

Selvita

Good Q316 results; green light for expansion

Q316 results update

Pharma & biotech

Selvita continued to deliver organic growth in Q316, with further significant addition to profits from a one-off gain after the sale of assets connected with the Nodthera formation earlier in summer. Following the approval of the first step of long-term expansion plans at the extraordinary general meeting on 25 October, we now include them in our model. This is the main driver behind the increase in our valuation to PLN427m or PLN32/share.

Year end	Revenue (PLNm)	PBT* (PLNm)	EPS* (PLN)	DPS (PLN)	P/E (x)	Yield (%)
12/14	41.6	5.4	0.56	0.0	42.0	N/A
12/15	56.1	7.5	0.84	0.0	28.0	N/A
12/16e	67.6	5.0	0.38	0.0	61.8	N/A
12/17e	76.9	6.0	0.44	0.0	53.4	N/A

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

Q316 profits boosted by asset sale gain

Total Q316 revenues of PLN20.4m were up 35% q-o-q and 45% y-o-y. This was higher than our estimate of PLN17.4m, mainly reflecting the positive effect of the sale of assets in connection to the recently established start-up Nodthera, which Selvita has booked as other revenue. The company continued to deliver organic growth within its services segment, with sales of PLN8.3m (excl. subsidies) meeting our expectations, while subsidies came in lower than we had expected. Ardigen, which makes up the Bioinformatics segment, delivered a positive surprise with improving prospects, an increasingly material addition to the top line and breaking even on operating profit.

R&D on track

The development of SEL24 (a dual PIM/FLT3 inhibitor) progressed according to plan in Q316, with the main activities focusing on obtaining permission from ethics committees. Following the FDA's acceptance of the investigational new drug application (IND), SEL24 can now proceed to Phase I/II in acute myeloid leukaemia patients; the trial is to start in Q416/Q117. SEL120, Selvita's second most advanced product CDK8 inhibitor in preclinical stage, is being developed as a novel therapy for oncology indications. In Q316 the major focus was on establishing patient stratification methods and detailed safety profiling. IND-enabling studies are expected to start in the coming months.

Valuation: PLN427m or PLN32/share

We have increased our valuation from PLN376m or PLN28.0/share to PLN427m or PLN32/share. The inclusion of the first phase of Selvita's long-term expansion plans was the main reason behind the positive effect, which was slightly offset by the lower cash position, while our revision post Q316 results mainly affected 2016 forecasts. In our view, continued organic growth of the Services segment is the main value driver for Selvita's share price in the near term; however, once the R&D pipeline matures, the value inflection will also be driven by Innovation.

22 November 2016

Price **PLN23.5**
Market cap **PLN322.64**

Net cash (PLNm) end Q316	29.7
Shares in issue	13.4m
Free float	45%
Code	SLV
Primary exchange	WSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(11.3)	(4.5)	(4.5)
Rel (local)	(11.5)	(2.1)	10.0
52-week high/low	PLN27.0	PLN16.6	

Business description

Selvita is a drug discovery services provider based in Poland. It employs c 370 staff (30% with PhDs) and operates two main business units: the Innovations Platform (internal NME pipeline) and Research Services (medicinal chemistry/biology, biochemistry).

Next events

SEL24 Phase I start	Q416/Q117
SEL120 IND studies start	Q416/Q117

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Financials

Q316 performance: Profits boosted by asset sale gain

Segment performance

Total Q316 revenues of PLN20.4m (up 35% q-o-q and 45% y-o-y) surpassed our expectations of PLN17.4m. This was mainly due to the one-off gain of PLN6.1m (recognised as other operating revenue) in the **Innovation segment** after the sale of assets connected to the recently established start-up [Nodthera](#). As a result, Innovation segment sales excluding subsidies were up 228% q-o-q and 117% y-o-y. Adjusting for this one-off gain, Innovation achieved revenues of PLN2.5m vs PLN2.6m in Q216 and PLN3.9m in Q315. Notably, Innovation (R&D activities) includes revenues in the form of milestone payments from drug discovery partnerships, which tend to be volatile from quarter to quarter. However, this business is a long-term focus for Selvita, as it includes advanced research agreements with large international pharmaceutical corporations offering potentially higher margins.

The profitability-driving **Services segment** performed in line with our expectations, with sales excluding subsidies reaching PLN8.3m versus our estimate of PLN8.2m. This corresponds to a decent y-o-y growth of 30% and 5% q-o-q.

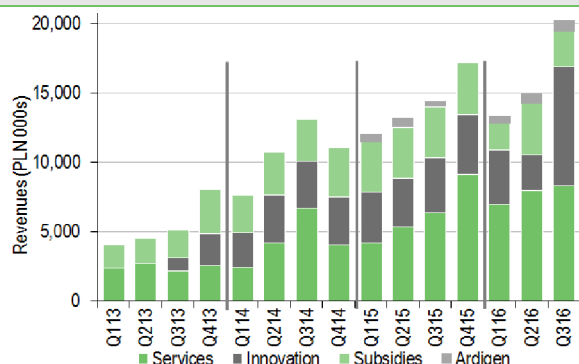
Selvita booked PLN2.6m in total **subsidies** (allocated to both the Innovation and Services segments) in Q316 – below our expectation of PLN4.2m – as the company switched EU financial frameworks (it completed significant R&D projects in 2015 and started new ones in 2016). So far Selvita has been very successful in obtaining subsidized funding for its innovative projects and we expect this to continue in the near term.

Ardigen's positive surprise

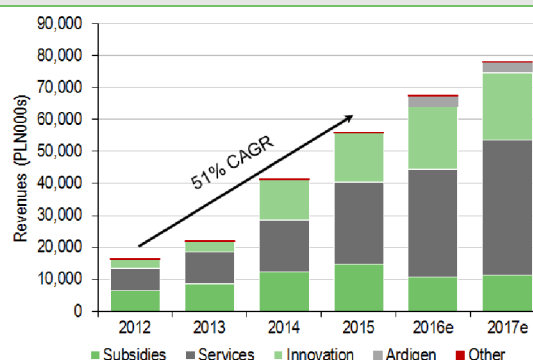
Selvita's spin-out bioinformatics company Ardigen delivered a positive surprise with Q316 sales of PLN810k topping our expectations of PLN725k. Selvita has a 60% stake in the company and has consolidated the accounts since Q116. Ardigen was established to diversify from laboratory software and IT support services to develop new solutions to leverage the emerging big data applications tailored for precision medicine. Our initial 2016 expectations were for flattish sales with a small addition to the top line and a neutral effect on the bottom line. However, the segment has consistently performed better than expected and our 2016 sales estimate now stands at PLN3.1m or around 4.6% of the total. Selvita's Q316 report described positive growth prospects for Ardigen. In Q316 Ardigen concluded a multi-year framework agreement with a top 10 US-based pharma company for the provision of bioinformatics services. Selvita also expects the new leads in the US will allow the delivery of additional sales already happening in Q416 to continue into 2017.

Profits from organic growth combined with one-off gain

Total Q316 operating expenses of PLN17.4m were in line with our expectations and included a non-cash cost of PLN0.91m related to the employee stock options programme (ESOP; PLN5.0m in 2016 so far). Adjusting for this but taking into account the reported gain associated with the Nodthera asset sale, operating profit was PLN3.9m versus an operating loss of PLN793k in Q216 and PLN435k in Q315. Adjusting for the one-off asset sale gain, Selvita's Q316 operating loss was PLN2.2m, partly reflecting the capacity expansion and increased cost base compared to 2015 (for example the total number of employees increased from 264 in August 2015 to around 370 in Q316). Notably, net profit was reduced by PLN653k because of the application of the equity method to the valuation of the ownership in Nodthera.

Exhibit 1: Quarterly revenue performance


Source: Edison Investment Research, Selvita

Exhibit 2: Annual revenue performance


Source: Edison Investment Research, Selvita. Note: Other is unallocated income.

Estimate revisions for 2016

We have made several revisions to our estimates (Exhibit 3). Q316 Services revenue (excluding subsidies) was in line with our previous estimate; we therefore leave it almost unchanged. We have increased our 2016 Innovation segment sales (excl. subsidies) estimate by 29% mainly due to the gains from the asset sale, while we keep our Q416 and 2017 forecasts unchanged. We also lowered our subsidy forecast for Q416, reflecting the average quarterly level in 9M16. As a result, the net effect on our total 2016 sales was minor at a 2% increase. After a slight downward total operating cost adjustment, the net effect on profits in 2016 was positive (a significant relative increase due to the low profit margin), while 2017 estimates remain virtually unchanged.

Exhibit 3: Changes to estimates

PLN000s	2015 Actual	2016e Old	2016e New	% change	2017e Old	2017e New	% change
Revenue	56,077	66,252	67,642	+2%	76,571	76,935	+0%
Operating Profit*	6,802	2,560	4,161	+63%	5,835	5,945	+2%
Operating Profit (%)	12.1%	3.9%	6.2%	2.3pp	7.6%	7.7%	0.1pp
Profit Before Tax*	7,550	3,618	4,967	+37%	5,845	5,958	+2%
Profit After Tax*	7,550	3,530	5,131	+45%	5,687	5,875	+3%
EPS (PLN)*	0.58	0.24	0.38	+60%	0.42	0.44	+3%

Source: Selvita accounts, Edison Investment Research. Note: *Adjusted for employee incentive programme expenses in 2015, 2016 and 2017 and positive impact of PLN3.4m for deferred tax asset changes in 2015. 2016 results not adjusted for the one-off asset sale gain.

Expansion plans and long-term estimate revision

As described in our previous reports, on 21 September 2016 Selvita announced its long-term expansion plans with the first step approved at the extraordinary general meeting on 25 October. The expansion plans include a new laboratory infrastructure development close to the current Selvita facilities in Krakow, with a total area of c 14,000sqm and space for c 1,000 employees.

The process is expected to be carried out in a stepwise manner and the near-term project includes one new fully equipped facility covering c 5,000sqm; work is estimated to be completed in 2019. To finance the project, Selvita will use a mix of cash, bank financing, tax incentives (the property will be located in a special economic zone) and public grants. The purchase price for the land is PLN7.5m, and while the total costs of this first phase are still being refined, a rough estimate could be around PLN70m (includes the land cost). We now add these capital expenditures in our model and revise our long-term estimates to reflect the increase in capacity. The main changes are:

- PLN7.5m land costs (75% funded with a loan and rest in cash) in 2017.

- PLN31m capex in each of 2018 and 2019; since a mix of funding sources was announced without any details, we include long-term debt in our model to finance this and will revise it once Selvita provides more information.
- The first building will have around one-third of the total expected capacity, so we assume that around 300 new employees could be hired compared to currently existing c 370. Since Selvita has already added a significant number of new hires (over 70 in 2016 alone) and new facilities will be opened in Poznan in early 2017, we believe the current capacity is not fully utilized and existing infrastructure will provide room for sales growth in the near term. Overall, our updated long-term estimates include sales from the Services and Innovation segments more than doubling over the next six years, with an increase in operating costs starting in 2019 when the development of the first building is expected to be completed.

Valuation

The inclusion of the expansion plans was the main driver behind the increase in our valuation, slightly offset by the lower cash position. Our R&D assumptions are unchanged and we calculate Selvita's valuation at PLN427m or PLN32/share, compared to PLN376m or PLN28/share previously. We note that due to the early stage of the lead R&D projects, the success probabilities typically range from 5% to 15%. In other words, if all programmes (Exhibit 4) are successful, based on our model the valuation would be PLN1.0bn.

Exhibit 4: Selvita valuation model

Division	Metric	Non risk adj. value (PLNm)	Probability of success (%)	Risk-adj. value (PLNm)	Value per share (PLN)	Notes
Services/ research collaborations	DCF (Q216-2021)	40	100	40	3.01	Services: sliding scale pa growth from c 25% in 2017 to 20% in 2023; research collaborations: +10% pa growth; subsidies: +5.0% pa growth; tax = 2-11% sliding scale (2016-23); 10% WACC.
	Terminal value	245.1	100%	245.1	18.23	0.75% growth on 2023 FCF
	Subtotal	285.6		285.6	21.24	
Internal pipeline	SEL24	318.9	15%	69.1	5.14	\$750m indicative peak sales (2029); launch in 2023; 5% royalty (pre-clinical); 15% probability of success (pre-clinical). Includes deal milestone estimates: \$15m upfront in 2017 (60%); \$10m on start of Phase II in 2018 (60%); \$20m on start Phase III in 2020 (15%); \$40m on NDA filing/approval in 2022 (7.5%). 12.5% WACC. Internal R&D Phase I costs of \$5m over 2016/2017.
	SEL120	292.8	5%	34.6	2.58	\$750m indicative peak sales (2029); launch in 2023; 5% royalty (pre-clinical); 5% probability of success (pre-clinical). Includes deal milestone estimates: \$3m upfront in 2017 (60% probability); \$5m on IND/Phase I start in 2017 (50%); \$15m on start Phase II in 2018 (25%); \$20m on start Phase III in 2020 (10%); \$40m on NDA filing/approval in 2022 (5%). 12.5% WACC. Internal R&D pre-Phase I costs of \$1m in 2016.
	Collaborations	87.0	5%	8.2	0.61	Indicative oncology projects to reflect the value of the partnership with Merck KGaA. Assume two projects in Phase I in 2020. Milestones of up to \$31.5m each relate to candidate selection, start of Phase I, initiation of pivotal trials, launch in major regions and sales thresholds. Royalties on annual sales of 0.5% up to \$500m, 1% on \$500m-1bn and 2% on sales greater than \$1bn. Probability of 5% to market.
	Subtotal	698.7		111.9	8.33	
Net cash		29.7		29.7	2.21	
Selvita total		1,014.0		427.1	31.8	Based on 13.4m shares outstanding.

Source: Edison Investment Research

Exhibit 5: Financial summary

	PLN'000s	2013	2014	2015	2016e	2017e
Year end 31 December		Local GAAP	Local GAAP	Local GAAP	Local GAAP	Local GAAP
PROFIT & LOSS						
Revenue		21,914	41,557	56,077	67,642	76,935
of which: Services (research outsourcing)		9,812	16,121	25,612	33,729	42,161
Innovation pipeline funding		3,241	12,744	15,416	19,560	16,416
Subsidies		8,688	12,430	14,700	10,818	14,824
EBITDA		(146)	7,626	10,235	7,640	10,685
Operating Profit (before GW and except.)		(2,228)	5,272	6,802	4,161	5,945
Intangible Amortisation		0	0	0	(0)	(0)
Exceptionals/Other		0	0	(4,729)	(5,857)	(586)
Operating Profit		(2,228)	5,272	2,073	(1,696)	5,359
Net Interest		(198)	155	748	805	13
Exceptionals/Other		0	0	0	0	0
Profit Before Tax (norm)		(2,427)	5,427	7,550	4,967	5,958
Profit Before Tax (reported)		(2,427)	5,427	2,821	(890)	5,372
Tax		(19)	(45)	(5)	164	(83)
Deferred tax		0	468	3,417	0	0
Profit After Tax (norm)		(2,445)	5,850	10,962	5,131	5,875
Profit After Tax (reported)		(2,445)	5,850	6,233	(726)	5,289
Average Number of Shares Outstanding (m)		10.5	10.5	13.1	13.3	13.4
EPS - normalised (PLN)		(0.23)	0.56	0.84	0.38	0.44
EPS - reported (PLN)		(0.23)	0.56	0.48	(0.06)	0.39
Dividend per share (PLN)		0.0	0.0	0.0	0.0	0.0
BALANCE SHEET						
Fixed Assets		7,067	9,494	16,718	30,655	40,891
Intangible Assets		282	331	2,274	5,274	5,274
Tangible Assets		4,932	6,845	8,597	15,799	26,035
Other		1,854	2,318	5,847	9,583	9,583
Current Assets		11,191	17,310	48,524	43,062	40,178
Stocks		391	706	1,174	1,158	1,142
Debtors		5,161	10,314	17,961	14,385	14,385
Cash		5,418	4,878	28,807	26,066	23,198
Other		221	1,411	582	1,453	1,453
Current Liabilities		(11,401)	(15,271)	(16,319)	(16,154)	(16,237)
Creditors		(3,481)	(6,055)	(3,927)	(6,854)	(6,854)
Provisions		(2,104)	(2,801)	(3,327)	(4,375)	(4,375)
Deferred revenues		(5,455)	(4,617)	(7,384)	(4,061)	(4,061)
Short term borrowings		(161)	(91)	(33)	(197)	(197)
Other		(200)	(1,708)	(1,648)	(666)	(749)
Long Term Liabilities		(3,454)	(2,278)	(2,043)	(6,940)	(12,565)
Long term borrowings		0	0	0	0	(5,625)
Deferred revenues		(3,222)	(2,010)	(1,513)	(4,172)	(4,172)
Other long term liabilities		(232)	(268)	(529)	(2,768)	(2,768)
Net Assets		3,403	9,254	46,880	50,622	52,267
CASH FLOW						
Operating Cash Flow		(7,198)	(4,902)	(16,430)	(12,504)	(8,340)
Net Interest		0	0	0	0	0
Tax		0	0	0	(4)	0
Capex		(2,167)	(3,610)	(5,190)	(13,680)	(14,976)
Acquisitions/disposals		0	0	0	0	0
Financing		0	0	27,314	0	0
Dividends		0	0	0	0	0
Other (incl. subsidies)		9,567	7,972	18,354	23,449	20,449
Net Cash Flow		202	(540)	24,049	(2,740)	(2,867)
Opening net debt/(cash)		(5,192)	(5,257)	(4,787)	(28,773)	(25,868)
HP finance leases initiated		0	0	0	0	0
Exchange rate movements		0	0	0	0	0
Other		(137)	71	(63)	(165)	0
Closing net debt/(cash)		(5,257)	(4,787)	(28,773)	(25,868)	(23,001)

Source: Edison Investment Research, Selvita accounts. Note: *Non-cash cost related to the employee stock options programme.

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