# Abzena

FY18 results

## FY18 results – clouds lifting

Healthcare equipment & services

**Following a stronger H2 and Abzena's FY18 results, we have made major changes to our model across both the services business and the Abzena *Inside* royalty portfolio. The FY18 reported revenues of £22.0m were ahead of our forecast and up c 18% over FY17. This was driven by 60% growth in bio-manufacturing where fortunately, most of the investment in capacity was directed in FY18. Last week's announcement of a proposed royalty monetisation will help to address the FY19 working capital requirement.**

| Year end | Revenue (£m) | PBT* (£m) | EPS* (p) | DPS (p) | P/E (x) | Yield (%) |
|---|---|---|---|---|---|---|
| 03/17 | 18.7 | (8.3) | (5.82) | 0.0 | N/A | N/A |
| 03/18 | 22.0 | (13.5) | (6.04) | 0.0 | N/A | N/A |
| 03/19e | 26.1 | (10.0) | (4.52) | 0.0 | N/A | N/A |
| 03/20e | 34.1 | (5.6) | (2.38) | 0.0 | N/A | N/A |

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

## Positive FY18 announcement

After last year's trading update, the tone of Abzena's FY18 results announcement was much more upbeat. A stronger H2 resulted in FY18 revenues growing by about 18% to £22.0m (FY17, £18.7) and beat our £21.6m estimate. The investment programme increased the FY adjusted EBITDA loss to £12.0m (FY17 £7.5m, and our FY18 estimate of £10.8m). Encouragingly for the future, the value of the contracts secured in the second-half of FY18 was £15.4m; a 42% jump over the more sedate £10.8m in H118. The year-end cash position of £6.8m reflected the continued investment programme, which drove the FY loss to £14.2m.

## Fundraisings will resolve working capital requirement

Last week's announcement of a proposed royalty monetisation transaction will help relieve the funding gap before break-even and should assist investors in valuing the Abzena *Inside* portfolio. We anticipate new cash inflows of £7.0m over two years (£5.0 before YE19 and £2.0m before YE20) are required to tide over the services business to break even in FY21.

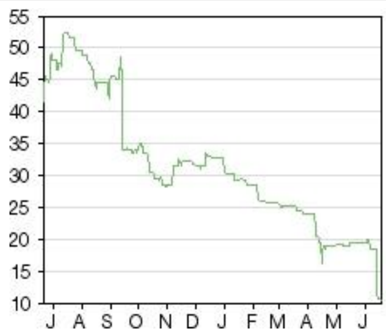
## Valuation: Cumulative changes post FY18 results

We have made significant changes to our model, which now forecasts FY19 revenues at £26.1m from £34.1m, and aligning with the slightly higher than 18% revenue growth discussed in the FY18 results. This is more than offset by the annual £2m operating cost savings over the next five years after which, operational costs are rebased. We have also taken into account the changes to the earlier-stage Abzena *Inside* portfolio and prudently reduced to zero the value of any preclinical products. The cost-saving programme and reduced capex adds c £50m to our valuation, while the Abzena *Inside* portfolio value declines by £25.8m. After the FY18 results, our valuation remains virtually unchanged at £89.9m or 42.1p per share from £90.0m or 42.1p per share but will need to be updated after any new cash inflow.

**19 June 2018**

| | |
|---|---|
| **Price** | **10.40p** |
| **Market cap** | **£22m** |
| | US$1.35/£ |
| Net cash (£m) at 31 March 2018 | 6.8 |
| Shares in issue | 214.2m |
| Free float | 39% |
| Code | ABZA |
| Primary exchange | AIM |
| Secondary exchange | N/A |

### Share price performance




| % | 1m | 3m | 12m |
|---|---|---|---|
| Abs | (46.7) | (58.8) | (74.9) |
| Rel (local) | (45.8) | (61.3) | (75.7) |
| 52-week high/low | | 52.2p | 10.4p |

### Business description

Abzena is a UK group that offers a range of services and technologies for biopharmaceutical development including immunogenicity tests, protein engineering, bioconjugation, polymer/synthetic chemistry, biomanufacturing and ADC chemistry.

### Next events

| | |
|---|---|
| Interim 2019 results | Q418 |
| Phase III results and further licences from Abzena *Inside* products | 2018 |

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## Financials: Upbeat FY18 results

After last summer's trading update, the pre-close statement and the FY18 results announcement conveyed a welcome upbeat message that the clouds are lifting from Abzena's services business. After a stronger second half of the year, Abzena reported FY18 revenues of £22.0m, higher than our estimates and up 18% over FY17. The stars of the second half were bio-manufacturing and chemistry with c 60% and c 15% revenue growth, respectively. Immunology revenues dragged down the biology research services business, but this had been previously announced. The 14% decline in FY17 immunology revenues was due to increased competition but is hoped to be reversed in FY19. In the first bullet point of its FY18 results announcement, Abzena noted that its ambitious targets at the start of FY18 were missed and we interpret this as a sign of maturity for the company. Abzena has now moved beyond this stage and the board anticipates slightly higher revenue growth in FY19 compared to FY18. Our model now forecasts 19.1% revenue growth, or £26.1m for FY19 and 30.4% service revenue growth, or £34.1m for FY20 as increased capacity feeds through to sales in manufacturing and chemistry.

Abzena has completed a period of intense investment in the service business and in its facilities, particularly at the Babraham Research Campus in Cambridge, but also in equipment, services and real-estate costs. As a result, the adjusted EBITDA loss increased to £12.0m (FY17 £7.5m; our estimate £10.8m) but there are a number of important points of note here. The board announced that Abzena's current capacity can now generate annual revenues in excess of £60m per year and the company has disclosed that it expects to generate positive EBITDA on annual revenues above £38m. Therefore, there is significant revenue and profit capacity within the group. Further significant capital expenditures in FY19 are not expected (we forecast £2.1m in FY19 and then maintenance capital expenditures at c £0.3m until 2021, after which they increase by 1% annually) and we estimate a £10.1m operating loss in FY19. The c $10m additional expansion of the Lusk Boulevard manufacturing facility will now follow the confirmation of customer demand, a contribution from the landlord and additional funding. Aside from the working capital requirement between FY19 and FY20 (see below), which will be partially addressed by last week's announcement of a proposed royalty monetisation transaction (although no details have currently been released), the only limiting step in Abzena's continued revenue growth would then be the execution by its business development group.

For a business that grew its total revenues by 18% in FY18 and 30% H118 to H218, Abzena's increased manufacturing capacity investment is logical because this is the fastest growing part of the business. As this capacity is sold, it will be the driver for revenue growth. We interpret the now-completed manufacturing investment as not just increasing sales via capacity, but also increasing efficiency and therefore margins. The newly commissioned 500L stirred-tank bioreactor completed its first production batch, and we will be interested to incorporate the implied margin improvements of this new capacity because stirred-tanks take fewer people to run and have faster batch turnaround times than Wave production. Two significant contracts for ADC conjugation manufacturing have been signed and will be delivered from the Bristol facility in FY19. We have not yet incorporated either these margin improvements or all of the capacity increases in our model but will revisit after the detail of the H119 interim results.

## Addressing the working capital requirement

At the FY18 results, Abzena's board were exploring a number of options to address a working capital requirement in FY19. This will be partially resolved by last week's announcement of a proposed royalty monetisation transaction. While the FY18 results announcement mentioned the raising of either debt or equity, we had viewed the most likely transaction to be the monetisation of a portion of the royalties and milestones from the Abzena *Inside* portfolio of product rights. There are many, mostly private equity, funds whose business is to acquire portions late-stage life science products and with two Phase III products in the Abzena *Inside* portfolio, this route has the significant advantages of avoiding further shareholder dilution or the issuance of expensive debt. The latter would be likely to be secured on Abzena's assets. Last week's announcement is expected to smooth Abzena's path to break even and a further modest debt or equity transaction is still expected, although this second tranche could be later in FY20. We currently forecast a total cash inflow of £7.0m between FY19 and FY20, which is currently simulated by long-term debt in our model. At the very least, the royalty monetisation transaction should help investors better value the Abzena *Inside* portfolio and validate the attractiveness of the two late-stage rights.

With the capital expenditure programme now largely complete, a cost-efficiency programme is also underway led by the recently appointed interim COO, Brian Johnson, who has no heritage with Abzena so is better placed to objectively reduce its operating expenses by c £2m per year. We have included these cost savings in our model and phased them in to reach £2m a year by the end of FY19. In our model this programme is extended until FY24. This lower rebased operational cost base has magnified effects on our valuation because the lower spend is risk-adjusted from FY20, the cost savings appear early in the NPV valuation and when R&D and SG&A start growing again from FY25, they do so from a much lower level than in our previous model.

## More yin than yang in the product royalty portfolio

The move of Bioverativ's (now Sanofi's) sutimlimab (formally BIVV009) into Phase III means that Abzena now has royalty rights to two Phase III products. The discontinuation of Vascular Pharmaceuticals' VPI-2690B in Phase II and the removal of the Halozyme's ADC products have reduced our valuation of the product royalty portfolio by £1.1m and £3.4m, respectively. Until they enter clinical development, we have also reduced to zero the rNPV of the royalties and milestones from any preclinical assets in the Abzena *Inside* portfolio. In addition, we have reduced the royalty rate to reflect an average of 0.625% across the portfolio.

There have not been any other material changes in the two most advanced products in the Abzena *Inside* portfolio. Gilead Sciences' andecaliximab (MMP9 monoclonal antibody antagonist) for gastric cancer and solid tumours remains in Phase III and Phase I, respectively. Bioverativ's sutimlimab (anti-C1s antibody for cold-agglutinin disease) started two Phase III studies in November 2017. Bioverativ was recently acquired by Sanofi for $11.6bn. Should the board complete a monetisation transaction that would help validate the Abzena *Inside* portfolio, it is likely to involve one or both of these late-stage assets to a private equity fund.

## Model update across services and royalties

We have incorporated changes in our model that include the revised revenue growth in the services business, the £2m annual cost savings in operational expenditure and the discontinuations and rebasing of preclinical assets in the Abzena *Inside* portfolio. The effect of the £2m annual cost savings over five years across SG&A and R&D is magnified in the valuation as these costs are risk-adjusted from FY20. These changes are summarised in Exhibit 1.

**Exhibit 1: Abzena model valuation changes**

| | December 2017 rNPV (£m) | December 2017 rNPV per share (p) | June 2018 rNPV (£m) | June 2018 rNPV per share (p) | June 2018 % rNPV |
|---|---|---|---|---|---|
| Services business | 18.2 | 8.5 | 52.0 | 24.3 | 57.8 |
| Abzena *Inside* portfolio | 56.9 | 26.6 | 31.1 | 14.6 | 34.6 |
| Sub-total | 83.2 | 35.1 | 83.1 | 38.9 | 92.4 |
| Cash | 14.9 | 7.0 | 6.8 | 3.2 | 7.6 |
| Total valuation | 90.0 | 42.1 | 89.9 | 42.1 | 100 |

Source: Edison Investment Research, Abzena announcement

We have introduced our FY20 revenue forecasts in the biology, bio-manufacturing and chemistry businesses of £6.0m, £16.9 and £10.7m, respectively.

We had also incorporated the end-FY18 cash position of £6.8m at the FY results, but last week's announcement implied cash inflows in FY19 and FY20, which we anticipate will total £7.0m, and will address the working capital shortfall before Abzena reaches break-even.

Cumulatively, these changes across the service and royalty businesses keep our valuation virtually unchanged at £89.9m or 42.1p per share.

## M&A comes to life science tools

A recent May 2018 report by Bourne Partners on the contract development and manufacturing organisation (CDMO) sector, or life science tools space, noted the drivers that are expected to result in increased consolidation of small- to mid-sized companies in the pharmaceutical services sector. These included large CDMOs such as Lonza, looking to acquire novel development and analytical capabilities to bolster their value chains, but also the involvement of private equity like the Carlyle Group as financial roll-up players in the CDMO space.

**Exhibit 2: Financial summary**

| £000s | 2016 | 2017 | 2018 | 2019e | 2020e |
|---|---|---|---|---|---|
| Year end 31 March | IFRS | IFRS | IFRS | IFRS | IFRS |
| **PROFIT & LOSS** | | | | | |
| Revenue | 9,854 | 18,654 | 21,950 | 26,135 | 34,089 |
| of which: Biology | 5,299 | 5,719 | 4,926 | 5,535 | 6,037 |
| Manufacturing | 2,096 | 5,316 | 8,483 | 10,100 | 16,868 |
| Chemistry | 2,174 | 6,961 | 8,024 | 10,000 | 10,684 |
| Total Service revenues | 9,569 | 17,996 | 21,433 | 25,635 | 33,589 |
| Licenses/milestones/royalties | 285 | 658 | 517 | 500 | 500 |
| Cost of Sales | (5,319) | (10,547) | (12,315) | (13,715) | (17,970) |
| Gross Profit | 4,535 | 8,107 | 9,635 | 12,420 | 16,119 |
| R&D expenses | (4,216) | (3,849) | (3,568) | (3,175) | (2,834) |
| SG&A expenses | (9,047) | (14,611) | (21,193) | (20,329) | (19,845) |
| EBITDA | (6,817) | (7,430) | (12,516) | (7,601) | (3,110) |
| Operating Profit (before amort. and except.) | (7,618) | (8,607) | (13,683) | (10,105) | (5,632) |
| Intangible Amortisation | (588) | (723) | (726) | (579) | (528) |
| Depreciation | (801) | (1,177) | (1,167) | (2,504) | (2,522) |
| Exceptionals | (2,542) | 0 | 0 | 0 | 0 |
| Other | (155) | (412) | (533) | (400) | (400) |
| Operating Profit | (10,903) | (9,742) | (14,942) | (11,084) | (6,560) |
| Other | 0 | 0 | 0 | 0 | 1 |
| Net Interest | 244 | 277 | 188 | 68 | 72 |
| Profit Before Tax (norm) | (7,374) | (8,330) | (13,495) | (10,037) | (5,560) |
| Profit Before Tax (reported) | (10,659) | (9,465) | (14,754) | (11,016) | (6,488) |
| Tax | 961 | 347 | 593 | 384 | 486 |
| Profit After Tax (norm) | (6,413) | (7,983) | (12,902) | (9,653) | (5,074) |
| Profit After Tax (reported) | (9,698) | (9,118) | (14,161) | (10,632) | (6,002) |
| Average Number of Shares Outstanding (m) | 109.4 | 137.2 | 213.6 | 213.6 | 213.6 |
| EPS - normalised (p) | (5.86) | (5.82) | (6.04) | (4.52) | (2.38) |
| EPS - reported (p) | (8.86) | (6.65) | (6.63) | (4.98) | (2.81) |
| Dividend per share (p) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **BALANCE SHEET** | | | | | |
| Fixed Assets | 27,347 | 33,494 | 34,649 | 33,666 | 30,916 |
| Intangible Assets | 23,177 | 25,882 | 23,135 | 22,556 | 22,029 |
| Tangible Assets | 4,170 | 7,612 | 11,514 | 11,110 | 8,888 |
| Other | 0 | 0 | 0 | 0 | 0 |
| Current Assets | 22,108 | 11,267 | 19,640 | 19,300 | 15,448 |
| Stocks | 1,379 | 1,876 | 1,939 | 1,939 | 1,939 |
| Debtors | 5,436 | 4,982 | 10,170 | 10,170 | 10,170 |
| Cash | 13,724 | 4,135 | 6,785 | 7,191 | 3,339 |
| Other | 1,569 | 274 | 746 | 0 | 0 |
| Current Liabilities | (5,850) | (6,319) | (6,903) | (6,903) | (6,903) |
| Creditors | (5,488) | (6,032) | (6,557) | (6,557) | (6,557) |
| Short term borrowings | 0 | 0 | 0 | 0 | 0 |
| Short term leases | 0 | (169) | (213) | (213) | (213) |
| Other | (362) | (118) | (133) | (133) | (133) |
| Long Term Liabilities | (2,549) | (2,508) | (3,697) | (8,697) | (10,697) |
| Long term borrowings | 0 | 0 | 0 | (5,000) | (7,000) |
| Long term leases | 0 | (494) | (448) | (448) | (448) |
| Other long term liabilities | (2,549) | (2,014) | (3,249) | (3,249) | (3,249) |
| Net Assets | 41,056 | 35,934 | 43,689 | 37,366 | 28,764 |
| **CASH FLOW** | | | | | |
| Operating Cash Flow | (11,330) | (8,100) | (15,913) | (7,669) | (3,182) |
| Net Interest | 244 | 277 | 188 | 68 | 72 |
| Tax | 371 | 1,665 | 39 | 39 | 486 |
| Capex | (2,047) | (3,320) | (6,107) | (2,100) | (300) |
| Acquisitions/disposals | (9,357) | 0 | 0 | 0 | 0 |
| Equity financing | 20,013 | (89) | 23,913 | 0 | 0 |
| Dividends | 0 | 0 | 0 | 0 | 0 |
| Other | 31 | (22) | 500 | 68 | 72 |
| Net Cash Flow | (2,075) | (9,589) | 2,620 | (9,594) | (2,852) |
| Opening net debt/(cash) | (15,799) | (13,724) | (4,135) | (6,755) | (2,161) |
| HP finance leases initiated | 0 | 0 | 0 | 0 | 0 |
| Other | 0 | 0 | 0 | 0 | 0 |
| Closing net debt/(cash) | (13,724) | (4,135) | (6,755) | (2,161) | (1,309) |

Source: Edison Investment Research, company reports

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