrolment of patients into clinical trials; unforeseen adverse events in connection with clinical trials; reliance on the completeness and accuracy of data packages provided by the product originator; reliance on third-party contract research organisations (CROs) for the conduct of clinical trials; and reliance on contract manufacturing organisations (CMOs) for the manufacturing of product candidates in sufficient quantity and in compliance with good manufacturing practice (GMP). | Mereo has carefully selected and continues to closely manage a range of experienced external partners. Each programme has been carefully planned with detailed feasibility work undertaken prior to programme commencement and regular reviews with each vendor are conducted on an ongoing basis. Our highly experienced team have oversight of each study. |
| **Commercial** | Mereo does not currently have any approved products. Its future success is dependent on obtaining a commercial return from its product candidates, either by entering into arrangements with third parties for commercialisation or commercialising certain product candidates itself.<br><br>Mereo's ability to obtain a commercial return on product candidates could be influenced by a number of factors, including the ability to establish sales and marketing capabilities; the ability to enter into product divestment or licensing agreements with third parties; competition that may lead to third parties developing or commercialising products earlier or more successfully than Mereo; the ability to achieve commercially reasonable rates for product reimbursement for product candidates commercialised by Mereo; and physician and patient acceptance of product candidates approved for commercial sale. | Whilst Mereo is not yet close to commercialisation with any of its product candidates, the management team and the Board keep in close contact with relevant industry contacts and maintain a dialogue in respect of future potential licensing and divestment opportunities, as well as continuing to review the market backdrop in relevant therapy areas and geographies. |
| **Regulatory** | Mereo operates in a highly regulated industry, giving rise to a number of risks that could affect the development and commercialisation of its product candidates, including the ability to obtain required regulatory marketing approvals; the ability to maintain orphan drug status for its product candidate BPS-804; and the impact of changes to current legislation and potential future legislation as they relate to regulatory matters. | Mereo has a well developed in-house quality process and standard operating procedures (SOPs) managed by a dedicated Head of Quality and the highly experienced Mereo team receive regular updates and reviews in respect of regulatory requirements. In March 2016, BPS-804 was granted Orphan Drug Designation for the treatment of OI by the Food and Drug Administration (FDA). In June 2016, the European Commission also granted Orphan Drug Designation to BPS-804. |

| Risk | Description | Mitigation |
|---|---|---|
| **Intellectual property (IP)** | Mereo's ability to successfully license, divest or commercialise its product candidates depends in large part on its ability to obtain and maintain effective patent protection for its products in the US, Europe and other territories. If Mereo is unable to obtain or maintain patent protection for its product candidates, or if the scope of the patent protection is not sufficiently broad, competitors could develop and commercialise similar products which would materially affect Mereo's potential commercial return from its products. Mereo is subject to additional risks, including infringement of IP rights and inability to protect the confidentiality of its know-how, which could have an adverse effect on the competitive advantage of its product candidates. | Mereo has continued to expand its IP portfolio during the year. In December 2016, Mereo also announced the expansion of its IP protection through new patent applications and the grant of pending patent applications for acumapimod, BPS-804 and BGS-649 in the US, the EU and other territories. Mereo has a dedicated Head of IP and utilises expert external counsel in the prosecution and maintenance of its IP portfolio. |
| **Financial** | Mereo has a limited operating history, has incurred losses since its inception and does not have any approved or revenue-generating products. Mereo expects to incur losses for the foreseeable future, and there is no certainty that it will ever generate a profit. Mereo may not be able to raise additional funds that will be needed to support development or commercialisation of its product candidates, and any additional funds that are raised could cause dilution to existing investors. Mereo's financial situation could be adversely impacted by any future changes in UK taxation legislation, including the R&D tax credit regime. Mereo has significant expenditures in US Dollars and Euros; consequently, its financial results could be adversely impacted by foreign currency movements. | Mereo has a strong balance sheet with net cash and cash equivalents at 31 December 2016 of £53.6 million following a private placement and introduction to the AIM market in June 2016. The Board is confident that Mereo has sufficient resources to complete its current clinical development programmes. |
| **Operational** | Mereo's future success depends upon its ability to retain key Executives, including the Chief Executive Officer, and to attract, retain and motivate qualified individuals. Mereo anticipates expanding its operational capabilities, and there is a risk that it may encounter difficulties in managing this growth which could disrupt the business. Mereo's growth plans are dependent upon its ability to identify further product candidates and to integrate such products into its business. Mereo's operations may be adversely impacted if it is unable to comply with the terms of licensing or acquisition agreements and applicable laws and regulations, including data privacy. | The Group continues to attract highly experienced people and continued to expand its team through 2016 to reflect the growth in activity. The Group has a range of short, medium and long-term incentives including share options to attract and retain key staff. During the year total headcount increased from 15 to 23. |
| **Manufacturing** | The Group does not have its own manufacturing infrastructure but relies on third parties for the production of its product candidates. Mereo's ability to commence or continue its development activities could be impacted by a failure to meet expectations in terms of quality, scheduling scale-up, reproducibility, yield, purity, cost, potency or quality or the failure to adhere to regulatory requirements. | Mereo entered into a supply services agreement with Novartis in respect of its three product candidates. In addition, the Group is working with a number of other experienced manufacturers in respect of its drug manufacturing capabilities and requirements. |

# FINANCIAL REVIEW

## Mereo is well financed to reach key value inflection points.

*"2016 was a transformational year for the Group that saw a significant fundraise, the drawdown of the balance of funding from the 2015 private financing and admission of the Company's shares to the AIM market. Mereo now has a strong balance sheet and sufficient cash resources to fund its current development programmes and to execute its business strategy."*

**RICHARD JONES**
CHIEF FINANCIAL OFFICER

The financial statements are presented for the year ended 31 December 2016; comparative data is shown for the Group's first accounting period, from the parent company's incorporation on 10 March 2015 to the financial year end on 31 December 2015.

During June 2016, the Group raised gross proceeds of £14.8 million in a private placement with institutional investors and additionally drew down the remaining balance of £56.5 million gross proceeds from the £76.5 million private financing round that was completed in July 2015, in total therefore the Group raised £71.3 million gross proceeds in 2016, £68.3 million net of expenses. This will enable the Group to continue to fund its existing programmes for each of its three current product candidates to achieve key value inflection points in 2017 and 2018, as detailed in the Strategic Report.

On 9 June 2016, following completion of the private placement, the Company's shares were admitted to trading on the AIM market of the London Stock Exchange under the ticker symbol "MPH".

The Group is structured to provide flexibility for the eventual sale, licensing or commercialisation of its product candidates, with each being developed within a wholly owned subsidiary company. External research and development activities are contracted directly by the Group's subsidiary companies, with the parent company employees providing services on an "arm's-length" basis to facilitate efficient development of product candidates. It is envisaged that future product acquisitions can be added to the Group with modest increases in internal resource.

### Revenue

The Group did not generate any revenue from product sales or licensing activities during the period.

### Research and development expenses

Research and development (R&D) expenses during the period amounted to £24.6 million (2015: £5.4 million). Excluding a non-cash charge relating to share-based payments, adjusted R&D expenses were £22.8 million (2015: £5.0 million). This expenditure

primarily related to payments to contract research organisations (CROs) for the ongoing and planned clinical trials for each of the Group's product candidates and to contract manufacturing organisations (CMOs) for the provision of drug products to support the clinical studies. R&D expenses are expected to increase in 2017, with the planned initiation of the first pivotal clinical study and associated manufacturing activities for the Group's orphan disease candidate BPS-804 alongside the ongoing clinical studies for acumapimod and BGS-649, both of which are due to read out as planned in H2 2017.

## Administrative expenses

Administrative expenses during the period amounted to £11.6 million (2015: £7.7 million). Excluding share-based payments and one off advisory fees adjusted Administrative expenses amounted to £5.7 million (2015: £5.2 million) This expenditure primarily related to employee-related expenses, including the Board and executive management, costs of the Group's premises and professional advisors' fees. Underlying administrative expenses are expected to increase in 2017 ahead of inflation reflecting a small planned increase in headcount and a full year's cost relating to being a listed company.

## Financial and other income

The Group earns interest on its cash reserves from short-term deposits. Interest earned during the period amounted to £0.2 million (2015: £0.03 million). The Group has benefited during 2016 from holding a significant amount of its cash in US Dollars (see below), where the available interest rates have been higher than those available for Sterling deposits, reflecting the underlying base rates and future base rate expectations. In addition, the Group registered a non-cash gain on these deposits of £2.3 million (2015: £nil) from the gain on translation of these deposits at the year-end reflecting a strengthening of the US Dollar against Sterling during the year.

## Taxation

The Company's subsidiaries conduct all research and development activities and consequently are responsible for submitting claims under the UK research and development small or medium-sized enterprise ("R&D tax credit") scheme. The R&D tax credit scheme provides additional taxation relief for qualifying expenditure on R&D activities, with 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 Company's subsidiaries received the first R&D tax cash repayment during the year, totalling £0.9 million, in respect of the claim for the period ended 31 December 2015. The R&D tax credit receivable in the balance sheet of £5.3 million is an estimate of the cash repayments the Company's subsidiaries expect to qualify for in respect of activities during the year ended 31 December 2016; however, as at the date of this report these amounts have not yet been agreed with HMRC.

## Loss per share

Basic loss per share for the year was 63 pence (2015: 101 pence). On an adjusted non-GAAP basis, excluding one-off items and share-based payments, Loss per share was 51 pence (a comparative 2015 adjusted loss per share has not been presented after taking into account that the Company was formed in 2015 and therefore the nature of the operating expenses was not compatible between 2015 and 2016). Taking account that Admission and the associated fund raising occurred part way through the year, on an adjusted non-GAAP proforma basis, loss per share was 36 pence.

For definitions of adjusted and proforma adjusted loss per share please see note 10.

## Liquidity, cash, cash equivalents and money market investments

The Group's cash, cash equivalents and money market investments at the period end totalled £53.6 million (2015: £12.2 million).

During June 2016, the Group raised gross proceeds of £14.8 million in a private placement with institutional investors, of which £3.4 million was in the form of a convertible loan, and additionally drew down the remaining balance of £56.5 million gross proceeds from the £76.5 million private financing round that was completed in July 2015, in total therefore the Group raised £71.3 million gross proceeds in 2016, £68.4 million net of expenses.

The net cash outflow from operating activities in 2016 was £27.4 million against a loss before tax of £33.7 million, with the major reconciling items being the non-cash charge for share-based payments of £7.5 million, the R&D credit received of £0.9 million and other movements in working capital of £2.0 million.

A significant component of the Group's clinical trial expenditure is denominated in US Dollars. The Group has in place a conservative hedging strategy in respect of its USD requirements that ensures that sufficient Sterling is converted to US Dollars at any time to cover up to the next twelve months anticipated operational requirements. At the time of Brexit, the Group therefore had significant US Dollar deposits converted at favourable rates. The Group continues to purchase US Dollars on an ongoing basis based on this policy and utilises a conservative assumption when considering the cash funding requirements for its operational activities.

## Other balance sheet items

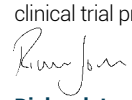
Intangible assets at the year end were £25.8 million (2015: £25.8 million), representing the value assigned to the Group's product candidates acumapimod, BGS-649 and BPS-804 upon acquisition from Novartis. The Group has performed an annual review of the value in use for these programmes at 31 December 2016 and has concluded that there is no impairment at that date.

Future commitments to Novartis (as described in note 24) will be recognised as an expense in the same period when related future cash inflows from product sales or outlicensing or other monetisation of the programmes by the Group are earned.

Trade and other receivables (including R&D tax credit receivable of £5.3 million) at the year end were £7.2 million (2015: £1.6 million) and trade and other payables were £3.2 million (2015: £4.0 million) at the year end.

## Outlook

Overall, the Group believes it is well positioned and well-funded to execute on its business strategy and to progress its existing products through the current clinical trial programmes in 2017 and 2018.



**Richard Jones**
Chief Financial Officer
24 February 2017

# BOARD OF DIRECTORS

## Mereo's Board has extensive experience in successful pharmaceutical and biotechnology companies.

### DR PETER FELLNER
CHAIRMAN

N

In addition to Mereo, Peter also serves as Chairman of the biotech and medtech companies Ablynx NV, Vernalis plc and Consort Medical plc. He has previously served on the boards of a wide range of life science companies, including as Vice-Chairman of Astex Pharmaceuticals Inc. until its sale to Otsuka in 2013, Chairman of Optos plc until its acquisition by Nikon Corporation, Director of the global biopharmaceutical company UCB SA from 2005 to 2014 and Chairman of Acambis plc from 2006 until its acquisition by Sanofi in 2008. He was Chairman of Celltech Group plc until its acquisition by UCB in 2004, having been CEO from 1990. Before joining Celltech he was CEO of Roche UK from 1986 to 1990. He served as a member of the Medical Research Council from 2000 to 2007.

### DR DENISE SCOTS-KNIGHT
CEO AND CO-FOUNDER

Denise has over 25 years' experience in the biopharmaceutical industry both in R&D management and as a venture capitalist. She started her career in R&D management at Amersham and Fisons and as a Senior Executive at Scientific Generics before joining Rothschild Asset Management as an Investment Manager. In 1999 she joined Nomura and became a Managing Director after heading the life science investment team investing globally in biotechnology companies. She led the Phase4 Partners MBO from Nomura in 2010. Denise has served on many US and European private and public boards including Idenix (prior to its acquisition by Merck for $3.85 billion). She is currently a board member of OncoMed (OMED) and Albireo (ALBO). Denise has a PhD and a BSc (Hons) from Birmingham University and was a Fulbright scholar at UC Berkeley.

### RICHARD JONES
CFO

Richard joined the Company as Chief Financial Officer and an Executive Director on 30 January 2017. Richard was previously at Shield Therapeutics plc where he was Chief Financial Officer and Company Secretary. He was initially appointed as a Non-Executive Director at Shield in 2010 before moving to CFO in 2011 where he had a leading role establishing the finance operations and guiding Shield through its private funding and recent IPO, during which time the group raised over £60 million from both institutional, private and venture capital investors to fund both clinical development and commercialisation activities. Prior to this, Richard had a career in investment banking, holding senior positions at Investec and Brewin Dolphin Securities, where he advised healthcare clients on a wide range of transactions and fundraisings including IPOs, M&A and fundraisings. Richard qualified as a Chartered Accountant with PwC in 1991.

### DR FRANK ARMSTRONG
SENIOR INDEPENDENT NON-EXECUTIVE DIRECTOR

N R +

Frank has served as CEO to a number of healthcare and biopharmaceutical companies including CuraGen and Fulcrum Pharma. He held senior management positions including Executive VP Product Development at Bayer AG, Senior VP Medical Research at Zeneca Pharmaceuticals (now AstraZeneca) and Senior VP at Merck Serono. Frank holds an MBChB from the University of Edinburgh and became a member of the Royal College of Physicians in 1984. He was elected Fellow of the Royal College of Physicians, Edinburgh, in 1993 and also Fellow of the Faculty of Pharmaceutical Physicians in 1994.

- A Audit and Risk Committee
- R Remuneration Committee
- N Nomination Committee
- + Research and Development Committee
- ◆ Chairman of Committee

**PETER BAINS**
NON-EXECUTIVE DIRECTOR

N R +

Peter has nearly three decades of experience in the pharmaceutical industry encompassing strategic and operational leadership expertise across global geographies, functions and business segments. He is currently Representative Executive Officer and Chief Executive Officer of Sosei Group Corporation, a Tokyo-listed biotech company. Previously, he was Chief Executive Officer of Syngene International, which he successfully took public on the Mumbai exchange in 2015, where he continues to be a Non-Executive Director. He also currently serves as Non-Executive Director for Phase4 Partners and MiNA, and is also Non-Executive Chairman of Fermenta Biotech, a subsidiary of DIL, a Mumbai-listed company. Previously, he had a 23-year career at GlaxoSmithKline, where he held multiple senior roles. Peter received a BSc Combined (Honours) in Physiology/Zoology from Sheffield University.

**PAUL BLACKBURN**
NON-EXECUTIVE DIRECTOR

A N

Paul has over 40 years of experience in the field of finance. He has previously held the positions of Senior Vice President Strategic Finance Projects and Financial Controller at GSK, gaining extensive emerging markets, corporate finance and change experience. He also recently served on the GSK Audit and Risk Committee. He is currently a Board member of Syngene International and is also a member of Syngene's Audit and Risk and Stakeholder Relationships Committees.
In addition, Paul was appointed a Board member of the Precision Medicine Catapult in December 2016. He holds a BSc in Management Sciences from Warwick University and also a professional accounting qualification from the Chartered Institute of Management Accountants.

**DR ANDERS EKBLOM**
NON-EXECUTIVE DIRECTOR

A R N +

Anders has extensive experience as an executive and leader with broad business knowledge from senior roles in the biopharmaceutical industry, with global experience delivering products, projects, productivity and change management. He is currently Chairman of the Board at Karolinska University Hospital and Chairman/Non-Executive Board member of several biotech companies. During two decades at AstraZeneca, he was a member of global executive teams including Executive VP Global Drug Development, EVP Global Medicines Development, Global Head Clinical Development, Global Therapy Area Head, Global Head Science & Technology Integration, and CEO AstraZeneca AB Sweden. Anders is also a board-certified MD (anaesthesiology and intensive care), PhD, DDS and Associate Professor at Karolinska Institute, Stockholm, Sweden and a fellow of the Royal Swedish Academy of Engineering Sciences.

**KUNAL KASHYAP**
NON-EXECUTIVE DIRECTOR

A N

Kunal is a Chartered Accountant and is currently Chairman and Managing Director of Allegro Capital Advisors, a leading Indian investment bank. Kunal has a deep understanding of the life sciences industry, built over two decades of advising companies in the industry on fund raising, IPOs, mergers and acquisitions, and IP licensing. He is an Independent Director of GlaxoSmithKline Consumer Healthcare Ltd and Phase4 Partners. He was also Founder and Executive Director of Celstream Technologies, a leading software product engineering organisation. From 1994-2000 he was a global partner at Arthur Andersen responsible for building and developing the firm's practice in Southern India.

# KEY MANAGEMENT

*"I love working at Mereo because it allows me to pursue my passion of developing treatments for rare diseases with a high unmet need in a fast-paced environment with enthusiastic and energetic colleagues."*

**DR ANTHONY HALL**
THERAPY AREA HEAD, ORPHAN DISEASES

**DR FIONA BOR**
HEAD OF INTELLECTUAL PROPERTY

Fiona is the Head of Intellectual Property for Mereo Biopharma and is based in London having previously been Mylan's Vice President and Global Head of Regional IP. Fiona graduated in Natural Sciences from Cambridge University before going on to do a PhD at the Medical Research Council, UK and then a post-doc at Harvard Medical School USA. She started her career as a patent attorney at SmithKline Beecham (later GlaxoSmithKline) qualifying and working as a UK and European patent attorney. She spent two years in private practice before joining Teva and then Mylan. Fiona is also qualified as a UK patent attorney litigator and has substantial experience of UK High Court Litigation and litigation in other jurisdictions. She is a Principal Examiner for the Patent Examination Board, a member of the BIA IP Advisory Committee and is a regular speaker at conferences.

**DR ANTHONY HALL**
THERAPY AREA HEAD, ORPHAN DISEASES

Tony graduated from King's College London with first class honours in physiology and pharmacology before going on to study medicine at the Royal Free Hospital School of Medicine. He joined the pharmaceutical industry in 1994 and has spent many years working on the development of drugs for rare diseases. Immediately prior to joining Mereo, Tony worked at Prosensa/Biomarin on the development of antisense oligonucleotides for the treatment of Duchenne muscular dystrophy. He was also an integral part of the DevelopAKUre consortium, which raised money from the European Commission to develop a treatment for the ultra-rare genetic disease alkaptonuria. Tony speaks regularly at rare diseases conferences and is author of a number of articles and book chapters on orphan drugs, including his most recently published book entitled "The Patient Group Handbook: A Practical Guide for Research and Drug Development".

**IAN HODGSON**
HEAD OF CLINICAL OPERATIONS

Ian has over 17 years in Clinical Development positions in Small, Medium and Large Pharma and CROs, including Takeda Oncology, Shire, Sanofi, Alcon and ICON. Working within Clinical Science and Operational roles he has broad therapeutic and operations experience leading early and late-phase development to support successful registrations in the US, EU and Japan. He has been successful in operationalising several complex programs in orphan and speciality indications. Ian has a PhD in Medical Microbiology from the University of Edinburgh/Queen Margaret, a BSc (Hons) from Reading University as well as two years of post-doctorate vaccine research.

**STEWART JONES**
HEAD OF CMC

Stewart has over 25 years' experience in CMC, spanning the fine chemicals, CMO, Biotech and BioPharmaceuticals industries, during which he has been involved with several collaborations with big pharma. At Mereo Stewart is responsible for all of Mereo's manufacturing activities. Prior to joining Mereo in September 2015, Stewart was at Chroma Therapeutics for over nine years and was responsible for the development of the clinical portfolio, all of which have been successfully licensed on. Previously Stewart worked in the development department at Evotec (now known as Aptuit) for nine years leading teams on the manufacturing development of several different types of entities from small molecules to large molecules, peptides and liquid crystals, some of which have subsequently gone on to commercial launch. Stewart has a BSc (hons) in chemistry.

*"We have an extraordinary depth and breadth of development expertise in Mereo. It's a melting pot for innovation that powers medicine development in a way that I have not experienced anywhere else."*

**DR JACKIE PARKIN**
THERAPY AREA HEAD, RESPIRATORY ENDOCRINOLOGY

**DR ALASTAIR MACKINNON**
CHIEF MEDICAL OFFICER
CO-FOUNDER

Alastair is our Chief Medical Officer and a co-founder of Mereo. Prior to Mereo, he was a Partner at for Phase4 Partners, a global life science venture capital firm. He was also involved in Phase4's MBO in 2010 having originally joined Nomura in 2005. Before Nomura, he was a practising physician in the UK for ten years. Alastair received a BSc and MBBS from King's College London, is a Member of the Royal College of Surgeons of Edinburgh (MRCS) and has a Diploma in Corporate Finance from the London Business School. Alastair is a board member of Phase4 Partners.

**DR JACKIE PARKIN**
THERAPY AREA HEAD, RESPIRATORY ENDOCRINOLOGY

Jackie is an academically-trained physician with extensive technical, clinical, and development capabilities from over 30 years' experience in clinical medicine and pharmaceutical R&D. Following senior clinical roles in London teaching hospitals where she led services for immunodeficiency, infectious and autoimmune diseases, she progressed her career by moving to GlaxoSmithKline. Rising to Vice President, she gained a breadth of experience across all phases of pharmaceutical discovery and development, leading to successful regulatory approvals with small molecule and biological medicines. Jackie joined Mereo in October 2015 as the Therapeutic Area Head for Endocrinology and Respiratory, leading the development of acumapimod for treatment of acute exacerbations of COPD and BGS-649 in hypogonadotropic hypogonadism.

**JOHN RICHARD**
HEAD OF CORPORATE DEVELOPMENT, CO-FOUNDER

John is our Head of Corporate Development and a co-founder of Mereo. Prior to Mereo, he worked with the co-founders at Nomura then Phase4 Partners since 2000. He has significant corporate, operational and transactional experience, having served in various executive, director and advisory roles throughout his career. He is a board member of Aviragen, Phase4 Partners, QUE Oncology and Catalyst Biosciences. Previously, he was Executive VP Business Development at SEQUUS, where he was responsible for negotiating SEQUUS' acquisition by ALZA. John also headed business development for VIVUS and Genome Therapeutics; where he established numerous alliances. John holds a MBA from Harvard Business School and BS from Stanford University.

**CHARLES SERMON**
GENERAL COUNSEL, COMPANY SECRETARY, CO-FOUNDER

Charles is our General Counsel, Company Secretary and a co-founder of Mereo. He has over 20 years' experience in corporate law and biopharmaceuticals. He started his career as a corporate lawyer at Freshfields before joining Nomura as an Associate Director in 1998 where he worked for Nomura's life science investment team investing globally in biotechnology companies. Charles was part of Phase4 Partners' MBO from Nomura in 2010. Charles has an LLB (Hons) from Hull University.

# CORPORATE GOVERNANCE REPORT

**DR PETER FELLNER**
CHAIRMAN

## Chairman's governance overview

I am pleased to present the Corporate Governance Report for the year ended 31 December 2016.

The Board believes that strong governance is a central element of the successful growth and development of the Company. The Board and its Committees play a key role in the Company's governance by providing an independent perspective to the senior management team, and by seeking to ensure that an effective system of internal controls and risk management procedures is in place.

This section of the annual report describes our corporate governance structures and processes and how they have been applied throughout the year ended 31 December 2016.

## The Board

Following the closure of its initial private financing round in July 2015, the Company appointed an experienced Board with extensive expertise in clinical development, commercialisation and financing and further strengthened the Board with the appointment of Paul Blackburn as Chairman of the Audit and Risk Committee prior to the Company's Admission to AIM in June 2016. At 31 December 2016 the Board comprised six Non-Executive Directors and one Executive Director.

The initial five Non-Executive Directors (Peter Fellner, Frank Armstrong, Peter Bains, Anders Ekblom and Kunal Kashyap) were issued with share options in recognition of their assistance in establishing the Company in the period prior to completion of the private financing round. These share options have a vesting period of three years. In light of the limited number of options and relatively short remaining vesting period, the Board does not consider that the share options impact the independence of the Non-Executive Directors. One Director, Kunal Kashyap, is not considered to be independent due to a common shareholding in Phase4 Partners Limited with Denise Scots-Knight, CEO of Mereo. At the date of this report, therefore, there are two Executive Directors, five independent Non-Executive Directors and one non-independent Non-Executive Director. The biographies of the Directors serving at the date of this report are shown on pages 20 and 21.

The Board considers there to be sufficient independence on the Board and that all the Non-Executive Directors are of sufficient competence and calibre to add strength and objectivity to the Board, and bring considerable experience in scientific, clinical, operational and financial development of biopharmaceutical products and companies. In line with best corporate governance practice, the Board has appointed Frank Armstrong as the Senior Independent Director, providing an alternative conduit to the Chairman and CEO for any concerns of employees and shareholders.

| Name | Date of appointment | Date of resignation |
|---|---|---|
| Peter Fellner | 29 July 2015 | |
| Denise Scots-Knight | 1 July 2015 | |
| Frank Armstrong | 29 July 2015 | |
| Peter Bains | 29 July 2015 | |
| Paul Blackburn | 6 October 2015 | |
| Richard Bungay | 9 June 2016 | 31 October 2016 |
| Anders Ekblom | 29 July 2015 | |
| Richard Jones | 30 January 2017 | |
| Kunal Kashyap | 29 July 2015 | |

The Board is responsible to the shareholders for the proper management of the Group and meets regularly to set the overall direction and strategy of the Group and to review scientific, operational and financial performance. The Board has also convened on an ad-hoc basis between scheduled Board meetings to review the strategy and activities of the business. The key responsibilities of the Board are as follows:

- setting the Company's values and standards;
- approval of long-term objectives and strategy;
- approval of budgets and plans;
- oversight of operations ensuring adequate systems of internal controls and risk management are in place, maintenance of accounting and other records and compliance with statutory and regulatory obligations;
- review of performance in light of strategy and budgets, ensuring any necessary corrective actions are taken;
- approval of the annual report and financial statements and major projects such as new product acquisitions;
- changes to structure, size and the composition of the Board;
- determining the remuneration policy for the Directors and approval of the remuneration of the Non-Executive Directors; and
- approval of communications with shareholders and the market through a separate disclosure committee.

The Company Secretary, Charles Sermon, is responsible for ensuring that Board procedures are followed and applicable rules and regulations are complied with.

There is a clear separation of the roles of the Chief Executive Officer and the Non-Executive Chairman. The Chairman is responsible for overseeing the running of the Board, ensuring that no individual or group dominates the Board's decision making and ensuring the Non-Executive Directors are properly briefed on matters. The Chief Executive Officer has the responsibility for implementing the strategy of the Board and managing the day-to-day business activities of the Group.

All of the Directors are subject to re-election by shareholders at the third Annual General Meeting (AGM) after the AGM at which they were appointed or reappointed.

## Conflicts of interest

Under the Articles of Association the Directors may authorise any actual or potential conflict of interest a Director may have and may impose any conditions on the Director that are felt to be appropriate. Directors are not able to vote in respect of any contract, arrangement or transaction in which they have a material interest and they are not counted in the quorum.

A process has been developed to identify any of the Directors' potential or actual conflicts of interest. This includes declaring any new conflicts before the start of each Board meeting.

## Development, information and support

Updates are given to the Board on developments in governance and regulations as appropriate, including presentations from the Company's Nomad and legal advisors. The Company Secretary supports the Chairman in ensuring that the Board receives the information and support it needs in order to carry out its roles.

## Performance evaluation

The Board has a process for evaluation of its own performance and that of its Committees and individual Directors, including the Chairman. The Board intends that these evaluations are carried out annually.

## Attendance at Board meetings

The Directors' attendance at scheduled Board meetings during 2016 was as follows:

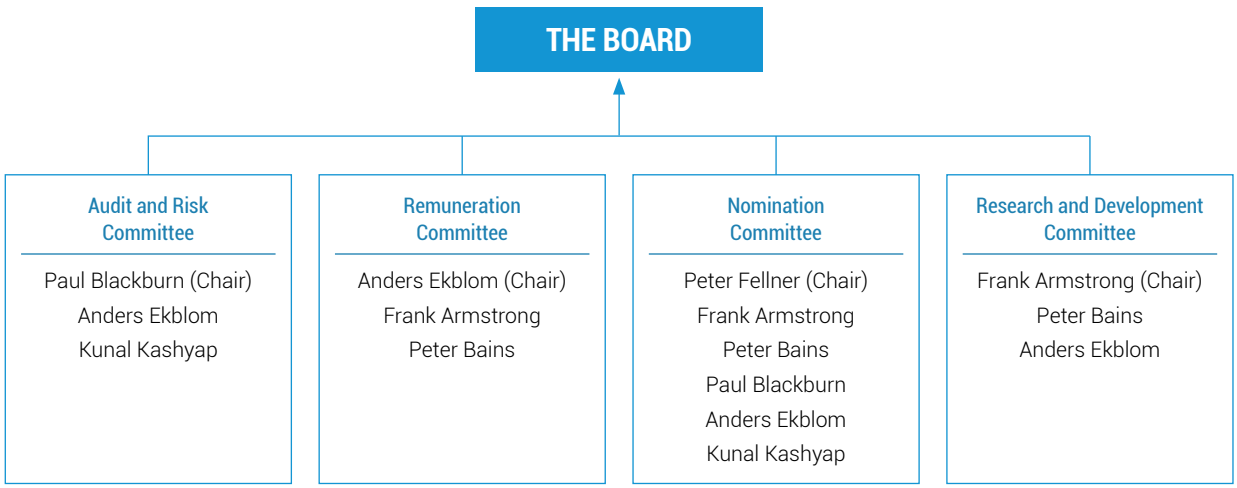
| | Attendance |
|---|---|
| Peter Fellner | 12/12 |
| Denise Scots-Knight | 12/12 |
| Frank Armstrong | 9/12 |
| Peter Bains | 10/12 |
| Paul Blackburn | 10/12 |
| Richard Bungay | 3/4 |
| Anders Ekblom | 11/12 |
| Kunal Kashyap | 12/12 |

# CORPORATE GOVERNANCE REPORT CONTINUED

## Board Committees

In order to effectively manage governance of the Group, the Board has delegated certain responsibilities to sub-committees, as detailed below:

The detailed charters for each of the Committees can be found on the Group's website at www.mereobiopharma.com. All of the Board Committees are authorised to obtain, at the Company's expense, professional advice on any matter within their terms of reference and to have access to sufficient resources in order to carry out their duties.




## Audit and Risk Committee

The Audit and Risk Committee is made up of three members, Paul Blackburn (Chairman) and Anders Ekblom, who are independent Non-Executive Directors, and Kunal Kashyap. While Kunal Kashyap is not considered to be independent by the Board, he has recent and relevant financial experience.

The Audit and Risk Committee will normally meet at least four times a year at the appropriate times in the reporting and audit cycle. The Committee has responsibility for, amongst other things:

- monitoring the financial integrity of the financial statements of the Group, including its annual and half year reports;
- reviewing and challenging where necessary any changes to, and consistency of, accounting policies, whether the Group has followed appropriate accounting standards and made appropriate estimates and judgements, the going concern assumption and all material information presented with the financial statements;
- involvement of the Group's auditor in the above processes;
- reviewing the effectiveness of the Group's internal control and risk management systems and reviewing and approving the statements to be included in the financial statements concerning internal controls and risk management;
- overseeing the process for managing risks across the Group, including reviewing the Group's corporate risk profile;
- regularly assessing the need for an internal audit function;
- considering and making recommendations to the Board, to be put to shareholders for approval at the Annual General Meeting in relation to the appointment, reappointment and removal of the Company's external auditor;
- ensuring that at least every ten years the audit services contract is put out to tender, in respect of the tender to oversee the selection process;
- overseeing the relationship with the external auditor, including approval of its remuneration, approval of its terms of engagement, annual assessment of its independence and objectivity, taking into account relevant professional and regulatory requirements and the relationship with the auditor as a whole, including the provision of any non-audit services;
- meeting regularly with the external auditor and, at least once a year, without any Executive Director or other member of management present to discuss any issues arising from the audit;
- reviewing and approving the annual audit plan and reviewing the findings of the audit;
- reviewing the Group's arrangements for its employees and contractors to raise concerns in confidence about possible improprieties in financial reporting or other matters, the Group's procedures for detecting fraud and the Group's anti-bribery and corruption procedures; and

- it focuses in particular on compliance with legal requirements, accounting standards and the rules of the FCA and ensuring that an effective system of internal financial control is maintained. The ultimate responsibility for reviewing and approving the annual report and accounts and the half yearly reports remains with the Board.

The Audit and Risk Committee monitors the relationship with the external auditor, Ernst & Young LLP, which was appointed in 2015 and reappointed at the 2016 AGM, to ensure that auditor independence and objectivity are maintained. As part of its review the Audit and Risk Committee monitors the provision of non-audit services by the external auditor. The breakdown of fees between audit and non-audit services is provided in note 6 to the financial statements. The Audit and Risk Committee also assesses the auditor's performance. Having reviewed the auditor's independence and performance, the Audit and Risk Committee is recommending that Ernst & Young LLP be reappointed as the Company's auditor at the next Annual General Meeting.

## Remuneration Committee

The Committee consists entirely of independent Non-Executive Directors. The Remuneration Committee will normally meet at least twice a year and has responsibility for, amongst other things:

- setting the remuneration policy for the Executive Directors and the Chairman, taking into account relevant legal and regulatory requirements, the provisions of the UK Corporate Governance Code and other guidance such as that issued by the Association of British Insurers and the National Association of Pension Funds;
- within the agreed policy determining the total individual remuneration package of each Executive Director and the Chairman;
- recommending and monitoring the level and structure of remuneration for senior management;
- approving the design of and determining the targets for any schemes of performance-related remuneration, including share schemes;
- considering whether the Directors should be eligible for annual bonuses and, if so, to consider the upper limits for such bonuses;
- considering whether the Directors should be eligible for benefits under long-term incentive schemes;
- agreeing the policy for authorising claims for expenses from the Executive Directors and the Chairman; and
- ensuring that contractual terms on termination, and any payments made, are fair to the individual and the Company and that failure is not rewarded and that the duty to mitigate loss is fully recognised.

During 2016 the Remuneration Committee set the remuneration policy for the Company to be operated following its Admission to AIM and set the targets used in assessing the bonus for the Chief Executive Officer and the Chief Financial Officer.

The Directors' Remuneration Report is presented on pages 29 to 32.

## Nomination Committee

The Nomination Committee comprises a majority of independent Non-Executive Directors and expects to meet at least twice a year at appropriate times in the operating cycle. The main duties of the Nomination Committee include:

- regularly reviewing the structure, size and composition (including the skills, knowledge, experience and diversity) required of the Board compared to its current position and making recommendations to the Board with regard to any changes;
- giving full consideration to succession planning for Directors and other senior Executives in the course of its work, taking into account the challenges and opportunities facing the Group, and what skills and expertise are therefore needed on the Board in the future;
- responsibility for identifying and nominating, for the approval of the Board, candidates to fill Board vacancies as and when they arise;
- formulating plans for succession for both Executive and Non-Executive Directors and in particular for the key roles of Chairman and Chief Executive Officer;
- assessing the reappointment of any Non-Executive Director at the conclusion of their specified term of office having given due regard to their performance and ability to continue to contribute to the Board in light of the knowledge, skills and experience required; and
- assessing the re-election by shareholders of any Director having due regard to their performance and ability to continue to contribute to the Board in light of the knowledge, skills and experience required and the need for progressive refreshing of the Board.

During the year, the Nomination Committee discussed and approved the appointment of Richard Jones as Chief Financial Officer, with effect from 30 January 2017.

## Research and Development Committee

Reflecting the importance of the Group's development activities, the Board has established a Research and Development Committee to provide oversight and guidance to the executive management. The Research and Development Committee meets at least twice a year and has responsibility for, amongst other things, oversight of:

- the research and development activities of the Group;
- relationships with key research and development suppliers;
- strategic development plans for products in the Group's portfolio; and
- the acquisition of new products.

# CORPORATE GOVERNANCE REPORT CONTINUED

## Research and Development Committee continued

The Committee is also tasked with being kept informed of strategic issues and commercial changes affecting the Group's research and development activities, and providing guidance and making recommendations to the Board in respect of such activities.

During 2016 the Research and Development Committee reviewed and provided input into clinical trial protocols for the Company's products and reviewed and provided input on new product opportunities.

## Corporate social responsibility

The Board recognises the importance of social, environmental and ethical matters and it endeavours to take into account the differing interests of the Group's stakeholders, including its investors, employees, suppliers and business partners, when operating its business.

## Risk management and internal control

The Board is responsible for the systems of internal control and for reviewing their effectiveness. The internal controls are designed to manage rather than eliminate risk and provide reasonable but not absolute assurance against material misstatement or loss. The Board reviews the effectiveness of these systems annually by considering the risks potentially affecting the Group. These procedures include the preparation of management accounts, forecast variance analysis and other ad-hoc reports. A Financial Procedures Manual sets out minimum reporting standards. Risks throughout the Group are considered and reviewed on a regular basis, as detailed under "Audit and Risk Committee" on page 26. Principal risks identified are set out in the Strategic Report on pages 16 and 17.

At present the Group does not have an internal audit function. Given the current size of the Group and the control systems that are in place the Audit and Risk Committee believes that there is sufficient management oversight to highlight any areas of weakness in the financial reporting systems. The Audit and Risk Committee will review the need for an internal audit function at least annually.

A comprehensive budgeting process is completed twice a year and is reviewed and approved by the Board. The Group's results, compared with the budget, are reported to the Board at each Board meeting and are discussed in detail.

The Group maintains appropriate insurance cover in respect of actions taken against the Directors because of their roles, as well as against material loss or claims against the Group. The insured values and type of cover are comprehensively reviewed on a periodic basis.

## Employment

The Board recognises its legal responsibility to ensure the wellbeing, safety and welfare of its employees and to maintain a safe and healthy working environment for them and for its visitors.

## Financial and business reporting

The Board seeks to present a balanced and understandable assessment of the Group's position and prospects in all half year, final and price-sensitive reports and other information required to be presented by statute. The Board receives a number of reports to enable it to monitor and clearly understand the Group's financial position. Procedures have been put in place to ensure that price-sensitive information is identified effectively and all communications with the market are released in accordance with expected time scales.

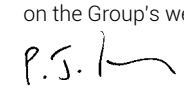
## Relations with shareholders

The Board recognises the importance of communication with its shareholders to ensure that its strategy and performance is understood and that its remains accountable to shareholders. The Group maintains a regular dialogue with institutional investors. The Group's website, www.mereobiopharma.com, has a dedicated investor section and provides useful information for the Company's shareholders including the latest announcements, press releases, published financial information, current development pipeline and other information about the Company. The Board as a whole is responsible for ensuring that a satisfactory dialogue with shareholders takes place, while the Chairman and the Chief Executive Officer ensure that the views of the shareholders are communicated to the Board as a whole. The Senior Independent Director acts as an alternative conduit for stakeholders' concerns.

The Board ensures that the Group's strategic plans have been carefully reviewed in terms of their ability to deliver long-term shareholder value.

Shareholders are welcome to attend the Group's AGM, where they have the opportunity to meet the Board. All shareholders will have at least 21 days' notice of the AGM, at which the Directors will be available to discuss aspects of the Group's performance and question in more detail.

This year's Annual General Meeting of the Company will be held on 27 June 2017. The Notice of Annual General Meeting is included with the Annual Report and financial statements and is available on the Group's website.



**Dr Peter Fellner**
Non-Executive Chairman
24 February 2017

# REMUNERATION REPORT

This report sets out the remuneration policy operated by the Group in respect of the Executive and Non-Executive Directors.

## The Remuneration Committee

The Board has delegated certain responsibilities for Executive Director remuneration to the Remuneration Committee. Details of the Remuneration Committee, its remit and activities are set out in the Corporate Governance Report on pages 24 to 28.

## Remuneration policy

The Group's remuneration strategy is to provide pay packages that will:

- reward delivery of value to shareholders and achievement of the Group's key strategic objectives;
- motivate and retain business-critical employees; and
- enable the Group to continue to attract high quality recruits.

The remuneration framework for Executive Directors is a combination of base salary, benefits, an annual bonus and awards under the Long Term Incentive Plan as described below. A similar pay structure is operated for other key members of senior management.

| Element | Description | Vesting/performance conditions |
|---|---|---|
| **Base salary** | Base salaries are reviewed annually with effect from 1 January each year. The review process is managed by the Remuneration Committee with reference to market salary data and the individual's performance and contribution to the Group during the year.<br><br>With effect from 1 January 2017 the base salary of Denise Scots-Knight, Chief Executive Officer, was increased by 7.3% to £365,000. Richard Jones, Chief Financial Officer, commenced employment with the Group on 30 January 2017 on a base salary of £250,000. | n/a |
| **Bonuses** | Annual bonuses for Executive Directors and senior management are based on achievement of Group strategic and financial targets. The annual bonus potential for the Executive Directors and senior management is a maximum of 100% of salary.<br><br>For the year ended 31 December 2016 bonuses were awarded at 70% of the maximum potential. | 70% of the annual bonus is paid in cash.<br><br>30% of the annual bonus is deferred into rights to acquire shares equal in value to the amount deferred free of charge ("awards"). The awards are made under the Deferred Share Bonus Plan (DSBP). The DSBP awards vest three years after the date of issue and have no performance conditions. |
| **Long Term Incentive Plan (LTIP)** | In order to further incentivise the Executive Directors and senior management, and align their interests with shareholders, the Group has put in place an LTIP scheme, under which rights to acquire shares at nil-cost may be awarded. The shares to satisfy LTIP awards are delivered through an employee benefit trust (EBT), as detailed in note 21 to the financial statements.<br><br>At the time of the Company's Admission to the AIM market of the London Stock Exchange ("Admission") the CEO received LTIP awards over shares equivalent to 300% of salary (the maximum permitted by the LTIP rules) at the price at Admission and key senior management received LTIP awards over shares equivalent to 225% of salary at the price at Admission. | The LTIP awards vest over a five-year period with 75% of the total award based upon the achievement of share price targets and 25% of the total award based upon the achievement of strategic targets. |
| **Share option scheme** | Prior to Admission, the Group operated a share option scheme (the "Historic Scheme"). At the time of Admission the Company established a new market value share option scheme (the "New Scheme"). Share options may be granted to all employees on commencement of employment with the Group and may be granted on a periodic basis thereafter. | Under the Historic Scheme share options for Executives vest over four-year period; share options for Non-Executive Directors vest over a three-year period; and there are no performance conditions other than continued service with the Company.<br><br>Under the New Scheme share options vest over a three-year period and NEDs are not eligible to participate. There are no performance conditions under the New Scheme. |

# REMUNERATION REPORT CONTINUED

## Remuneration policy continued

| Element | Description | Vesting/performance conditions |
|---|---|---|
| **Pension** | The Group operates a defined contribution pension scheme, which is available to all employees. The Company makes payments of 10% of basic salary for Executives (15% for the Chief Executive Officer) into any pension scheme or similar arrangement as the participating Executive may reasonably request (or a payment in lieu). Such payments are not counted for the purposes of determining bonuses or awards under the Mereo LTIP. | n/a |
| **Other benefits** | Other benefits provided to all employees are life assurance, income protection, private medical insurance and subsidised gym membership. | n/a |

## Executive Directors' service agreements and termination provisions

Details of the Executive Directors' service agreements are set out below.

| Director | Date of initial contract | Notice period by Company | Notice period by Director |
|---|---|---|---|
| Denise Scots-Knight, Chief Executive Officer | 29/07/2015 | 12 months | 12 months |
| Richard Jones, Chief Financial Officer | 30/01/2017 | 6 months | 6 months |

There are no specific provisions under which Executive Directors are entitled to receive compensation upon early termination, other than in accordance with the notice period.

At the Company's sole discretion it may make a payment in lieu of notice equivalent to the basic salary which the individual would have been entitled to receive following notice of termination.

Richard Bungay, CFO/COO, was appointed to the Board on 9 June 2016 and resigned on 31 October 2016, at which date he stepped down from the Board of Directors. His contract of employment ended on 13 January 2017.

## Non-Executive Directors

The remuneration payable to Non-Executive Directors is decided by the Chairman and the Executive Directors. Remuneration of Non-Executive Directors is currently as follows:

| | £ |
|---|---|
| Chairman | 100,000 |
| Non-Executive Director fee: | |
| Chair of Committee[1] | 48,000 |
| Member of two or more Committees (but not as chair)[1] | 44,000 |
| Member of one Committee or fewer[1] | 40,000 |
| Additional fee for Senior Independent Director | 8,000 |

(1) Excludes membership of Nomination Committee.

## Terms of appointment

| Non-Executive Director | Date of initial contract | Notice period by Company | Notice period by Director |
|---|---|---|---|
| Frank Armstrong | 29 July 2015 | 3 months | 3 months |
| Peter Bains | 29 July 2015 | 3 months | 3 months |
| Paul Blackburn | 6 October 2015 | 3 months | 3 months |
| Anders Ekblom | 29 July 2015 | 3 months | 3 months |
| Kunal Kashyap | 29 July 2015 | 3 months | 3 months |

The appointments for each Non-Executive Director are for an initial term of three years commencing on the date above until the conclusion of the Company's Annual General Meeting occurring approximately three years from that date and may be terminated by either party giving notice as shown above. There are no arrangements under which any Non-Executive Director is entitled to receive compensation upon the early termination of his appointment.

## Directors' remuneration

Under the terms of their service agreements, letters of appointment and applicable incentive plans, the remuneration and benefits of the Directors serving during the year ended 31 December 2016 are set out below. (See also note 7 on pagse 49 and 50.)

| | Basic salary and fees £ | Benefits in kind £ | Pension contributions £ | Total[1] bonus £ | Total[3] £ |
|---|---|---|---|---|---|
| Frank Armstrong | 56,000 | — | — | — | 56,000 |
| Peter Bains | 44,000 | — | — | — | 44,000 |
| Paul Blackburn | 48,000 | — | — | — | 48,000 |
| Richard Bungay[4] | 230,000 | 5,347 | 23,000 | 109,212[2] | 367,559 |
| Anders Ekblom | 48,000 | — | — | — | 48,000 |
| Peter Fellner | 100,000 | — | — | — | 100,000 |
| Kunal Kashyap | 40,000 | — | — | — | 40,000 |
| Denise Scots-Knight | 357,000 | 5,863 | 34,000 | 238,000[1] | 634,863 |

(1) Bonus is split 70% cash and 30% deferred after the DSBP.
(2) Bonus awarded 100% in cash.
(3) Prior to Admission of the Company's ordinary shares to trading on the AIM market of the London Stock Exchange ("Admission") on 9 June 2016 the Company operated as a private entity. The Directors believe therefore that the provision of comparative information would be misleading.
(4) As noted above, Richard Bungay resigned as a Director on 31 October 2016. For completeness, details of his remuneration have been included for the whole year.

## Directors' share interests

As at 31 December 2016 the Directors serving during the year had the following interests in share options and awards made under the LTIP:

| | Date of grant | At 1 January 2016 | Awarded[3] | Cancelled[1] | Lapsed[2] | **At 31 December 2016** | Exercise price | Latest date of exercise |
|---|---|---|---|---|---|---|---|---|
| **Denise Scots-Knight** | | | | | | | | |
| Share option scheme | 25/9/15 | 1,692,673 | — | (147,928) | — | **1,544,745** | £1.29 | 24/9/25 |
| LTIP | 9/6/16 | — | 461,538 | — | — | **461,538** | £nil | 9/6/22 |
| DSBP | 7/2/17 | — | 25,319 | — | — | **25,319** | £nil | 8/3/21 |
| | | 1,692,673 | 486,857 | (147,928) | — | **2,031,602** | | |
| **Richard Bungay** | | | | | | | | |
| Share option scheme | 25/9/15 | 846,336 | — | — | (581,856) | **264,480** | £1.29 | 24/9/25 |
| LTIP | 9/6/16 | — | 234,162 | — | (234,162) | **—** | £nil | n/a |
| | | 846,336 | 234,162 | — | (816,018) | **264,480** | | |
| **Frank Armstrong** | 29/9/15 | 236,974 | — | (20,710) | — | **216,264** | £1.29 | 28/9/25 |
| **Peter Bains** | 29/9/15 | 778,630 | — | (68,047) | — | **710,583** | £1.29 | 28/9/25 |
| **Paul Blackburn** | 11/5/16 | — | 236,974 | — | — | **236,974** | £1.84 | 10/5/26 |
| **Anders Ekblom** | 29/9/15 | 236,974 | — | (20,710) | — | **216,264** | £1.29 | 28/9/25 |
| **Peter Fellner** | 29/9/15 | 1,692,673 | — | — | — | **1,692,673** | £1.29 | 28/9/25 |
| **Kunal Kashyap** | 29/9/15 | 236,974 | — | (20,710) | — | **216,264** | £1.29 | 28/9/25 |

(1) Pursuant to a side letter entered into following Admission of the Company, 500,000 share options held by founders, including Directors and senior management, were cancelled on 7 July 2016.
(2) Following Richard Bungay's resignation on 31 October 2016 his unvested share options and LTIP shares lapsed.
(3) Awards to NEDs were made prior to Admission. Under the rules of the new share option scheme, awards to NED's are not permitted.

# REMUNERATION REPORT CONTINUED

## Directors' share interests continued

The first awards under the DSBP in respect of the annual bonus for the year ended 31 December 2016 were made on 7 February 2017. Since the expense relating to the DSBP shares has been reflected in the consolidated statement of comprehensive loss for the year ended 31 December 2016, the awards have been included in the share interests as at 31 December 2016.

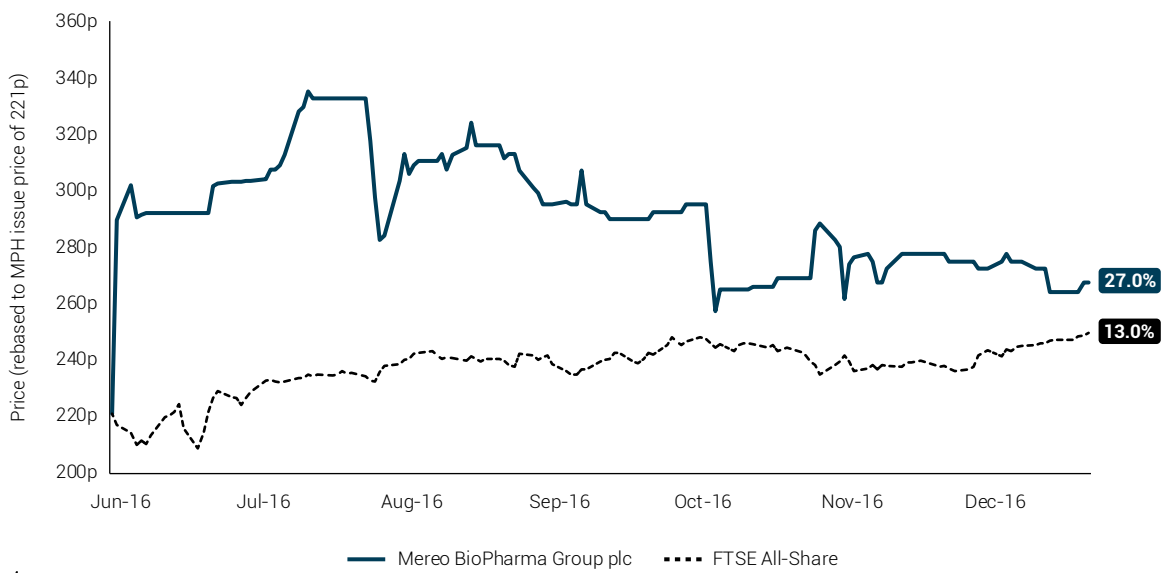
## Directors' interests in the share capital of the Company as at the date of this report

| Director | Number of ordinary shares | Percentage of issued share capital |
|---|---|---|
| Denise Scots-Knight | 844,199 | 1.31 |
| Peter Fellner | 10,000 | 0.02 |
| Frank Armstrong | 256,444 | 0.40 |
| Peter Bains | 107,906 | 0.17 |
| Paul Blackburn | 22,624 | 0.04 |
| NxtScience AB (on behalf of Anders Ekblom) | 93,002 | 0.14 |
| Kunal Kashyap | 1,497,735 | 2.33 |

The shares trade on the AIM market of the London Stock Exchange under the ticker symbol "MPH". The shares were admitted to trading on 9 June 2016 at a price of 221 pence and a market capitalisation of £142 million prior to which the shares were not publicly traded.

At 31 December 2016 the market price of the Company's shares was 268 pence per share and the market capitalisation was approximately £172 million.

The Board considers that the FTSE All-Share is an appropriate benchmark for the performance of its shares and a comparison is set out below rebased to Mereo's price at Admission on 9 June 2016 up to 31 January 2017. This chart highlights that Mereo's share price outperformed the index by 14% in the period.




**Anders Ekblom**
Chairman of the Remuneration Committee
24 February 2017

# DIRECTORS' REPORT

The Directors present their report and the audited financial statements for Mereo BioPharma Group plc and its subsidiaries (the "Group") for its financial year ended 31 December 2016. Comparative data is presented for the period from the parent company's incorporation on 10 March 2015 to 31 December 2015.

## Principal activities

The Group is principally engaged in the research and development of novel biopharmaceuticals for the treatment of rare and speciality diseases.

## Review of the business and future developments

The Strategic Report describes research and development activity during the year and outlines future planned developments. Details of the financial performance, including comments on the cash position and research and development expenditure, are given in the Financial Review. Principal risks and key performance indicators are outlined in the Strategic Report.

## Going concern

The Directors have reviewed the current and projected financial position of the Group, taking into account existing cash and deposits balances. Though the Group and Company continues to make losses, the Directors believe it is appropriate to prepare the financial information on the going concern basis. This is because the Group's research into new products continues to progress according to plan and the funding secured in June 2016 will allow it to meet its liabilities as they fall due for at least twelve months from the date of authorisation for issue of these consolidated financial statements.

## Results and dividends

The Group recorded a loss for the year before taxation of £33.7 million (period ended 31 December 2015: £13.1 million). Further details are given in the Financial Review. The Directors do not recommend payment of a dividend.

## Research and development

In the year ended 31 December 2016, the Group spent £24.6 million (period ended 31 December 2015: £5.4 million) on research and development. Details of the Group's research and development programmes can be found in the Strategic Report.

## Directors

Biographical details of the Directors are given on pages 20 and 21. All Directors served throughout the year except as follows: Richard Bungay resigned as a Director on 31 October 2016 and his employment ended on 13 January 2017, and Richard Jones was appointed on 30 January 2017.

The interests of the Directors in the share options of the Company are set out in the Remuneration Report.

## Directors' and officers' liability insurance

The Company has, as permitted by the Companies Act 2006, maintained insurance cover on behalf of the Directors, indemnifying them against certain liabilities which may be incurred by them in relation to the Group.

## Employees

The Directors are committed to continuing involvement and communication with employees on matters affecting both employees and the Group. Management conducts regular meetings with all employees on site.

## Health, safety and environment

The Directors are committed to ensuring the highest standards of health and safety, both for their employees and for the communities within which the Group operates. The Directors are also committed to minimising the impact of the Group's operations on the environment.

## Political contributions

Neither the Company nor any of its subsidiaries made any political donations or incurred any political expenditure during the year ended 31 December 2016 (period ended 31 December 2015: £nil).

## Financial risk management

A description of financial risk management is set out in note 16 to the financial statements.

# DIRECTORS' REPORT CONTINUED

## Disclosure of information to the auditor

Each of the persons who is a Director at the date of approval of this report confirms that:

- so far as the Director is aware, there is no relevant audit information of which the Group's auditor is unaware; and
- the Director has taken all the steps that he ought to have taken as a Director in order to make himself aware of any relevant audit information and to establish that the Group's auditor is aware of that information.

## Substantial interests

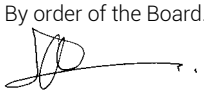
At 31 January 2017 the Company had been informed of the following substantial interests of over 3% in the issued share capital of the Company:

| | Number issued | Percentage of share capital |
|---|---|---|
| Woodford Equity Income Fund | 16,105,450 | 25.03 |
| Novartis Pharma AG | 12,546,480 | 19.50 |
| Invesco Perpetual High Income Fund | 12,546,204 | 19.50 |
| Woodford Patient Capital Trust | 11,130,873 | 17.30 |
| Invesco Perpetual UK Strategic Income Fund | 6,401,876 | 9.95 |

## Post balance sheet events

There were no subsequent events from the year end to the date of this report.

By order of the Board.



**Charles Sermon**
Company Secretary
24 February 2017

# STATEMENT OF DIRECTORS' RESPONSIBILITIES

The Directors are responsible for preparing the annual report, the Strategic Report, the Directors' Report and the financial statements in accordance with applicable laws and regulations.

Company law requires the Directors to prepare financial statements for each financial year. As required by the AIM Rules of the London Stock Exchange they are required to prepare the Group financial statements in accordance with International Financial Reporting Standards (IFRS) as adopted by the EU (EU IFRS) and applicable law and have elected to prepare the parent company financial statements on the same basis.

Under company law the Directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Group and parent company and of their profit or loss for that period.

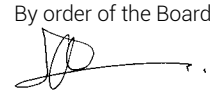
In preparing each of the Group and parent company financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether they have been prepared in accordance with IFRS as adopted by the EU; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group and the parent company will continue in business.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the parent company's and Group's transactions and disclose with reasonable accuracy at any time the financial position of the parent company and Group and enable them to ensure that its financial statements and Remuneration Report comply with the Companies Act 2006. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

The Directors are responsible for the maintenance and integrity of the corporate and financial information included on the Company's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

By order of the Board



**Charles Sermon**
Company Secretary
24 February 2017

# INDEPENDENT AUDITOR'S REPORT
## TO THE MEMBERS OF MEREO BIOPHARMA GROUP PLC

We have audited the financial statements of Mereo BioPharma Group plc for the year ended 31 December 2016 which comprise the consolidated statement of comprehensive loss, the consolidated and parent company balance sheets, the consolidated and parent company statements of cash flow, the consolidated and parent company statements of changes in equity and the related notes 1 to 26. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union and, as regards the parent company financial statements, as applied in accordance with the provisions of the Companies Act 2006.

This report is made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an Auditor's Report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

### Respective responsibilities of the Directors and the auditor

As explained more fully in the Directors' Responsibilities Statement set out on page 35, the Directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

### Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Group's and the parent company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the Directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the Annual Report and Accounts to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

### Opinion on financial statements

In our opinion:

- the financial statements give a true and fair view of the state of the Group's and of the parent company's affairs as at 31 December 2016 and of the Group's loss for the period then ended;
- the consolidated financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union;
- the parent company financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006.

### Opinion on other matter prescribed by the Companies Act 2006

In our opinion:

Based on the work undertaken in the course of the audit:

- the information given in the Strategic Report and the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements;
- the Strategic Report and the Directors' Report have been prepared in accordance with applicable legal requirements.

### Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent company financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of Directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Ernst & Young LLP

**David Hales (Senior statutory auditor)**
for and on behalf of Ernst & Young LLP,
Statutory auditor
Reading
24 February 2017

# CONSOLIDATED STATEMENT OF COMPREHENSIVE LOSS
## FOR THE YEAR ENDED 31 DECEMBER 2016

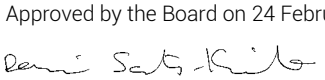
| | Notes | Year ended 31 December 2016 £ | 10 March 2015 to 31 December 2015 £ |
|---|---|---|---|
| Research and development expenses | | **(24,562,502)** | (5,445,015) |
| Administrative expenses | | **(11,616,816)** | (7,716,344) |
| **Operating loss** | | **(36,179,318)** | (13,161,359) |
| Net finance income | 8.1 | **195,141** | 25,717 |
| Net foreign exchange gain | | **2,262,626** | – |
| **Loss before tax** | | **(33,721,551)** | (13,135,642) |
| Taxation | 9 | **5,331,271** | 946,681 |
| **Loss attributable to equity holders of the parent** | | **(28,390,280)** | (12,188,961) |
| Other comprehensive income for the period, net of tax | | **–** | – |
| Total comprehensive loss for the period, net of tax and attributable to the equity holders of the parent | | **(28,390,280)** | (12,188,961) |
| **Basic and diluted loss per share** | 10 | **(£0.63)** | (£1.01) |
| Non-GAAP measure | | | |
| Adjusted loss per share | 10 | **(0.51)** | |
| Proforma adjusted loss per share | 10 | **(0.36)** | |

# BALANCE SHEETS
## AS AT 31 DECEMBER 2016

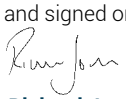
| | Notes | Group | | Company | |
|---|---|---|---|---|---|
| | | **31 December 2016 £** | 31 December 2015 £ | **31 December 2016 £** | 31 December 2015 £ |
| **Assets** | | | | | |
| **Non-current assets** | | | | | |
| Property, plant and equipment | 11 | **173,869** | 204,517 | **173,869** | 204,517 |
| Investments | 5 | **–** | – | **67,754,682** | 421,352 |
| Intercompany receivables | 13 | **–** | – | **–** | 35,699,919 |
| Intangible assets | 12 | **25,812,941** | 25,812,941 | **–** | – |
| Other receivables | | **–** | – | **–** | – |
| | | **25,986,810** | 26,017,458 | **67,928,551** | 36,325,788 |
| **Current assets** | | | | | |
| Prepayments | | **1,102,146** | 253,926 | **1,102,146** | 253,926 |
| R&D tax credits | 9 | **5,331,271** | 946,681 | **–** | – |
| Other receivables | 14 | **767,009** | 396,022 | **767,009** | 396,022 |
| Cash and short-term deposits | 17 | **53,577,571** | 12,247,986 | **53,577,571** | 12,247,986 |
| | | **60,777,997** | 13,844,615 | **55,446,726** | 12,897,934 |
| **Total assets** | | **86,764,807** | 39,862,073 | **123,375,277** | 49,223,722 |
| **Equity and liabilities** | | | | | |
| **Equity** | | | | | |
| Issued capital | 18 | **193,022** | 59,221 | **193,022** | 59,221 |
| Share premium | 18 | **99,975,399** | 26,212,880 | **99,975,399** | 26,212,880 |
| Other capital reserves | 18 | **12,667,562** | 21,660,105 | **12,667,562** | 21,660,105 |
| Accumulated profit/(loss) | | **(33,579,241)** | (12,188,961) | **3,031,229** | (2,827,315) |
| **Total equity** | | **79,256,742** | 35,743,245 | **115,867,212** | 45,104,891 |
| **Non-current liabilities** | | | | | |
| Provisions | 20 | **1,172,424** | 141,311 | **1,172,424** | 141,311 |
| Convertible loan | 19 | **3,126,526** | – | **3,126,526** | – |
| | | **4,298,950** | 141,311 | **4,298,950** | 141,311 |
| **Current liabilities** | | | | | |
| Trade and other payables | 23 | **3,209,115** | 3,977,517 | **3,209,115** | 3,977,520 |
| **Total liabilities** | | **7,508,065** | 4,118,828 | **7,508,065** | 4,118,831 |
| **Total equity and liabilities** | | **86,764,807** | 39,862,073 | **123,375,277** | 49,223,722 |

The Company loss for the year was £1,141,456 (2015: £2,827,315).

Approved by the Board on 24 February 2017 and signed on its behalf by



**Dr Denise Scots-Knight**
Director



**Richard Jones**
Director

Company number: 9481161 (England & Wales)

# CONSOLIDATED AND COMPANY STATEMENT OF CASH FLOWS
## FOR THE YEAR ENDED 31 DECEMBER 2016

| | Notes | Group | | Company | |
|---|---|---|---|---|---|
| | | **31 December 2016 £** | Period ended 31 December 2015 £ | **31 December 2016 £** | Period ended 31 December 2015 £ |
| **Operating activities** | | | | | |
| Loss before tax | | **(33,721,551)** | (13,135,642) | **(1,141,456)** | (2,827,315) |
| Adjustments to reconcile loss before tax to net cash flows: | | | | | |
| Depreciation of property, plant and equipment | 11 | **32,940** | 11,361 | **32,940** | 11,361 |
| Share-based payment expense | 21 | **6,494,018** | 2,982,265 | **4,905,559** | 2,560,916 |
| Provision for social security contributions on employee share options | | **1,031,109** | 141,311 | **794,960** | 121,346 |
| Interest received | 8.1 | **(374,906)** | (25,717) | **(374,906)** | (299,759) |
| Interest on convertible loan | | **179,765** | — | **179,765** | — |
| Capitalisation of Intercompany balances | | **—** | — | **(29,808,806)** | — |
| Working capital adjustments: | | | | | |
| Increase in receivables | | **(1,219,202)** | (649,948) | **(1,219,202)** | (10,565,215) |
| (Decrease)/increase in payables | | **(768,402)** | 3,977,517 | **(768,402)** | 4,025,774 |
| Tax received | | **946,681** | — | **—** | — |
| **Net cash flows from operating activities** | | **(27,399,548)** | (6,698,853) | **(27,399,548)** | (6,972,892) |
| **Investing activities** | | | | | |
| Purchase of property, plant and equipment | 11 | **(3,467)** | (215,878) | **(3,467)** | (215,878) |
| Disposal of property, plant and equipment | 11 | **1,175** | — | **1,175** | — |
| Investment in subsidiaries | 5 | **—** | — | **—** | (3) |
| Interest received | 8.1 | **374,906** | 25,717 | **374,906** | 299,759 |
| **Net cash flows used in investing activities** | | **372,614** | (190,161) | **372,614** | 83,878 |
| **Financing activities** | | | | | |
| Proceeds from issue of ordinary shares | 18 | **67,888,820** | 20,005,000 | **67,888,820** | 20,005,000 |
| Transaction costs on issue of shares | 18 | **(2,995,864)** | (868,000) | **(2,995,864)** | (868,000) |
| Proceeds from issue of convertible loan | 19 | **3,463,563** | — | **3,463,563** | — |
| **Net cash flows from financing activities** | | **68,356,519** | 19,137,000 | **68,356,519** | 19,137,000 |
| Net increase in cash and cash equivalents | | **41,329,585** | 12,247,986 | **41,329,585** | 12,247,986 |
| Cash and cash equivalents at beginning of the period | | **12,247,986** | — | **12,247,986** | — |
| **Cash and cash equivalents at 31 December** | 17 | **53,577,571** | 12,247,986 | **53,577,571** | 12,247,986 |

## Significant non-cash transaction

During the year 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 (see note 18).

During the year, 8,697,480 shares were issued to Novartis Pharma AG (for nil consideration), The fair value of these was £1.84 per share.

During the period ended 31 December 2015 the Company issued two bonus shares of £0.001 in nominal value for each ordinary held. The post-bonus share capital was consolidated such that each ordinary shareholder received one share for every three held. The total number of ordinary shares remained at 19,740,296 but the nominal value is now £0.003 (see note 18).

# CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
## FOR THE YEAR ENDED 31 DECEMBER 2016

| | Issued capital £ | Share premium £ | Other capital reserves £ | Accumulated losses £ | Total equity £ |
|---|---|---|---|---|---|
| **At 10 March 2015** | — | — | — | — | — |
| Loss for the period to 31 December 2015 | — | — | — | (12,188,961) | (12,188,961) |
| Issue of share capital (note 18) | 19,740 | 27,067,420 | — | — | 27,087,160 |
| Issue of bonus share capital (note 18) | 39,481 | (39,481) | — | — | — |
| Share-based payments – share options (note 21) | — | — | 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** | 59,221 | 26,212,880 | 21,660,105 | (12,188,961) | 35,743,245 |
| Loss for the year to 31 December 2016 | — | — | — | (28,390,280) | (28,390,280) |
| Issue of share capital (note 18) | 107,709 | 67,781,112 | — | — | 67,888,821 |
| Share-based payments – share options (note 21) | — | — | 6,185,067 | — | 6,185,067 |
| Share-based payments – LTIPS (note 21) | — | — | 133,601 | — | 133,601 |
| Share-based payments – deferred bonus shares (note 21) | — | — | 175,350 | — | 175,350 |
| Redemption of shares to be issued (note 18) | 26,092 | 15,977,271 | (16,003,363) | — | — |
| Equity element of convertible loan (note 19) | — | — | 516,802 | — | 516,802 |
| Share capital reduction (note 18) | — | (7,000,000) | — | 7,000,000 | — |
| Transaction costs on issuance of share capital (note 18) | — | (2,995,864) | — | — | (2,995,864) |
| **At 31 December 2016** | **193,022** | **99,975,399** | **12,667,562** | **(33,579,241)** | **79,256,742** |

# COMPANY STATEMENT OF CHANGES IN EQUITY
## FOR THE YEAR ENDED 31 DECEMBER 2016

| | Issued capital £ | Share premium £ | Other capital reserves £ | Accumulated losses £ | Total equity £ |
|---|---|---|---|---|---|
| **At 10 March 2015** | – | – | – | – | – |
| Loss for the period to 31 December 2015 | – | – | – | (2,827,315) | (2,827,315) |
| Issue of share capital (note 18) | 19,740 | 27,067,420 | – | – | 27,087,160 |
| Issue of bonus share capital (note 18) | 39,481 | (39,481) | – | – | – |
| Share-based payments – share options (note 21) | – | – | 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** | 59,221 | 26,212,880 | 21,660,105 | (2,827,315) | 45,104,891 |
| Loss for the year to 31 December 2016 | – | – | – | (1,141,456) | (1,141,456) |
| Issue of share capital (note 18) | 107,709 | 67,781,112 | – | – | 67,888,821 |
| Share-based payments (note 21) | – | – | 6,185,067 | – | 6,185,067 |
| Share-based payments – LTIPS (note 21) | – | – | 133,601 | – | 133,601 |
| Share-based payments – deferred bonus shares (note 21) | – | – | 175,350 | – | 175,350 |
| Redemption of shares to be issued (note 18) | 26,092 | 15,977,271 | (16,003,363) | – | – |
| Equity element of convertible loan (note 19) | – | – | 516,802 | – | 516,802 |
| Share capital reduction (note 18) | – | (7,000,000) | – | 7,000,000 | – |
| Transaction costs on issuance of share capital (note 18) | – | (2,995,864) | – | – | (2,995,864) |
| **At 31 December 2016** | **193,022** | **99,975,399** | **12,667,562** | **3,031,229** | **115,867,212** |

# NOTES TO THE FINANCIAL STATEMENTS

## 1. Corporate information

The consolidated financial statements of Mereo BioPharma Group plc and its subsidiaries (collectively, the "Group") for the year ended 31 December 2016 were authorised for issue in accordance with a resolution of the Directors on 24 February 2017. Mereo BioPharma Group plc (the "Company" or the "parent") is a public limited company incorporated and domiciled in the United Kingdom, and registered in England, whose shares are publicly traded. 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 (see note 4). Information on the Group's structure is provided in note 5. Information on other related party relationships of the Group is provided in note 25.

## 2. Significant accounting policies

### 2.1 Basis of preparation

The Group and Company's annual financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union and for the parent company in accordance with the Companies Act 2006.

The financial information is presented in Sterling.

### 2.2 Going concern

Though the Group and Company continue to make losses, the Directors believe it is appropriate to prepare the financial information on the going concern basis. This is because the Group's research into new products continues to progress according to plan and the funding secured in June 2016 will allow it to meet its liabilities as they fall due for at least twelve months from the date of authorisation for the issue of these consolidated financial statements.

### 2.3 Basis of consolidation

The consolidated financial information comprises the financial statements of Mereo BioPharma Group plc and its subsidiaries as at 31 December 2016. Subsidiaries are all entities over which the Group has control. The Group controls an entity when the Group is exposed to, or has rights to, variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity.

Subsidiaries are fully consolidated from the date on which control is transferred to the Group. They are deconsolidated from the date that control ceases. Intercompany transactions, balances and unrealised gains on transactions between Group companies are eliminated in preparing the consolidated financial statements. Accounting policies of subsidiaries are consistent with the policies adopted by the Group.

The Company has an employee share trust to facilitate share transactions pursuant to employee share schemes. Although the trust is a separate legal entity from the Group, it is consolidated into the Group's results in accordance with the IFRS 10 rules on special purpose vehicles. The Company is deemed to control the trust principally because the trust cannot operate without the funding the Group provides.

All Group subsidiaries prepare yearly financial information to 31 December consistent with the Company.

### 2.4 Summary of significant accounting policies

**a) Current versus non-current classification**

The Group presents assets and liabilities in its balance sheet based on current/non-current classification. An asset is current when it is:

- expected to be realised or intended to be sold or consumed in its normal operating cycle;
- held primarily for the purpose of trading;
- expected to be realised within twelve months after the reporting period; or
- cash or cash equivalent unless restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

## 2. Significant accounting policies continued

### 2.4 Summary of significant accounting policies continued

**a) Current versus non-current classification** continued

All other assets are classified as non-current.

A liability is current when:

- it is expected to be settled in its normal operating cycle;
- it is held primarily for the purpose of trading;
- it is due to be settled within twelve months after the reporting period; or
- there is no unconditional right to defer the settlement of the liability for at least twelve months after the reporting period.

The Group classifies all other liabilities as non-current.

Deferred tax assets and liabilities are classified as non-current assets and liabilities.

**b) Taxes**

**Current income tax**

Current income tax assets and liabilities are measured at the amount expected to be recovered from or paid to the taxation authorities. The tax rates and tax laws used to compute the amount are those that are enacted or substantively enacted at the reporting date in the countries where the Group operates and generates taxable income.

Current income tax relating to items recognised directly in equity is recognised in equity and not in the statement of comprehensive loss. Management periodically evaluates positions taken in the tax returns with respect to situations in which applicable tax regulations are subject to interpretation and establishes provisions where appropriate.

**Deferred tax**

Deferred tax is provided using the liability method on temporary differences between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes at the reporting date.

Deferred income tax assets are recognised for all deductible temporary differences, carry-forward of unused tax credits and unused tax losses, to the extent that it is probable that taxable profit will be available against which the deductible temporary differences and the carry-forward of unused tax credits and unused tax losses can be utilised. The carrying amount of deferred income tax assets is reviewed at the end of each reporting period and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred income tax asset to be utilised. Unrecognised deferred income tax assets are reassessed at the end of each reporting period and are recognised to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered.

Deferred tax assets and liabilities are measured on an undiscounted basis at the tax rates that are expected to apply to the year when the asset is realised, based on tax rates (and tax laws) enacted or substantively enacted at the end of the reporting period.

**c) Foreign currencies**

The functional currency of the Company and its subsidiaries is Sterling. Transactions in foreign currencies are initially recorded by the Group's entities at the rate ruling on the date the transaction first qualifies for recognition.

Differences arising on settlement or translation of monetary items are recognised in profit or loss.

Gains or losses on the retranslation of foreign currency balances at the year end are recognised in the consolidated statement of comprehensive loss under net foreign exchange gains/(losses).

# NOTES TO THE FINANCIAL STATEMENTS CONTINUED

## 2. Significant accounting policies continued

### 2.4 Summary of significant accounting policies continued

**d) Property, plant and equipment**

Property, plant and equipment is stated at cost, net of accumulated depreciation and accumulated impairment losses, if any. Such cost includes the cost of replacing part of the plant and equipment if the recognition criteria are met. All other repair and maintenance costs are recognised in profit or loss as incurred.

Depreciation is calculated on a straight-line basis over the estimated useful lives of the assets, as follows:

- Leasehold improvements ten years
- Office equipment five years
- IT equipment three years

An item of property, plant and equipment and any significant part initially recognised is derecognised upon disposal or when no future economic benefits are expected from its use or disposal. Any gain or loss arising on derecognition of the asset (calculated as the difference between the net disposal proceeds and the carrying amount of the asset) is included in the statement of comprehensive loss when the asset is derecognised.

The residual values, useful lives and methods of depreciation of property, plant and equipment are reviewed at each financial year end and adjusted prospectively, if appropriate.

**e) Leases**

Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating leases (net of any incentives received from the lessor) are charged to the statement of comprehensive loss on a straight-line basis over the period of the lease.

The Company leases its premises (see note 24). The Company recognises any lease incentives on a straight-line basis over the entire period of the lease, assuming that any break clauses available to the Company are not exercised. By not exercising any break clauses, the Company receives a 50% rent discount from the landlord for a fixed period of time as described in note 24, and this also forms part of the accounting policy.

The determination of whether an arrangement is, or contains, a lease is based on the substance of the arrangement at the inception date. The arrangement is assessed for whether fulfilment of the arrangement is dependent on the use of a specific asset or assets or the arrangement conveys a right to use the asset or assets, even if that right is not explicitly specified in an arrangement.

**f) Intangible assets**

Intangible fixed assets, relating to goodwill and intellectual property rights acquired through licensing or assigning patents and know-how, are carried at historical cost, less accumulated amortisation, where the useful economic life of the asset is finite and the asset will probably generate economic benefits exceeding costs. Where a finite useful life of the acquired intangible asset cannot be determined or the intangible asset is not yet available for use, the asset is tested annually for impairment by allocating the assets to the cash-generating units to which they relate. Amortisation would commence when product candidates underpinned by the intellectual property rights become available for commercial use. Amortisation would be calculated on a straight-line basis over the shorter of the remaining useful life of the intellectual property or the estimated sales life of the product candidates. No amortisation has been charged to date, as the product candidates underpinned by the intellectual property rights are not yet available for commercial use.

Expenditure on product development is capitalised as an intangible asset and amortised over the expected useful economic life of the product candidate concerned. Capitalisation commences from the point at which technical feasibility and commercial viability of the product candidate can be demonstrated and the Group is satisfied that it is probable that future economic benefits will result from the product candidate once completed. Capitalisation ceases when the product candidate receives regulatory approval for launch. No such costs have been capitalised to date.

Expenditure on research and development activities that do not meet the above criteria, including ongoing costs associated with acquired intellectual property rights and intellectual property rights generated internally by the Group, is charged to the statement of comprehensive loss as incurred. Intellectual property and in-process research and development from asset acquisitions are recognised as intangible assets at cost.

Future commitments to Novartis (as described in note 24) will be recognised as an expense in the same period when related future cash inflows from product sales or out-licensing or other monetisation of the programs by the Group are earned.

## 2. Significant accounting policies continued

### 2.4 Summary of significant accounting policies continued

**g) Financial instruments – initial recognition and subsequent measurement**

The Group's financial instruments comprise cash and cash equivalents, short-term bank deposits, and receivables and payables arising directly from operations. Cash and cash equivalents comprise cash in hand and short-term deposits which have an original maturity of one month or less and are readily convertible into known amounts of cash. Such assets are classified as current where management intends to dispose of the asset within twelve months of the end of the reporting period.

With the exception of a convertible loan note (see note 19) the Group does not have any committed borrowing facilities, as its cash, cash equivalents and short-term deposits are sufficient to finance its current operations. Cash balances are held on short-term deposits with quality financial institutions, in line with the Group's policy to minimise the risk of loss. The main risks associated with the Group's financial instruments relate to interest rate risk and foreign currency risk (see note 16).

Investments are recognised initially at fair value, being the transaction price. Subsequently, they are measured at cost less impairment. The carrying value of investments is reviewed annually for impairment to determine whether there is any indication that the carrying value may not be recoverable.

**h) Fair value measurement**

The Group does not record any financial instruments at fair value at each balance sheet date, nor disclose fair values in the notes. The Directors consider that the fair value of all financial instruments is not materially different from the carrying value at the balance sheet date.

**i) Impairment of non-financial assets**

Further disclosures relating to impairment of non-financial assets are also provided in the following notes:

- Disclosures for significant assumptions — note 3
- Property, plant and equipment — note 11
- Intangible assets not yet available for use — notes 12 and 15

The Group assesses, at each reporting date, whether there is an indication that an asset may be impaired. If any indication exists, or when annual impairment testing for an asset is required, the Group estimates the asset's recoverable amount. An asset's recoverable amount is the higher of an asset's or cash-generating unit's (CGU) fair value less costs of disposal and its value in use. The recoverable amount is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. When the carrying amount of an asset or CGU exceeds its recoverable amount, the asset is considered impaired and is written down to its recoverable amount.

In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. In determining fair value less costs of disposal, recent market transactions are taken into account. If no such transactions can be identified, an appropriate valuation model is used. These calculations are corroborated by valuation multiples, quoted share prices for publicly traded companies or other available fair value indicators.

Impairment losses of continuing operations are recognised in the statement of comprehensive loss in expense categories consistent with the function of the impaired asset.

For assets excluding goodwill, an assessment is made at each reporting date to determine whether there is an indication that previously recognised impairment losses no longer exist or have decreased. If such indication exists, the Group estimates the asset's or CGU's recoverable amount. A previously recognised impairment loss is reversed only if there has been a change in the assumptions used to determine the asset's recoverable amount since the last impairment loss was recognised. The reversal is limited so that the carrying amount of the asset does not exceed its recoverable amount, nor exceed the carrying amount that would have been determined, net of depreciation, had no impairment loss been recognised for the asset in prior years. Such reversal is recognised in the statement of comprehensive loss unless the asset is carried at a revalued amount, in which case the reversal is treated as a revaluation increase.

Intangible assets not yet available for use are tested for impairment annually as at 31 December at the CGU level, as appropriate, and when circumstances indicate that the carrying value may be impaired. An impairment test was performed at 31 December 2016.

# NOTES TO THE FINANCIAL STATEMENTS CONTINUED

## 2. Significant accounting policies continued

### 2.4 Summary of significant accounting policies continued

#### j) Cash and short-term deposits

Cash and short-term deposits in the balance sheet comprise cash at banks and on hand and short-term deposits with a maturity of one month or less, which are subject to an insignificant risk of changes in value.

#### k) Provisions

**General**

Provisions are recognised when the Group has a present obligation (legal or constructive) as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. When the Group expects some or all of a provision to be reimbursed, for example, under an insurance contract, the reimbursement is recognised as a separate asset, but only when the reimbursement is virtually certain. The expense relating to a provision is presented in the statement of comprehensive loss net of any reimbursement.

If the effect of the time value of money is material, provisions are discounted using a current pre-tax rate that reflects, when appropriate, the risks specific to the liability. When discounting is used, the increase in the provision due to the passage of time is recognised as a finance cost.

#### l) Share-based payments

Employees (including Senior Executives) of the Group receive remuneration in the form of share-based payments, whereby employees render services as consideration for equity instruments (equity-settled transactions).

Incentives in the form of shares are provided to employees under a share option plan. Key management are also provided with shares under a deferred bonus plan and a long term incentive plan (LTIP). In accordance with IFRS 2 Share-based Payment, charges for these incentives are expensed through the consolidated statement of comprehensive loss on a straight-line basis over their vesting period, based on the Group's estimate of shares that will eventually vest. The total amount to be expensed is determined by reference to the fair value of the options or awards at the date they were granted. For LTIP shares, the fair value 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.

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. When options are forfeited, the accounting expense for any unvested awards is reversed.

#### m) 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.

#### n) 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.

#### o) Employee Benefit Trust

The Group operates an Employee Benefit Trust (EBT): Mereo BioPharma Group plc Employee Benefit Trust.

The EBT has been established to fulfil awards made under the Deferred Share Bonus Plan and the Long Term Incentive Plan. The EBT is a Jersey-based trust which is funded by a loan from the Company, which it will utilise to buy shares at nominal value from the Company in sufficient quantity to fulfil the envisaged awards. The EBT will acquire shares in the Company and these will be deducted from the shareholders' funds on the consolidated balance sheet at the cost of acquisition less proceeds on disposal.

In compliance with IAS 32 Financial Instruments: Presentation Group, shares held by the EBT are included in the consolidated balance sheet as a reduction in equity. Gains and losses on Group shares are recognised directly in reserves.

The Group consolidated accounts treat the EBT as a wholly owned subsidiary company. Residual cash within the EBT is classified as a debtor (restricted cash) since it is not readily accessible by the Group.

## 3. Significant accounting judgements, estimates and assumptions

The preparation of the consolidated accounts requires the Group to make estimates and judgements that affect the reported amounts of assets, liabilities, revenues and expenses. The Group bases its estimates and judgements on historical experience and on various other assumptions that it considers to be reasonable. Actual results may differ from these estimates under different assumptions or conditions.

### Share-based compensation

Incentives in the form of shares are provided to employees under a share option plan, long term incentive plan and deferred share bonus plan. The fair value of the employee services received in exchange for the grant of the options is recognised as an expense. The expense is based upon a number of assumptions disclosed in note 21: Share-based payments. The selection of different assumptions could affect the results of the Group.

### Impairment of intangible assets and property, plant and equipment

An assessment was made in respect of indicators of impairment in the carrying value of the Group's intangible assets (see note 15) and leasehold improvements, office equipment and IT equipment as at 31 December 2016. The assessment of intangible assets involves a number of judgements regarding the likelihood of successful product approval, the costs of reaching approval and the subsequent commercial profitability of the product once approved.

## 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; and
- Orphan Diseases Unit, which develops drugs to treat various orphan diseases.

The Executive Management monitors the operating results of its business units separately as part of the process for making decisions about resource allocation and performance assessment. Segment performance is evaluated based on the progress of each development programme and the related development expenditure. Expenditure is measured consistently with the total expenditure included in the consolidated financial statements. The Group's financing (including finance costs and finance income) is managed on a Group basis and is only partially allocated to operating segments.

| Year ended 31 December 2016 | Respiratory Unit £ | Endocrinology Disorders Unit £ | Orphan Diseases Unit £ | Total segments £ | Unallocated £ | Consolidated £ |
|---|---|---|---|---|---|---|
| **Expenses** | | | | | | |
| Research and development | **(9,733,421)** | **(9,431,758)** | **(4,804,117)** | **(23,969,296)** | **(593,206)** | **(24,562,502)** |
| Administrative | **(2,747,085)** | **(2,787,307)** | **(3,076,405)** | **(8,610,797)** | **(3,006,019)** | **(11,616,816)** |
| Segment operating loss | **(12,480,506)** | **(12,219,065)** | **(7,880,522)** | **(32,580,093)** | **(3,599,225)** | **(36,179,318)** |
| **Assets** | | | | | | |
| Tax credit | **2,102,469** | **2,094,259** | **1,134,543** | **5,331,271** | **—** | **5,331,271** |
| Intangible assets (note 12) | **4,310,761** | **9,886,356** | **11,615,824** | **25,812,941** | **—** | **25,812,941** |

# NOTES TO THE FINANCIAL STATEMENTS CONTINUED

## 4. Segment information continued

| Period ended 31 December 2015 | Respiratory Unit £ | Endocrinology Disorders Unit £ | Orphan Diseases Unit £ | Total segments £ | Unallocated £ | Consolidated £ |
|---|---|---|---|---|---|---|
| **Expenses** | | | | | | |
| Research and development | (2,399,367) | (1,393,860) | (1,437,664) | (5,230,891) | (214,124) | (5,445,015) |
| Administrative | (1,641,880) | (1,695,991) | (1,739,566) | (5,077,437) | (2,638,907) | (7,716,344) |
| Segment operating loss | (4,041,247) | (3,089,851) | (3,177,230) | (10,308,328) | (2,853,031) | (13,161,359) |
| **Assets** | | | | | | |
| Tax credit | 300,024 | 290,965 | 355,692 | 946,681 | — | 946,681 |
| Intangible assets (note 12) | 4,310,761 | 9,886,356 | 11,615,824 | 25,812,941 | — | 25,812,941 |

### Unallocated

The majority of payroll and related costs, and expenses relating to the Group's facilities, are not allocated to segments as these are managed centrally, as are finance income and costs.

All non-current assets held by the Group are located in the United Kingdom.

## 5. Group information

### Investments in subsidiaries

| | £ |
|---|---|
| At 10 March 2015 | — |
| Additions in the period | 421,352 |
| **At 31 December 2015** | 421,352 |
| Additions in the period | 67,333,330 |
| **At 31 December 2016** | **67,754,682** |

### Information about subsidiaries

The consolidated financial statements of the Group include:

| Name | Principal activities | Country of incorporation | % equity interest 31 December 2016 |
|---|---|---|---|
| Mereo BioPharma 1 Limited | Pharmaceutical research and development | United Kingdom | **100** |
| Mereo BioPharma 2 Limited | Pharmaceutical research and development | United Kingdom | **100** |
| Mereo BioPharma 3 Limited | Pharmaceutical research and development | United Kingdom | **100** |
| Mereo BioPharma Group plc Employee Benefit Trust | Employee share scheme | Jersey | **–** |

The registered office of Mereo BioPharma 1 Limited, Mereo BioPharma 2 Limited and Mereo BioPharma 3 Limited is located at Fourth Floor, 1 Cavendish Place, London, W1G 0QF.

Mereo BioPharma 1 Limited, Mereo BioPharma 2 Limited and Mereo BioPharma 3 Limited each have issued share capital of one ordinary share of £1 fully paid or credited as fully paid, totalling £3.

Under IFRS, the Employee Benefit Trust is treated as a wholly owned subsidiary company.

A capital contribution of £1,588,459 (2015: £421,349) by Mereo BioPharma Group plc to its subsidiaries has been recorded for the granting of employees' share options for services rendered by the employees to the subsidiaries.

A capital contribution of £65,744,871 (2015: £nil) by Mereo BioPharma Group plc to its subsidiaries has been recorded for the conversion of intercompany balances at original cost.

## 6. Auditor's remuneration

During the period the Group obtained the following services from the auditor and its associates:

| | Year ended 31 December 2016 £ | Period ended 31 December 2015 £ |
|---|---|---|
| Audit of Group accounts | **50,000** | 24,000 |
| Audit of subsidiary accounts | **20,000** | 12,000 |
| Audit-related assurance services | **10,000** | – |
| Corporate finance transaction services | **169,196** | 430,000 |
| Taxation advisory services | **–** | 22,925 |
| **Total** | **249,196** | 488,925 |

## 7. Employees and Directors

The average monthly number of persons (including Executive Directors) employed by the Group and Company during the period was:

| | Year ended 31 December 2016 Number | Period ended 31 December 2015 Number |
|---|---|---|
| **By activity** | | |
| Office and management | **16** | 12 |
| Research and development | **7** | 3 |
| **Total** | **23** | 15 |

The Group contributes to defined contribution pension schemes for its Executive Directors and employees. Contributions of £13,001 (2015: £17,612 included in other liabilities) were payable to the funds at the period end.

The details of Directors of Mereo BioPharma Group plc who received emoluments from the Group and Company are shown in the table below:

| | Year ended 31 December 2016 £ | Period ended 31 December 2015 £ |
|---|---|---|
| Salaries and fees | **923,000** | 237,954 |
| Benefits in kind | **11,210** | 2,205 |
| Pension contributions | **57,000** | 13,750 |
| Bonus | **347,212** | 64,553 |
| **Total** | **1,338,422** | 318,462 |

Full details of the Directors' remuneration and Directors' options are contained in the Directors' Remuneration Report.

# NOTES TO THE FINANCIAL STATEMENTS CONTINUED

## 7. Employees and Directors continued

### Compensation of key management personnel of the Group

Key management includes Directors (Executive and Non-Executive), the General Counsel and the Chief Medical Officer. The compensation paid or payable to key management is set out below.

| | Year ended 31 December 2016 £ | Period ended 31 December 2015 £ |
|---|---|---|
| Short-term benefits | **2,111,712** | 759,170 |
| Post-employment benefits | **106,500** | 47,000 |
| IFRS 2 Share-based payment charge | **4,631,853** | 2,521,499 |
| **Total compensation paid to key management personnel** | **6,850,065** | 3,327,669 |

### Compensation of key management personnel of the Company

Key management includes Directors (Executive and Non-Executive). The compensation paid or payable to key management is set out below.

| | Year ended 31 December 2016 £ | Period ended 31 December 2015 £ |
|---|---|---|
| Short-term benefits | **1,506,512** | 537,838 |
| Post-employment benefits | **99,600** | 30,750 |
| IFRS 2 Share-based payment charge | **1,861,920** | 2,181,523 |
| **Total compensation paid to key management personnel** | **3,468,032** | 2,750,111 |

## 8. Other income/expenses and adjustments

### 8.1. Net finance income

| Group | Year ended 31 December 2016 £ | Period ended 31 December 2015 £ |
|---|---|---|
| Bank interest | **374,906** | 25,717 |
| Interest payable on convertible loan | **(179,765)** | – |
| **Net finance income** | **195,141** | 25,717 |

## 8. Other income/expenses and adjustments continued

### 8.2. Employee benefits expense

| | Group | | Company | |
|---|---|---|---|---|
| | **31 December 2016 £** | 31 December 2015 £ | **31 December 2016 £** | 31 December 2015 £ |
| **Included in research & development expenses:** | | | | |
| Salaries | **1,150,222** | 317,862 | **196,440** | 78,036 |
| Social security costs | **344,467** | 50,107 | **64,340** | 13,578 |
| Pension contributions | **50,864** | 16,120 | **12,446** | 5,456 |
| Share-based payment expense | **1,550,884** | 327,559 | **288,199** | 113,325 |
| **Included in administrative expenses:** | | | | |
| Salaries | **2,132,920** | 779,540 | **1,688,801** | 644,754 |
| Social security costs | **1,040,409** | 188,684 | **934,141** | 179,068 |
| Pension contributions | **109,187** | 44,163 | **84,249** | 35,729 |
| Share-based payment expense | **4,943,133** | 2,654,706 | **4,617,360** | 2,477,591 |
| **Total employee benefits expense** | **11,322,086** | 4,378,741 | **7,885,976** | 3,547,537 |

### 8.3. Operating loss

| Group | **Year ended 31 December 2016 £** | Period ended 31 December 2015 £ |
|---|---|---|
| Employee benefits expense (note 8.2) | **11,322,086** | 4,378,741 |
| Externally contracted research and development | **21,417,083** | 3,754,788 |
| Legal and professional fees including patent costs | **782,492** | 2,087,343 |
| Operating lease expense | **293,328** | 127,954 |
| Depreciation | **33,397** | 11,361 |
| Other expenses | **2,330,932** | 2,801,172 |
| **Total operating loss** | **36,179,318** | 13,161,359 |

# NOTES TO THE FINANCIAL STATEMENTS CONTINUED

## 9. 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 (SME) 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 financial statements represents the credit receivable by the Group for the year. The 2016 amounts have not yet been agreed with the relevant tax authorities.

Reconciliation of the accounting loss multiplied by the United Kingdom's domestic tax rate for 2016:

| Group | **Year ended 31 December 2016 £** | Period ended 31 December 2015 £ |
|---|---|---|
| United Kingdom corporation tax R&D credit | **5,331,271** | 946,681 |
| **Income tax credit** | **5,331,271** | 946,681 |

The tax credit for the year is lower than the standard rate of corporation tax in the UK of 20%. The differences are explained below:

| Group | **Year ended 31 December 2016 £** | Period ended 31 December 2015 £ |
|---|---|---|
| **Loss on ordinary activities before income tax** | **(33,721,551)** | (13,135,642) |
| Loss on ordinary activities before tax at the United Kingdom's statutory income tax rate of 20% | **6,744,310** | 2,627,129 |
| Expenses not deductible for tax purposes (permanent differences) | **(15,116)** | (438,196) |
| Temporary timing differences | **(1,300,044)** | (599,975) |
| Research and development relief uplift | **2,134,107** | 378,956 |
| Tax losses carried forward to future periods | **(2,231,986)** | (1,021,233) |
| **Tax credit for the period** | **5,331,271** | 946,681 |

A reduction in the rate of UK corporation tax to 19% from 1 April 2017 and to 17% from 1 April 2020 has been substantively enacted. UK deferred tax assets and liabilities are recognised at a rate of 17%.

At 31 December 2016, the Group had tax losses to be carried forward of approximately £16,343,508 (2015: £5,106,165).

### Deferred tax

Deferred tax relates to the following:

| | **31 December 2016 £** | 31 December 2015 £ |
|---|---|---|
| Losses | **2,788,396** | 919,110 |
| Accelerated capital allowances | **(9,883)** | — |
| Other | **2,210** | 3,170 |
| **Net deferred tax asset** | **2,770,723** | 922,280 |

The deferred tax asset has not been recognised as there is uncertainty regarding when suitable future profits against which to offset the accumulated tax losses will arise. There is no expiration date for the accumulated tax losses.

## 10. 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.

| | Year ended 31 December 2016 | | | Period ended 31 December 2015 | | |
|---|---|---|---|---|---|---|
| Group | **Loss £** | **Weighted shares number** | **Loss per share £** | Loss £ | Weighted shares number | Loss per share £ |
| IFRS – basic and diluted | **(28,390,280)** | **44,789,893** | **(0.63)** | (12,188,961) | 12,009,419 | (1.01) |
| Adjusted – basic and diluted | **(22,956,976)** | **44,789,893** | **(0.51)** | — | — | — |
| Proforma adjusted – basic and diluted | **(22,956,976)** | **64,340,798** | **(0.36)** | — | — | — |

The Company operates share option schemes (see note 21) 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 future (see note 18). There have been no other transactions involving ordinary shares or potential ordinary shares between the reporting date and the date of authorisation of these financial statements.

The adjusted loss is calculated after adding back non-recurring items and share-based payment charges as illustrated in the table below. A comparative 2015 adjusted loss per share has not been presented after taking into account that the Company was formed in 2015 and therefore the nature of the operating costs is not comparable between 2015 and 2016. The adjusted loss per share will be disclosed in future years on a consistent basis.

The adjusted loss per share is calculated using the weighted average number of ordinary shares in issue during the period.

The adjusted proforma loss per share is calculated using the number of ordinary shares in issue following admission to the AIM market of the London Stock Exchange (that is it assumes the admission took place on 1st January 2016 in respect of the number of shares in issue to enable better comparison in future years). As the date of admission to the AIM market was on 9 June 2016, comparatives for the previous period have not been provided.

| | **Year ended 31 December 2016** |
|---|---|
| **Group** | |
| Loss for the period | **(28,390,280)** |
| Share-based payments | **6,494,018** |
| Provision for social security on share options | **1,031,109** |
| Non-capitalised IPO costs | **45,000** |
| Corporate finance costs | **125,803** |
| Net gain on foreign exchange | **(2,262,626)** |
| Adjusted loss | **(22,956,976)** |

# NOTES TO THE FINANCIAL STATEMENTS CONTINUED

## 11. Property, plant and equipment

| Group and Company | Leasehold improvements £ | Office equipment £ | IT equipment £ | Total £ |
|---|---|---|---|---|
| **Cost or valuation** | | | | |
| At 1 January 2016 | 155,494 | 20,024 | 40,360 | 215,878 |
| Additions | — | — | 3,467 | 3,467 |
| Disposals | — | — | (1,175) | (1,175) |
| **At 31 December 2016** | **155,494** | **20,024** | **42,652** | **218,170** |
| **Depreciation and impairment** | | | | |
| At 1 January 2016 | (5,625) | (1,335) | (4,401) | (11,361) |
| Disposals | — | — | 457 | 457 |
| Depreciation for the period | (15,549) | (4,005) | (13,843) | (33,397) |
| **At 31 December 2016** | **(21,174)** | **(5,340)** | **(17,787)** | **(44,301)** |
| **Net book value** | | | | |
| **At 1 January 2016** | **149,869** | **18,689** | **35,959** | **204,517** |
| **At 31 December 2016** | **134,320** | **14,684** | **24,865** | **173,869** |

| Group and Company | Leasehold improvements £ | Office equipment £ | IT equipment £ | Total £ |
|---|---|---|---|---|
| **Cost or valuation** | | | | |
| At 10 March 2015 | — | — | — | — |
| Additions | 155,494 | 20,024 | 40,360 | 215,878 |
| **At 31 December 2015** | 155,494 | 20,024 | 40,360 | 215,878 |
| **Depreciation and impairment** | | | | |
| At 10 March 2015 | — | — | — | — |
| Depreciation for the period | (5,625) | (1,335) | (4,401) | (11,361) |
| **At 31 December 2015** | (5,625) | (1,335) | (4,401) | (11,361) |
| **Net book value** | | | | |
| **At 10 March 2015** | — | — | — | — |
| **At 31 December 2015** | 149,869 | 18,689 | 35,959 | 204,517 |

## 12. Intangible assets

| Group | Acquired development programmes £ |
|---|---|
| **Cost at 1 January 2016 and 31 December 2016** | **25,812,941** |
| **Amortisation and impairment** | |
| At 1 January 2016 | – |
| Impairment (note 15) | – |
| **At 31 December 2016** | **–** |
| **Net book value** | |
| At 1 January 2016 | 25,812,941 |
| **At 31 December 2016** | **25,812,941** |

| Group | Acquired development programmes £ |
|---|---|
| Cost at 10 March 2015 | – |
| Acquisition of new programmes | 25,812,941 |
| At 31 December 2015 | 25,812,941 |
| **Amortisation and impairment** | |
| At 10 March 2015 | – |
| Amortisation | – |
| Impairment (note 15) | – |
| At 31 December 2015 | – |
| **Net book value** | |
| At 10 March 2015 | – |
| At 31 December 2015 | 25,812,941 |

The Group's strategy is to acquire clinical-stage development programmes for the treatment of specialist and rare diseases from large pharmaceutical companies.

On 28 July 2015, the Group acquired three development programmes from Novartis AG.

BPS-804 is a human monoclonal antibody which is being developed to reduce fractures in the orphan disease osteogenesis imperfecta. The net book value of the programme at 31 December 2016 was £11,615,824.

BGS-649 is being developed as a therapy for the treatment of obese men with hypogonadatropic hypogonadism. The net book value of the programme at 31 December 2016 was £9,886,356.

Acumapimod is being developed as an acute therapy for acute exacerbations of chronic obstructive pulmonary disease. The net book value of the programme at 31 December 2016 was £4,310,761.

# NOTES TO THE FINANCIAL STATEMENTS CONTINUED

## 13. Intercompany receivables

| | Group | | Company | |
|---|---|---|---|---|
| | **31 December 2016 £** | 31 December 2015 £ | **31 December 2016 £** | 31 December 2015 £ |
| Intercompany loan notes | **—** | — | **—** | 25,812,941 |
| Intercompany receivables | **—** | — | **—** | 9,886,978 |
| | **—** | — | **—** | 35,699,919 |

On 30 June 2016 Mereo BioPharma Group resolved to capitalise the intercompany loans and all outstanding intercompany receivables at that date, and any intercompany balances in existence at 31 December were similarly extinguished.

## 14. Other receivables

| | Group | | Company | |
|---|---|---|---|---|
| | **31 December 2016 £** | 31 December 2015 £ | **31 December 2016 £** | 31 December 2015 £ |
| Rent deposit | **293,328** | 293,328 | **293,328** | 293,328 |
| Accrued interest | **228,775** | 4,010 | **228,775** | 4,010 |
| VAT recoverable | **241,306** | 98,684 | **241,306** | 98,684 |
| Cash held by Employee Benefit Trust | **3,600** | — | **3,600** | — |
| | **767,009** | 396,022 | **767,009** | 396,022 |

## 15. Impairment testing of acquired development programmes not yet available for use

Acquired development programmes not yet available for use are allocated to the Group's operating segments and are assessed annually for impairment.

Carrying amount of acquired development programmes allocated to each of the operating segments:

| | **Respiratory Unit 31 December 2016 £** | **Endocrinology Disorders Unit 31 December 2016 £** | **Orphan Diseases Unit 31 December 2016 £** | **Total 31 December 2016 £** |
|---|---|---|---|---|
| Acquired development programmes | **4,310,761** | **9,886,356** | **11,615,824** | **25,812,941** |

| | Respiratory Unit 31 December 2015 £ | Endocrinology Disorders Unit 31 December 2015 £ | Orphan Diseases Unit 31 December 2015 £ | Total 31 December 2015 £ |
|---|---|---|---|---|
| Acquired development programmes | 4,310,761 | 9,886,356 | 11,615,824 | 25,812,941 |

The Group considers the future development costs, the probability of successfully progressing each programme to product approval and likely commercial returns after product approval, among other factors, when reviewing for indicators of impairment. The results of this testing did not indicate any impairment of the acquired products' rights in the year to 31 December 2016.

The acquired development programmes are assets which are not used in launched products. These assets have not yet begun to be amortised but have been tested for impairment by assessing their value in use. Value-in-use calculations for each programme are utilised to calculate the recoverable amount. The calculations use pre-tax cash flow projections covering the period through product development to commercial sales up to the later of loss of patent protection or market exclusivity, which extend beyond five years from the balance sheet date; no cash flows are included after this date. Approved products are assumed to be out-licensed such that the Group receives signature fees, milestone receipts and royalties on sales; therefore, the Company does not incur any costs of commercialisation after out-licensing.

## 15. Impairment testing of acquired development programmes not yet available for use continued

Key assumptions for the value-in-use calculations are described as follows:

- development costs to obtain regulatory approval – costs are estimated net of any contributions expected from collaborative arrangements with future partners. The Directors have developed cost estimates based on their previous experience and in conjunction with the expertise of their clinical development partner, ICON;
- launch dates of products – these reflect management's expected date of launch for products based on the timeline of development programmes required to obtain regulatory approval. The assumptions are based on the Directors' and ICON's prior experience;
- probability of successful development – management estimates probabilities of success for each phase of development based on industry averages and knowledge of specific programmes;
- out-licensing signature fees, milestones and royalty rates on sales – management estimates these amounts based on prior experience and access to values from similar transactions in the industry, which are collated and accessible from specialist third-party sources;
- sales projections – these are based on management's internal projections using external market data and market research commissioned by the Company;
- profit margins and other operational expenses – these are based on the Company's internal projections of current product manufacturing costings, with input from manufacturing partners where applicable, and estimates of operating costs based on management's prior industry experience;
- cash flow projections – the periods over which cash flows are forecast (based on the current patent protection periods relevant to the asset), are as follows:
  - acumapimod (respiratory) – 16 years;
  - BGS-649 (endocrinology) – 14 years; and
  - BPS-804 (orphan diseases) – 16 years: and
- discount rates – the discount rate is estimated on a pre-tax basis reflecting the estimated cost of capital of the Group and is applied consistently across each of the operating segments. The cost of capital was calculated at 11.2% (2015: 11.2%).

At this stage of product development, the key sensitivity for all three development programmes is the probability of successful completion of clinical trials in order to obtain regulatory approval for sale. Therefore, full impairment of a development programme is expected should such related trials be unsuccessful.

## 16. Financial and capital risk management

### 16.1. Capital risk management

For the purpose of the Group's capital management, capital includes issued capital, share premium, the equity component of a convertible loan note and all other equity reserves attributable to the equity holders of the parent.

The Group's objectives when managing capital are to safeguard the ability to continue as a going concern and ensure that sufficient capital is in place to fund the Group's research and development activities. The Group's principal method of adjusting the capital available is through issuing new shares. The Group's share capital and share premium are disclosed in note 18. The Group monitors the availability of capital with regard to its forecast future expenditure on an ongoing basis. The Group has extinguished its liability instruments (loan notes) through the issue of equity instruments during the period.

### 16.2. Financial risk management objectives and policies

The Group's simple structure, operating from a single location in the United Kingdom, and the lack of external debt financing reduces the range of financial risks to which it is exposed. During the year, the Company issued unsecured convertible loan notes to a shareholder, Novartis Pharma AG (see note 19). Monitoring of financial risk is part of the Board's ongoing risk management, the effectiveness of which is reviewed annually. The Group's agreed policies are implemented by the Chief Financial Officer, who submits periodic reports to the Board.

Except for the convertible loan notes, the Group's principal financial instruments comprise trade payables and trade receivables which arise directly from its operations and are not designed as a means of raising finance for the Group's operations. The Group has various financial assets, such as receivables and cash and short-term deposits, which arise directly from its operations. The Group does not consider that its financial instruments gave rise to any material financial risks during the year to 31 December 2016.

# NOTES TO THE FINANCIAL STATEMENTS CONTINUED

## 16. Financial and capital risk management continued

### 16.2. Financial risk management objectives and policies continued

#### Interest rate risk

The Group's policy in relation to interest rate risk is to monitor short and medium-term interest rates and to place cash on deposit for periods that optimise the amount of interest earned while maintaining access to sufficient funds to meet day-to-day cash requirements.

The Group does not have any committed external borrowing facilities, as its cash and cash equivalents and short-term deposit balances are sufficient to finance its current operations. The interest payable on the loan note issued to Novartis AG is fixed at the effective rate on inception. Consequently, there is no material exposure to interest rate risk in respect of interest payable.

#### Foreign currency risk

The Group currently has no revenue. The majority of operating costs are denominated in Sterling, Euros and US Dollars. Foreign exchange risk arises from future commercial transactions and recognised assets and liabilities. In relation to foreign currency risk, the Group's policy is to hold the majority of its funds in Sterling, and to use short to medium-term currency purchase options (including foreign currency deposits and spot purchases) to manage short to medium-term fluctuations in exchange rates.

#### Credit risks

The Group's policy is to place funds with financial institutions which have a minimum long-term credit rating with S&P of A. The Group does not allocate a quota to individual institutions but seeks to diversify its investments where this is consistent with achieving competitive rates of return. It is the Group's policy to place not more than £10 million with any one counterparty.

#### Cash flow and liquidity risk

Credit risk from balances with banks and financial institutions is managed by the Group's finance department in accordance with the Group's policy. Investments of surplus funds are made only with approved counterparties and within credit limits assigned to each counterparty. Counterparty credit limits are reviewed by the Group's Board of Directors on an annual basis, and may be updated throughout the year subject to approval of the Group's Audit and Risk Committee. The limits are set to minimise the concentration of risks and therefore mitigate financial loss through a counterparty's potential failure to make payments.

The Group's maximum exposure to credit risk for the components of the balance sheet at 31 December 2016 is the carrying amounts as illustrated in note 16.

The Group monitors its funding requirements through preparation of short-term, mid-term and long-term forecasts. All short-term deposits are immediately convertible to liquid funds without penalty and are recorded in the balance sheet at their open market value. Please refer to note 2.2 "Going Concern" regarding the Directors' assessment of liquidity for further information.

## 17. Cash and short-term deposits

| Group and Company | **31 December 2016 £** | 31 December 2015 £ |
|---|---|---|
| Cash at banks and on hand | **421,292** | 647,007 |
| Short-term deposits | **53,156,279** | 11,600,979 |
| | **53,577,571** | 12,247,986 |

Cash at banks earns interest at floating rates based on daily bank deposit rates. Short-term deposits are available immediately and earn interest at the respective short-term deposit rates.

## 18. Issued capital and reserves

| Ordinary share capital | Year ended 31 December 2016 £ | 10 March to 31 December 2015 £ |
|---|---|---|
| Balance at beginning of year/period | **59,221** | 1 |
| Issuances in the period | **133,801** | 59,220 |
| Nominal share capital as at 31 December | **193,022** | 59,221 |

| **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 2016 for private placement | **5,135,962** |
| **At 31 December 2016** | **64,340,798** |
| **Nominal value at 31 December 2016 (£)** | **0.003** |
| **Issued capital at 31 December 2016 (£)** | **193,022** |

| **Ordinary shares issued and fully paid (post ordinary share split)** | |
|---|---|
| At 10 March 2015 – Incorporation capital | 1,000 |
| Founders' shares | 4,999,000 |
| Issued on 29 July 2015 for private financing round | 14,740,296 |
| Bonus shares issued on 27 November 2015 | 39,480,592 |
| Consolidation of post-bonus share capital | (39,480,592) |
| **At 31 December 2015** | 19,740,296 |
| **Nominal value at 31 December 2015 (£)** | 0.003 |
| **Issued capital at 31 December 2015 (£)** | 59,221 |

On 29 July 2015, there was a subdivision of 5,000 ordinary shares of £1.00 in nominal value in the capital of the Company to 5,000,000 ordinary shares of £0.001 in nominal value in the capital of the Company (the "ordinary share split").

On 27 November 2015 the Company issued two ordinary bonus shares of £0.001 in nominal value for each ordinary share held and consolidated the post-bonus share capital such that each ordinary shareholder received one share for every three held. The nominal value of each ordinary share changed to £0.003.

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.

# NOTES TO THE FINANCIAL STATEMENTS CONTINUED

## 18. Issued capital and reserves continued

| Share premium | 31 December 2016 £ |
|---|---|
| **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 | **(2,995,863)** |
| Share capital reduction on 21 March 2016 | **(7,000,000)** |
| **At 31 December 2016** | **99,975,399** |

| Share premium | 31 December 2015 £ |
|---|---|
| **At 10 March 2015** | — |
| Issuance of share capital for private financing round on 29 July 2015 | 27,067,420 |
| Transaction costs for issued share capital | (868,000) |
| Profit on transfer of loan notes for equity | 52,941 |
| Consolidation of post-bonus share capital on 27 November 2015 | (39,481) |
| **At 31 December 2015** | 26,212,880 |

### Other capital reserves

| | £ |
|---|---|
| **At 1 January 2016** | 21,660,105 |
| Share-based payments expense during the period | 6,494,018 |
| Shares issued | (16,003,363) |
| Equity component of convertible loan instrument | 516,802 |
| **At 31 December 2016** | **12,667,562** |

| | £ |
|---|---|
| **At 10 March 2015** | — |
| Share-based payments expense during the period | 2,982,265 |
| Shares to be issued | 18,677,840 |
| **At 31 December 2015** | 21,660,105 |

## 18. Issued capital and reserves continued

### Share-based payments

The Group has a share option scheme under which options to subscribe for the Group's shares have been granted to certain Executives, Non-Executive Directors and employees (see note 21 for further details).

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. Refer to note 21 for further details of these plans. Of the £6,494,018 share-based payment expense in the year, £298,836 is an accelerated charge relating to 500,000 share options which were cancelled on 9 June 2016.

### Shares issued/to be issued

Of the 14,740,296 ordinary shares issued on 29 July 2015, 3,849,000 shares were issued to Novartis Pharma AG (Novartis). This left a further 10,151,000 shares to be issued to Novartis pro rata to their percentage shareholding as and when the Company issued further ordinary shares.

Of the 44,600,502 ordinary shares issued on 9 June 2016, 8,697,480 shares were issued to Novartis as fully paid up bonus shares (for nil consideration), the number of which was calculated to maintain its shareholding at 19.5%. The fair value of these shares was £1.84 per share. A further 1,453,520 shares are to be issued to Novartis pro rata to their percentage shareholding as and when the Company issues further ordinary shares.

## 19. Convertible loan note

On 3 June 2016, the Company issued 3,463,563 £1 unsecured convertible loan notes ("Notes") to Novartis Pharma AG, a related party (see Note 25). 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 the date of issue 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 carrying amount at 31 December 2016 is £3,126,526.

The value of the equity component of the Notes at 31 December 2016 was calculated as £516,802.

## 20. Provisions

| Group and Company<br>social security contributions on share options | **Year ended 31 December 2016 £** | 10 March to 31 December 2015 £ |
|---|---|---|
| At beginning of year/period | **141,311** | – |
| Accretion of discount | **7,293** | – |
| Arising during the year/period | **1,084,181** | 141,311 |
| Released | **(60,365)** | – |
| At 31 December | **1,172,420** | 141,311 |
| Current | **–** | – |
| Non-current | **1,172,420** | 141,311 |

The provision for social security contributions on share options is calculated based on the number of options outstanding at the reporting date that are expected to be exercised. The provision is based on the estimated gain arising on exercise of the share options, using the best estimate of the market price at the balance sheet date. Since the Directors assume the options will be held for their full contractual life of ten years (see note 21) the liability has been classified as non-current. The provision has been discounted.

# NOTES TO THE FINANCIAL STATEMENTS CONTINUED

## 21. Share-based payments

The charge for share-based payments under IFRS 2 arises across the following schemes:

| | Group | | Company | |
|---|---|---|---|---|
| | **31 December 2016 £** | 31 December 2015 £ | **31 December 2016 £** | 31 December 2015 £ |
| Unapproved option plan | **6,185,067** | 2,982,265 | **4,667,854** | 2,560,916 |
| Long term incentive plan | **133,601** | — | **104,040** | — |
| Deferred share bonus plan | **175,350** | — | **133,666** | — |
| | **6,494,018** | 2,982,265 | **4,905,560** | 2,560,916 |

### Option Plan

#### Historic Scheme

Under the Mereo BioPharma Group plc Share Option Plan (the "Option Plan"), the Group, at its discretion, granted share options to employees, including executive management, and Non-Executive Directors. Share options vest over four years for executive management and employees and over three years for Non-Executive Directors. There are no performance conditions attached to the options issued under the Option Plan. The fair value of share options granted was 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. The fair value calculation does not include any allowance for dividends as the Company has no available profits for distribution.

The exercise price of the share options will be equal to the market price of the underlying shares on the date of grant, less a discount agreed with the Group's institutional investors. The contractual term of the share options is ten years.

Of the £6,185,067 expense recognised under the option plan for employee services received during the year, £298,836 is an accelerated charge relating to 500,000 options which were cancelled on 9 June 2016.

#### New Scheme

No share options were issued during the year under the Mereo BioPharma Group plc Share Option Scheme that was established at Admission.

### Movements during the period

The following table illustrates the number and weighted average exercise prices (WAEP) of, and movements in, share options during the period:

| | **2016 Number** | **2016 WAEP £** | 2015 Number | 2015 WAEP £ |
|---|---|---|---|---|
| Outstanding at beginning of period | **8,964,394** | **1.29** | — | — |
| Granted during the period | **1,316,117** | **1.49** | 8,964,394 | 1.29 |
| Cancelled during the period | **(500,000)** | **1.29** | — | — |
| Forfeited during the period | **(581,856)** | **1.29** | — | — |
| Outstanding at 31 December | **9,198,655** | **1.32** | 8,964,394 | 1.29 |
| Exercisable at 31 December | **3,115,337** | **1.29** | — | — |

The weighted average remaining contractual life for the share options outstanding as at 31 December 2016 was 8.3 years (2015: 9.6 years).

The weighted average fair value of options granted during the year was £1.29 (2015: £1.33).

Options outstanding at the end of the period had an exercise price of between £1.29 and £2.21.

## 21. Share-based payments continued

### Movements during the period continued

The following tables list the weighted average inputs to the models used for the fair value of share options granted during the period ended 31 December 2016:

| | Year ended 31 December 2016 | Period ended 31 December 2015 |
|---|---|---|
| Expected volatility (%) | **56** | 56 |
| Risk-free interest rate (%) | **1.48–2.07** | 1.85-2.07% |
| Expected life of share options (years) | **10** | 10 |
| Market price of ordinary shares (£) | **1.84–2.21** | 1.84 |
| Model used | **Black Scholes** | Black Scholes |

Since there is no historical data in relation to the expected life of the share options the contractual life of the options was used in calculating the expense for the period.

Volatility was 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 share options.

### Long Term Incentive Plan

Under the Mereo BioPharma Group plc Long Term Incentive Plan (the "LTIP Plan"), initiated in 2016, 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 employees 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 expense recorded is based upon 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 year to 31 December 2016 was £133,601 (31 December 2015: £nil).

### Movements during the period

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

| | 2016 Number | 2015 Number |
|---|---|---|
| Granted during the period | **1,199,658** | – |
| Cancelled during the period | **–** | – |
| Forfeited during the period | **(234,162)** | – |
| Outstanding at 31 December | **965,496** | – |
| Exercisable at 31 December | **–** | – |

The weighted average remaining contractual life for the LTIP options outstanding as at 31 December 2016 was 3.7 years.

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

# NOTES TO THE FINANCIAL STATEMENTS CONTINUED

## 21. Share-based payments continued

The following tables list the weighted average inputs to the models used for the fair value of LTIP options granted during the period ended 31 December 2016:

### LTIP Share Price Element

| | Year ended 31 December 2016 |
|---|---|
| Expected volatility (%) | 48.9 |
| Risk-free interest rate (%) | 0.48–0.74 |
| Expected life of share options (years) | 3–5 |
| Market price of ordinary shares (£) | 2.21 |
| Model used | Monte Carlo |

### LTIP Strategic Element

| | Year ended 31 December 2016 |
|---|---|
| Expected volatility (%) | 48.9 |
| Risk-free interest rate (%) | 0.74 |
| Expected life of share options (years) | 5 |
| 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.

### Deferred Share Bonus Plan

Under the Mereo BioPharma Group plc Deferred Share Bonus Plan (DSBP), 30% of the annual bonus for the senior management team is payable in deferred shares, which are governed by the DSBP scheme rules. At the date of grant of the awards, the monetary bonus amount will be divided by the closing share price to give the number of shares issued to the employee under the DSBP. The number of shares is fixed and not subject to adjustment between the issue date and vesting date. Under the DSBP, awards vest after three years from the date of the award. There are no further performance conditions attached to the award, nor any service conditions (including no requirement for continued employment once the awards have been made). The scheme does allow for adjustment of awards in the event of a material misstatement of Mereo's accounts or fraud or misconduct on the part of an individual. The scheme also allows for adjustment of awards in the event there was an error in calculating the vesting of the awards.

Since the awards are issued at nil cost they will be satisfied by the issue of shares from the Employee Benefit Trust.

The following table illustrates the number of, and movements in, DSBP options during the year:

| | 2016 Number | 2015 Number |
|---|---|---|
| Granted during the period | 62,180 | – |
| Outstanding at 31 December | 62,180 | – |
| Exercisable at 31 December | – | – |

The weighted average remaining contractual life for the DSBP options outstanding as at 31 December 2016 was four years.

The weighted average fair value of deferred share bonus plan options granted during the year was £2.80.

## 22. Loss of the parent company

The parent company has taken advantage of the exemption permitted by Section 408 of the Companies Act 2006 not to present an income statement for the year. The parent company's loss for the year was £1,141,456 (2015: £2,827,315), which has been included in the Group's statement of comprehensive loss.

## 23. Trade and other payables

| | Group | | Company | |
|---|---|---|---|---|
| | **31 December 2016 £** | 31 December 2015 £ | **31 December 2016 £** | 31 December 2015 £ |
| Trade payables | **994,901** | 1,263,747 | **994,901** | 1,263,747 |
| Social security and other taxes | **113,205** | 107,661 | **113,205** | 107,661 |
| Other payables | **13,001** | 17,612 | **13,001** | 17,615 |
| Accruals | **2,088,008** | 2,588,497 | **2,088,008** | 2,588,497 |
| Intercompany payable | **—** | — | **—** | 3 |
| | **3,209,115** | 3,977,517 | **3,209,115** | 3,977,520 |

Terms and conditions of the above financial liabilities:

- trade payables are non-interest bearing and are normally settled on 30-day terms; and
- other payables are non-interest bearing and have an average term of one month.

## 24. Commitments and contingencies

### Operating lease commitments — Group as lessee

The Company has entered into a lease for its premises at Fourth Floor, 1 Cavendish Place, London W1G 0QF. The term of the lease agreement is from 17 August 2015 through to 16 August 2025.

The premises comprise approximately 4,000 square feet. The principal rent for the premises is £162,960 per annum through 16 December 2016 and £325,920 per annum thereafter, subject to increase on 17 August 2020 based on the open market value of the premises (the "Principal Rent"). In addition to the Principal Rent, the Company is responsible for value added tax on the Principal Rent and certain insurance costs and service charges incurred by the landlord.

The Company may break the lease agreement on 16 August 2020 by providing six months' prior written notice to the landlord. If the Company does not exercise its break option, the landlord will decrease by 50% the Principal Rent for the period from 16 August 2020 through to 15 April 2021.

Future minimum rentals payable under non-cancellable operating leases as at 31 December are, as follows:

| Land and buildings | **31 December 2016 £** | 31 December 2015 £ |
|---|---|---|
| Within one year | **325,920** | 293,328 |
| After one year but not more than five years | **854,576** | 1,063,708 |
| More than five years | **—** | — |
| | **1,180,496** | 1,357,036 |

The Group does not have any other operating leases.

# NOTES TO THE FINANCIAL STATEMENTS CONTINUED

## 24. Commitments and contingencies continued

### Finance leases – Group as lessee

The Group did not have any leasing arrangements classifying as finance leases at 31 December 2016 (2015: nil).

### Financial commitments

As described in note 25, each of Mereo BioPharma 1 Ltd, Mereo BioPharma 2 Ltd and Mereo BioPharma 3 Ltd issued to Novartis loan notes (which were assigned by Novartis to the Company in exchange for ordinary shares pursuant to the Subscription Agreement) and each of Mereo BioPharma 1 Ltd, Mereo BioPharma 2 Ltd and Mereo BioPharma 3 Ltd agreed to make future payments to Novartis comprising amounts equal to ascending specified percentages of tiered annual worldwide net sales (beginning at high single digits and reaching into double digits at higher sales) by such subsidiary of products that include the assets acquired. The levels of ascending percentages of tiered annual worldwide net sales are the same for each of Mereo BioPharma 1, Mereo BioPharma 2 and Mereo BioPharma 3 under the respective Purchase Agreements.

Each of Mereo BioPharma 1 Ltd, Mereo BioPharma 2 Ltd and Mereo BioPharma 3 Ltd further agreed that in the event it transfers, licenses, assigns or leases all or substantially all of its assets, it will pay Novartis a percentage of the proceeds of such transaction. The Company will retain the majority of the proceeds from such a transaction. Such percentage is the same for each of Mereo BioPharma 1 Ltd, Mereo BioPharma 2 Ltd and Mereo BioPharma 3 Ltd under the respective Purchase Agreements. The payment of a percentage of proceeds is not payable with respect to any transaction involving equity interests of Mereo BioPharma plc, a merger or consolidation of Mereo BioPharma Group plc, or a sale of any assets of Mereo BioPharma Group plc.

## 25. Related party disclosures

Note 5 provides information about the Group's structure, including details of the subsidiaries and the holding company. The following shows the transactions that have been entered into with related parties for the relevant financial period.

On 30 June 2016 Mereo BioPharma Group plc resolved to capitalise the intercompany loans and all outstanding intercompany receivables at that date, and any intercompany balances in existence at 31 December were similarly extinguished. A capital contribution of £65,744,871 by Mereo BioPharma Group plc to its subsidiaries was recorded extinguishing all intercompany balances at 31 December 2016.

Novartis Pharma AG ("Novartis") holds shares in the Company at 31 December 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 19).

On 28 July 2015, Mereo BioPharma 1 Ltd, Mereo BioPharma 2 Ltd and Mereo BioPharma 3 Ltd each acquired certain assets from Novartis, each company issuing a loan note to Novartis as consideration. The total amount was £25,812,941. The loan notes were interest bearing at a fixed rate of 2% above the Bank of England rate.

Of the 14,740,296 ordinary shares issued on 29 July 2015, 3,849,000 shares were issued to Novartis. This left a further 10,151,000 shares are to be issued to Novartis pro rata to their percentage shareholding as and when the Company issued further ordinary shares. Of the 44,600,502 ordinary shares issued on 9 June 2016, 8,697,480 shares were issued to Novartis at a price of £1.84 per share. A further 1,453,520 shares are to be issued to Novartis pro rata to their percentage shareholding as and when the Company issues further ordinary shares.

On 28 July 2015, Mereo BioPharma Group plc entered into a subscription agreement to obtain investor funding. As part of the subscription agreement (as amended by an agreement dated 1 June 2016), Novartis Pharma AG assigned its loan notes with the three subsidiaries to Mereo BioPharma Group plc and extinguished the loan notes in return for the receipt of 3,849,000 ordinary shares in the Company.

As part of the extinguishing of the loan notes as described above, an intercompany loan was established from Mereo BioPharma Group plc to Mereo BioPharma 1 Ltd. The initial amount was £4,310,761 with interest bearing at a fixed rate of 2% above the Bank of England rate. As described above, the intercompany loan formed part of the intercompany balances that were capitalised on 30 June 2016.

## 25. Related party disclosures continued

A total of £11,969,916 (2015: £8,211,558) was charged by Mereo BioPharma Group plc to Mereo BioPharma 1 Ltd in the year in respect of recharged expenses.

As part of the extinguishing of the loan notes as described above, an intercompany loan was established from Mereo BioPharma Group plc to Mereo BioPharma 2 Ltd. The initial amount was £9,886,356 with interest bearing at a fixed rate of 2% above the Bank of England rate. As described above, the intercompany loan formed part of the intercompany balances that were capitalised on 30 June 2016.

A total of £11,720,614 (2015: £12,838,180) was charged by Mereo BioPharma Group plc to Mereo BioPharma 2 Ltd in the year in respect of recharged expenses.

As part of the extinguishing of the loan notes as described above, an intercompany loan was established from Mereo BioPharma Group plc to Mereo BioPharma 3 Ltd. The initial amount was £11,615,824 with interest bearing at a fixed rate of 2% above the Bank of England rate. As described above, the intercompany loan formed part of the intercompany balances that were capitalised on 30 June 2016.

A total of £7,301,106 (2015: £14,650,182) was charged by Mereo BioPharma Group plc to Mereo BioPharma 3 Ltd in the year in respect of recharged expenses.

The Group purchased goods and services from Novartis in the year as set out below:

| | **31 December 2016 £** | 31 December 2015 £ |
|---|---|---|
| Manufacture and supply of clinical trial material | **968,219** | – |

The amount outstanding to be paid to Novartis at 31 December 2016 was £35,249.

Dr Frank Armstrong is a director of Dr Frank Armstrong Consulting Ltd, and a Director of the Company. During the period to 31 December 2015 the Company made purchases, in the ordinary course of business, at a cost of £120,412 from Dr Frank Armstrong Consulting Ltd. These purchases were for assistance with diligence activities, contributed advice and reimbursement of travel costs prior to completion of the purchase agreements.

Dr Denise Scots-Knight, Kunal Kashyap and Peter Bains are directors of Phase4 Partners Ltd and Directors of the Company. During the period to 31 December 2015 the Group made purchases, in the ordinary course of business, at a cost of £458,359 from Phase4 Partners Ltd. These purchases were for reimbursement of pre-establishment third-party consultancy services and reimbursement of office and travel costs.

### Terms and conditions of transactions with related parties

The purchases from related parties are made on terms equivalent to those that prevail in arm's length transactions. There have been no guarantees provided or received for any related party receivables or payables. For the year ended 31 December 2016 the Group has not recorded any impairment of receivables relating to amounts owed by related parties. This assessment is undertaken each financial year through examining the financial position of the related party and the market in which the related party operates.

## 26. Standards issued but not yet effective

The standards and interpretations that are issued, but not yet effective, up to the date of issuance of the Group's financial statements are disclosed below. The Group intends to adopt these standards, if applicable, when they become effective.

### IFRS 15 Revenue from Contracts with Customers

IFRS 15 was issued in May 2014 and establishes a new five-step model that will apply to revenue arising from contracts with customers. Under IFRS 15 revenue is recognised at an amount that reflects the consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer. The principles in IFRS 15 provide a more structured approach to measuring and recognising revenue.

The new revenue standard is applicable to all entities and will supersede all current revenue recognition requirements under IFRS. Either a full or modified retrospective application is required for annual periods beginning on or after 1 January 2018 with early adoption permitted. The Group is currently assessing the impact of IFRS 15 and plans to adopt the new standard on the required effective date.

# NOTES TO THE FINANCIAL STATEMENTS CONTINUED

## 26. Standards issued but not yet effective continued

### IFRS 16 Leases

IFRS 16 specifies how an IFRS reporter will recognise, measure, present and disclose leases. The standard provides a single lessee accounting model, requiring lessees to recognise assets and liabilities for all leases unless the lease term is twelve months or less or the underlying asset has a low value. Lessors continue to classify leases as operating or finance, with IFRS 16's approach to lessor accounting substantially unchanged from its predecessor, IAS 17.

IFRS 16 was issued in January 2016 and applies to annual reporting periods beginning on or after 1 January 2019.

The Group is currently assessing the impact of IFRS 16 and plans to adopt the new standard on the required effective date.

### Other standards

The following standards and interpretations, applicable for annual periods beginning on or after 1 January 2017, are not expected to have any impact on the results of the Group or the presentation of the financial statements:

- IFRS 9 Financial Instruments
- IFRS 10 Consolidated Financial Statements – Amendments regarding the sale or contribution of assets between an investor and its associate or joint venture and amendments regarding the application of the consolidation exception
- IFRS 11 Joint Arrangements – Amendments regarding the accounting for acquisitions of an interest in a joint operation
- IFRS 12 Disclosure of Interests in Other Entities – Amendments regarding the application of the consolidation exception
- IFRS 14 Regulatory Deferral Accounts
- IAS 1 Presentation of Financial Statements – Amendments resulting from the disclosure initiative
- IAS 7 Statement of Cash Flows – Amendments resulting from the disclosure initiative
- IAS 12 Income Taxes – Amendments to recognition of deferred tax assets for unrealised losses
- IAS 16 Property, Plant and Equipment – Amendments regarding the clarification of acceptable methods of depreciation and amortisation and amendments bringing bearer plants into the scope of IAS 16
- IAS 27 Separate Financial Statements (as amended in 2011) – Amendments reinstating the equity method as an accounting option for investments in subsidiaries, joint ventures and associates in an entity's separate financial statements
- IAS 28 Investments in Associates and Joint Ventures – Amendments regarding the application of the consolidation exception
- IAS 38 Intangible Assets – Amendments regarding the clarification of acceptable methods of depreciation and amortisation
- IAS 41 Agriculture – Amendments bringing bearer plants into the scope of IAS 16
- Amendments resulting from September 2014 Annual Improvements to IFRSs:
  - IFRS 2 Classification and Measurement of Share-based Payment Transactions
  - IFRS 5 Non-current Assets Held for Sale and Discontinued Operations
  - IFRS 7 Financial Instruments: Disclosures
  - IFRIC Interpretation 22 Foreign Currency Transactions and Advance Consideration
  - IAS 19 Employee Benefits
  - IAS 34 Interim Financial Reporting

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# DELIVERING ON OUR STRATEGY

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