

Evotec

Upgraded on healthy cash flows post acquisition

Evotec ended 2016 with the landmark deal with Celgene for Evotec's induced pluripotent stem cell (iPSC) platform, bringing in a \$45m upfront payment. Other recent highlights were Novo A/S' €90.3m investment in the company and the acquisition of Cyprotex, an ADME-Tox and DMPK specialist that will enhance Evotec's core service offering and also add new clients. Evotec's Q316 results were solid, with better-than-expected margins being the main surprise for us, which prompted us to upgrade our forecasts and raise our valuation to €1.2bn.

Year end	Revenue (€m)	PBT* (€m)	EPS* (€)	DPS (€)	P/E (x)	Yield (%)
12/14	89.5	(0.7)	(0.02)	0.0	N/A	N/A
12/15	127.7	1.2	(0.01)	0.0	N/A	N/A
12/16e	162.4	27.4	0.14	0.0	52.7	N/A
12/17e	194.0	42.4	0.21	0.0	35.1	N/A

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

All-cash acquisition of Cyprotex

Following shareholder approval, Evotec finalised the acquisition of Cyprotex in December 2016 with a total cash outlay of £55.7m (shares and repayment of debt). The offer price of £1.60 per Cyprotex share implied a 9.4% premium to the volume weighted average price of the 30 trading days on AIM prior to the offer, and an undemanding price to sales ratio of 2.4x (based on Cyprotex's H116 sales), compared to Evotec's price to sales ratio of 4.1x (using our FY16 sales estimate) at the time of the announcement.

Landmark Celgene deal and new strategic investor

Over the past several years, Evotec has developed its iPSC platform, which it will now use with Celgene to identify disease-modifying therapeutics for neurodegenerative diseases. Celgene has exclusive options to in-license compounds and in return Evotec will receive \$45m as an upfront payment with another \$250m in potential milestone payments and low double-digit royalties for each programme. Other major recent news was Novo, a healthcare investor and part of Novo Nordisk Foundation, taking an 8.9% stake in Evotec after investing some €90.3m during a private placement in February 2017. Notably, the investment has been made with no discount to the share price. Novo is the controlling shareholder in Novo Nordisk and Novozymes among others and manages assets valued at around €47bn in total. The investment marks a progression of Evotec's fine-tuned model of an established drug discovery services business combined with advancing innovation in-house and with partners via collaborations or equity investments.

Valuation: Increased to €1.2bn or €7.9/share

We have increased our valuation of Evotec from €620.3m or c €4.7/share to €1.2bn or €7.9/share, as a result of upgrading our earnings estimates, inclusion of the Cyprotex business, \$45m upfront payment from Celgene, Novo's €90.3m investment, and rolling our model forward by one quarter.

Company update

Pharma & biotech

7 March 2017

Price €7.38
Market cap €1080m

Estimated net cash (€m) at end Q416 (with Cyprotex acquisition) + upfront payment + Novo's investment 187

Shares in issue (incl. Novo's investment) 146.2m

Free float 80%

Code EVT

Primary exchange Frankfurt

Secondary exchange N/A

Share price performance



%	1m	3m	12m
Abs	7.6	21.6	125.5
Rel (local)	3.6	9.5	85.2
52-week high/low	€7.9	€3.1	

Business description

Evotec is a drug discovery alliance and development partnership company that provides outsourcing solutions to pharmaceutical companies, including Bayer, CHDI, Janssen, Pfizer and Sanofi. It has operations in Germany, France, the UK and the US.

Next events

Further strategic alliances H117

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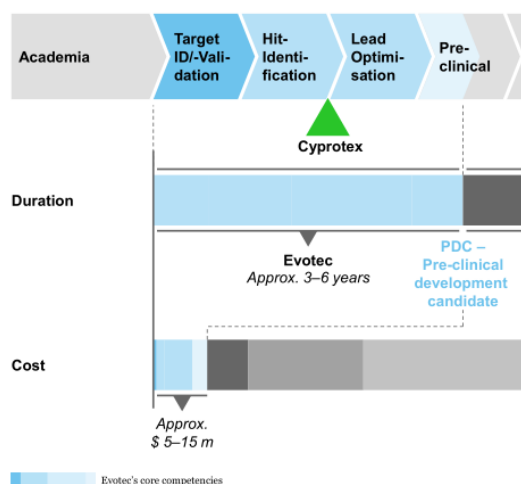
Besides the Celgene collaboration, Evotec continued to forge new partnerships on top of reaching another preclinical milestone by delivering a fifth preclinical candidate in endometriosis programme run in partnership with Bayer (one candidate in Phase I). In our view, among the most notable developments over the past several months was LAB282, a newly established venture with Oxford University and Oxford Sciences Innovation (OSI). OSI will contribute some €14m over the initial three years, while the translational projects will be sourced from Oxford University. LAB282 aims to advance assets through preclinical proof-of-concept and potentially create spin outs. In addition to execution of the research, Evotec also retained the option to participate in future equity financing rounds. In addition, Evotec made two new equity investments: in Eternigen's (metabolic diseases, novel target) €8m series A round backed by a consortium; and Fibrocor Therapeutics' (fibrosis) launch, with C\$2.8m backed together with MaRS Innovation. All these deals are recent examples of Evotec's continued search for innovative forms of partnering with the goal to leverage its drug discovery expertise.

Cyprotex enhances Evotec core competences

In December 2016, Evotec finalised the acquisition of Cyprotex, a UK-listed ADME-Tox (absorption, distribution, metabolism, excretion, toxicology) and DMPK (drug metabolism and pharmacokinetics) specialist, with cash outlay of £55.7m for shares and repayment of all debt. The offer price of £1.60 per Cyprotex share was a 9.4% premium to the volume weighted average price of the 30 trading days on AIM prior to the offer.

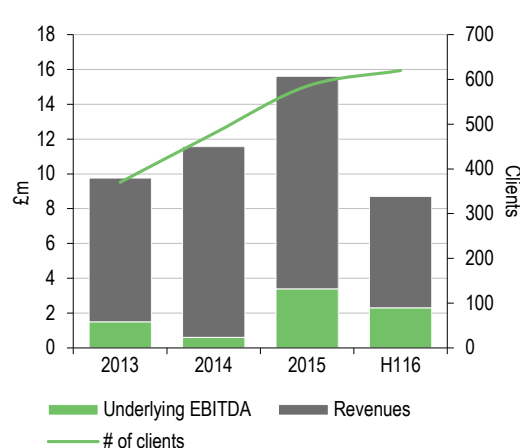
Cyprotex is a niche player and one of the largest contract research organisations specialising in ADME-Tox and DMPK. It has clients in a variety of industries including pharmaceuticals, chemicals, agrochemicals and cosmetics. During a conference call, Evotec hinted that it will continue to work with clients from other industries beyond pharmaceuticals, which will diversify its existing client base. In our view, besides potential synergies, the acquisition expands Evotec's specialist offering, but importantly also adds new clients. Headquartered in the UK and founded in 1999, Cyprotex has 136 employees with rising numbers of clients and partnerships (Exhibit 2). Cyprotex's sales increased 18% y-o-y in 2014 and 35% y-o-y in 2015, with the positive growth trend set to continue in 2016. The underlying EBITDA margin was 22% in 2015 and Evotec expects the deal to be accretive to EBITDA in 2017.

Exhibit 1: Cyprotex's fit within Evotec



Source: Evotec

Exhibit 2: Cyprotex's client base



Source: Cyprotex,

New deal with Celgene

Evotec announced a new drug discovery and development collaboration with Celgene on 15 December 2016 to identify disease-modifying therapeutics for neurodegenerative diseases, with the initial focus on amyotrophic lateral sclerosis, Alzheimer's disease, Parkinson's disease and a few others. The deal involves Evotec's proprietary iPSC platform, which Evotec developed over the past five years. Celgene received exclusive options to in-license compounds after Evotec carries out preclinical work with its iPSC platform in the areas covered by the agreement using its own compound library, but Celgene could also test its compounds. In return, Evotec received \$45m as an upfront payment with another \$250m in potential milestone payments and low double-digit royalties for each programme that Celgene may in-license. The initial term of the collaboration is five years. Although in the neurodegenerative disease area Celgene has an exclusive option to in license the identified compounds, Evotec mentioned that this platform will be expanded into other disease areas, therefore enabling more partnerships in the future.

iPSCs differ from embryonic stem cells. iPSC were genetically modified to 'regress' from fully differentiated cells, like skin cells, to younger stages where they regain the ability to multiply and differentiate into any type of cell. This overcomes several major issues related to human embryonic stem cells, such as ethical hurdles and sourcing. iPSC technology was discovered 10 years ago and was expected to revolutionise medicine with new cell therapies and boost regenerative medicine. However, major safety issues, such as iPSC developing into tumours, meant that clinical development was challenging. Instead iPSC revolutionised the research industry by allowing researchers to model diseases, enhance drug screening and look into patient stratification even before the compound reached the clinical stage, eg 'clinical trial in a dish'.¹ The importance of the Celgene/Evotec deal is that it confirms the scale of Evotec's iPSC platform, which to our knowledge is among the pioneers of the drug discovery industry.

Financials

Q3 profit significantly boosted by milestone payments

Evotec's Q316 revenues grew 35.9% y-o-y to €45.2m and well surpassed our expectations. This was primarily driven by upfront, milestone or other licence-related payments from third parties, which totalled to €8.7m (vs €3.4m in Q216 and €1.1m a year ago) and can partially be explained by the milestone payment from Bayer booked in Q316 after the initiation of the Phase I trial in endometriosis. Excluding milestones, upfront and licence payments, the Q316 sales from the core drug discovery services business came in at €36.5m, slightly ahead of our expected €35.1m.

The Q316 gross margin of 45.1% (vs 35.6% in Q216 and 31.3% a year ago) was positively affected by significant milestone payments. Adjusted gross margin of 32.1% was still ahead of our expected 27.4%. R&D expenses of €3.8m were lower than our forecast of €5.0m, as well as reported SG&A of €6.0m versus our estimate of €6.8m. Evotec's Q316 operating profit was further increased by net other income of €1.4m (mainly R&D tax credits) and came in at €12.0m versus our estimate of €1.5m.

Estimate revision and Cyprotex acquisition boost EPS

We have made only small changes to our top line estimate for 2016, while the forecast for 2017 was increased by the revenues from the Cyprotex business. Our long-term estimates were mostly affected by the increase in long-term margins, as Evotec reported better-than-expected gross and

¹ Y. Avior et al. Pluripotent stem cells in disease modelling and drug discovery. March 2016, Vol 17, Nature.

operating profit margins. Our adjusted EBITDA estimate for 2016 has been significantly revised upwards and we now expect it to more than quadruple year-on-year.

Cyprotex acquisition

Evotec guided that it expects €18-20m in revenues from the Cyprotex business in 2017, which looks conservative compared to historical €18.6m in FY15 and €10.4m in H116 (using the same exchange rate of €1.19/£ at the closure of the deal) and a CAGR of 21% between 2013 and 2016 (using two times H116 for FY16 sales). We find the conservative stance reasonable given the integration period; hence in our model we include revenues of €19m in 2017 and subsequently assume c 10% growth gradually slowing to 5% by 2025. Cyprotex's gross margin averaged an impressive 78% over 2013-15, compared to Evotec's 30% (using revenues excluding milestone payments); we use a 75% margin for this business going forward. Cyprotex's operating costs (excluding a goodwill impairment one-off in 2014) averaged c 73% of the total revenues over 2013-15 compared to just 25% estimated for Evotec in 2016 (using revenues excluding milestone payments). We expect synergies in running the combined businesses and assume that Evotec will be able to bring the operating costs for the Cyprotex business down to c 60%.

Out of the total amount of £55.7m (€66.3m at €1.19/£) paid by Evotec, Cyprotex's equity purchase price was £41.8m (€49.7m) while the remainder was used to repay the seller's debt. The upfront from Celgene will be received on closure of the collaboration deal, but for accounting purposes will be deferred over a five-year period and will be reflected as income to the EVT Innovate business segment. Including the cash of €90.3m received after Novo's investment, we calculate that Evotec should have accumulated a solid net cash position of €187m (estimated end-Q416 net cash less acquisition costs plus Celgene's upfront plus Novo's investment).

The estimate revision and the inclusion of the Cyprotex business have resulted in changes to our forecasts, as shown in Exhibit 3.

Exhibit 3: Summary of the main changes to our Evotec financial forecasts

€000s	2015	2016e			2017e		
	Reported	Old	New	% change	Old	New	% change
Revenues	127,677	157,431	162,392	+3%	177,399	194,045	+9%
Underlying revenues*	115,400	143,067	143,288	+0%	156,269	174,941	+12%
Gross profit	37,987	53,767	62,206	+16%	63,971	88,636	+39%
Gross margin	29.8%	34.2%	38.3%	4.2pp	36.1%	45.7%	9.6pp
Research and development costs	(18,343)	(18,788)	(16,975)	-10%	(19,254)	(15,534)	-19%
Selling, general and administration costs	(25,166)	(24,874)	(24,061)	-3%	(25,987)	(33,497)	+29%
Adjusted EBITDA**	8,690	26,594	38,869	+46%	30,517	51,389	+68%
Adjusted EBITDA margin %	6.8%	16.9%	23.9%	7.0pp	17.2%	26.5%	9.3pp
Operating profit (reported)	11,640	13,333	25,740	+93%	18,834	39,710	+111%
Operating profit margin %	9.1%	8.5%	15.9%	7.4pp	10.6%	20.5%	9.8pp
Profit before tax (norm)	1,179	14,981	27,380	+83%	21,221	42,394	+100%
Profit after tax (norm)	(1,462)	9,773	18,991	+94%	15,914	31,160	+96%
EPS (€, norm)	(0.01)	0.07	0.14	+104%	0.11	0.21	+83%

Source: Edison Investment Research, Evotec accounts. Note: *Underlying revenues exclude milestones, upfront and licence payments. **EBITDA adjusted for changes in contingent considerations.

Valuation

We value Evotec at €1.2bn or €7.9/share, up from €620.3m or c €4.7/share previously. This is based on the revision of our estimates, the inclusion of the Cyprotex business and Novo's investment, the addition of the upfront payment from Celgene and rolling our model forward.

We maintain our valuation approach, which includes a DCF model for the services business and separate risk-adjusted NPV models for the R&D programmes. For Evotec's drug discovery business, we use a DCF model with a cost of capital of 10%, a terminal growth rate of 2.5%, a long-

term operating profit margin of c 35% achievable within the next 10 years and maintenance capex of around €8-9m. In our R&D pipeline valuation, we include the most advanced clinical- and preclinical-stage products, for which we keep our assumptions unchanged as described in [our previous reports](#). Evotec's shareholders enjoyed a strong share price rally this year, which we expect will be further supported by healthy cash flows and a maturing preclinical pipeline.

Exhibit 4: Summary of risk-adjusted DCF valuation of Evotec

	Value (€m)	Value/share (€)	Probability	rNPV (€m)	rNPV/share (€)
Drug alliance business	851.1	5.82	100%	851.1	5.82
Clinical-stage R&D assets					
EVT201	18.8	0.13	30%	5.6	0.04
EVT401	67.7	0.46	30%	20.3	0.14
Undisclosed programmes	204.8	1.40	10%	20.5	0.14
Endometriosis	274.5	1.88	10%	27.5	0.19
Preclinical-stage R&D assets					
EVT770	160.4	1.10	5%	8.0	0.05
EVT801/701/601	244.5	1.67	5%	12.2	0.08
Multiple sclerosis	484.5	3.31	5%	9.7	0.07
Microbiome	102.5	0.70	5%	5.1	0.04
Net cash (at end Q416 + upfront + Novo's investment)	186.9	1.28	100%	186.9	1.28
Total	2,595.8	17.76		1,147.0	7.85

Source: Edison Investment Research. Note: WACC = 10% for drug discovery business, 12.5% for R&D projects.

Exhibit 5: Financial summary*

	€'000s	2012	2013	2014	2015	2016e	2017e
Year end 31 December		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS							
Revenue		87,265	85,938	89,496	127,677	162,392	194,045
Cost of Sales		(56,242)	(54,715)	(60,118)	(89,690)	(100,186)	(105,409)
Gross Profit		31,023	31,223	29,378	37,987	62,206	88,636
Adjusted EBITDA		10,217	10,394	7,711	8,690	38,869	51,389
Operating Profit (before GW and except.)		3,071	7,392	(1,942)	328	29,242	41,983
Intangible Amortisation		(2,768)	(3,222)	(2,462)	(2,860)	(2,084)	(2,273)
Other		(3,311)	2,430	(926)	5,850	5,987	105
Exceptionals		(3,505)	(25,521)	(1,977)	14,172	(1,417)	0
Operating Profit		(3,202)	(21,351)	(6,381)	11,640	25,740	39,710
Net Interest		(1,204)	(1,609)	(1,152)	(1,193)	(863)	411
Other		(608)	(688)	2,374	2,044	(999)	0
Profit Before Tax (norm)		1,259	5,095	(720)	1,179	27,380	42,394
Profit Before Tax (FRS 3)		(5,014)	(23,648)	(5,159)	12,491	23,878	40,121
Tax		(793)	(299)	(1,858)	(2,641)	(8,389)	(11,234)
Deferred tax		8,285	(1,486)	39	6,666	(46)	0
Profit After Tax (norm)		466	4,796	(2,578)	(1,462)	18,991	31,160
Profit After Tax (FRS 3)		2,478	(25,433)	(6,978)	16,516	15,443	28,887
Average Number of Shares Outstanding (m)		117.3	121.2	131.3	131.7	132.6	146.2
EPS - normalised (€)		0.00	0.04	(0.02)	(0.01)	0.14	0.21
EPS - FRS 3 (€)		0.02	(0.21)	(0.05)	0.13	0.11	0.19
Dividend per share (€)		0.00	0.00	0.00	0.00	0.00	0.00
Gross Margin (%)		35.6	36.3	32.8	29.8	38.3	45.7
EBITDA Margin (%)		11.7	12.1	8.6	6.8	23.9	26.5
Operating Margin (before GW and except.) (%)		3.5	8.6	-2.2	0.3	18.0	21.6
BALANCE SHEET							
Fixed Assets		137,323	104,854	99,300	121,598	116,228	171,801
Intangible Assets		105,608	79,962	75,025	70,802	63,337	114,192
Tangible Assets		27,181	24,239	24,045	38,334	37,623	42,340
Other		4,534	653	230	12,462	15,269	15,269
Current Assets		88,104	122,526	125,300	166,940	166,873	281,354
Stocks		2,445	2,358	3,111	3,133	4,123	4,338
Debtors		15,053	17,777	25,259	21,069	24,452	32,229
Cash		64,159	96,143	88,822	133,940	129,879	236,367
Other		6,447	6,248	8,108	8,798	8,419	8,419
Current Liabilities		(33,882)	(38,953)	(33,068)	(56,400)	(46,025)	(67,834)
Creditors		(20,659)	(21,731)	(19,705)	(42,187)	(38,733)	(60,542)
Short term borrowings		(13,223)	(17,222)	(13,363)	(14,213)	(7,292)	(7,292)
Long Term Liabilities		(38,998)	(29,460)	(33,149)	(45,044)	(39,066)	(67,985)
Long term borrowings		(4,178)	0	(8,186)	(8,730)	(7,509)	(7,509)
Other long term liabilities		(34,820)	(29,460)	(24,963)	(36,314)	(31,557)	(60,476)
Net Assets		152,547	158,967	158,383	187,094	198,011	317,336
CASH FLOW							
Operating Cash Flow		12,175	7,084	(3,701)	16,343	20,869	84,067
Net Interest		111	(237)	41	102	(288)	411
Tax		(329)	(190)	(137)	(792)	(386)	(1,401)
Capex		(10,129)	(4,607)	(5,282)	(11,496)	(9,787)	(8,732)
Acquisitions/disposals		(3,000)	(1,150)	(2,436)	37,114	0	(58,170)
Financing		701	32,398	658	1,971	660	90,313
Dividends		0	0	0	0	0	0
Other		0	(159)	(1,813)	(551)	(8,352)	0
Net Cash Flow		(471)	33,139	(12,670)	42,691	2,717	106,488
Opening net debt/(cash)		(46,895)	(46,758)	(78,921)	(67,273)	(110,997)	(115,078)
HP finance leases initiated		0	0	0	0	0	0
Exchange rate movements		(953)	501	(792)	(1,072)	3,099	0
Other		1287	(1,477)	1814	2,104	(1,735)	0
Closing net debt/(cash)		(46,758)	(78,921)	(67,273)	(110,997)	(115,078)	(221,566)

Source: Edison Investment Research, Evotec accounts. Note: *Pro forma including Cyprotex starting from 2017. EBITDA is adjusted for changes in contingent considerations and income from bargain purchases.

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