

Abzena

Starting to get back on track

Interim results

Pharma & biotech

21 December 2017

Price **32.75p**

Market cap **£70m**

US\$1.34/£

Net cash (£m) at 30 November 2017 14.9

Shares in issue 213.8m

Free float 39%

Code ABZA

Primary exchange AIM

Secondary exchange N/A

Share price performance



% 1m 3m 12m

Abs 1.6 (3.7) (1.5)

Rel (local) (0.3) (7.0) (9.1)

52-week high/low 56.0p 28.2p

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

Phase III results and further licences from Abzena *inside* products 2018

Full-year results Q218

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In its interim results for the year-ending March 2018, Abzena started to move out from under the shadow of September's disappointing trading update. Investors should be relieved that Abzena continues to demonstrate a growing service business even against the backdrop of an investment programme aimed at increasing capacity. Group revenues were up 7.6% year-on-year for the first half, while the Abzena *Inside* portfolio continues to expand and products within it advance.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
03/16	9.9	(7.4)	(5.86)	0.0	N/A	N/A
03/17	18.7	(8.3)	(5.82)	0.0	N/A	N/A
03/18e	21.6	(13.1)	(5.91)	0.0	N/A	N/A
03/19e	31.0	(9.7)	(4.35)	0.0	N/A	N/A

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

Babies not thrown out with the bathwater

Abzena demonstrated revenue growth in two out of its three service lines in the first half of FY18, despite the lower performance across all three service lines that was announced in its September trading update. Only the revenues from its Biology research services lagged the comparable period a year ago and this was partly the result of industry-wide introspection on the standardisation of immunogenicity assays, and partly by being capacity-constrained in protein engineering.

Eyes on the capacity prize

Service revenue growth during a period of higher investment on both sides of the Atlantic demonstrates that management have not taken their eyes away from the bigger prize of a service business that is refractory to a delay in any one contract. The more tactical objectives of increasing protein engineering capacity in the UK and consolidation and expansion of manufacturing at Abzena's San Diego site are not just aimed at larger capacity. These should bring higher margins as, for example, automated bioreactors have quicker turnaround cycles and require fewer staff to run.

Valuation: £90m or 42.1p per share not demanding

We have made changes to our valuation, which reduce it to £90m from £110m. These changes reflect cash at the end of November (£14.9m or 7p per share) and the average cash burn rate over the first eight months of FY18. In addition, we have reduced our FY18, FY19 and FY20 sales forecasts by c £1.0m, c £1.0m and c £3.0m, respectively, to better reflect the sales growth rates mentioned in the company's September's trading update. We suspect that investors may take a wait-and-see stance after September's trading update, although after a period where revenue growth has been rebased, we may now be past the worst. After Abzena's full-year results we will be looking to incorporate the more accurate estimates of its increased capacity and margins in later years.

Half-year results review

After the disappointment of the trading update earlier in September, where revenues at all three of Abzena's service offerings were below expectations, some reassurance of 7.6% revenue growth (£9.6m) at group level in the six months to 30 September 2017 should be welcomed by investors. Two out of three of Abzena's service lines demonstrated meaningful growth, if lower than was previously expected, compared to H117. While Biology research services was the laggard with a revenue decline to £2.3m in the first half, at least the capacity constraint issue is addressable by the existing investment programme. The adjusted EBITDA loss of £7.0m and reported loss of £8.0m were both about twice that reported in the previous half-year's numbers, representing increased operational expenditure in the face of close to flat sales.

At the time of the fund-raising in April, management aspired to that stock issuance being the last before break-even. We believe this is still achievable and our model continues to forecast adjusted EBITDA break-even in c FY20. Depending on the interplay between capital expenditure phasing and revenue growth on Abzena's cash balance, the investigation of a secured debt facility in order to maintain healthy headroom without further shareholder dilution looks eminently sensible. For the moment, we have not included a debt facility in our model.

Keep an eye on Biology research services

The issues at Biology research services that resulted in a decline in sales in the half-year to September were (a) demand exceeding capacity and (b) industry introspection on immunogenicity assays. Increasing demand is a good thing as long as customers are not lost while extra capacity is built. In framing the sector's debate on immunogenicity assays, Abzena's thought leadership and engagement with key opinion leaders and customers continue so that Abzena's enhanced assay capabilities become recognised as the standard.

Abzena sees a significant proportion of its service business deriving from repeat customers, with seven of its top 10 customers returning for a more integrated service. This was demonstrated in the recent announcement of the largest manufacturing contract awarded to date (~\$5m). This ADC manufacturing contract award was by a longstanding customer of the Chemistry business. An integrated service offering is important for the maximisation of cross-selling opportunities. One of the challenges of this interconnection was seen earlier in the year when a delay to a project at the manufacturing process development stage had a knock-on effect on the planned GMP manufacturing campaign. Although the antibody will be manufactured by Abzena for the client now the issue has been fixed, freed-up manufacturing capacity and cost can be difficult to absorb at short notice.

Emerging from the shadow and awaiting midday

While much comfort was given on the profile of Abzena as a growing biopharmaceutical services business, it will probably take another earnings announcement before investor confidence returns. Between then and now, further licence agreements for Abzena *Inside* products should be expected. New contracts like that recently signed on ADC manufacturing with a US biotech company have already occurred, so business development appears to be humming along. In the medium term, two of Abzena's *Inside* products will report Phase III results next year. Gilead Sciences' andecaliximab is in Phase III for gastric cancer and management appeared excited by Bioverativ's BIVV009 in cold agglutinin disease. One of the reasons for this could be that haematological clinical trials can have much shorter treatment durations than oncology studies and results for the first BIVV009 Phase III study might be available during the first half of 2019.

The only way is investment

The only way out of the revenue volatility caused by delays that occur in the earlier stages of a project (as described above) is to have more capacity available. This means that a delay to one programme (even if Abzena eventually recognises the full value of the integrated contract) has much less of an effect on the group. Currently, the top 10 customers account for 58% of revenues and this can probably be expected to reduce over time as multiple and larger contracts are awarded. Abzena's investment program has the additional objective of increasing margins since the new automated bioreactors have shorter downtimes and need less committed labour.

Valuation: £90m (42.1p/share) on services/royalty mix

We have reduced our fair value to £90m (from £110m) or 42.1p per share (vs 52p) by using the cash number at the end of November, a revised exchange rate, average burn rate (calculated on the average monthly change in cash in Abzena's year to date) and number of shares in issue. In addition, we have looked at the sales growth rate implied by September's trading update and applied it across the services businesses and licensing revenues through to FY20. As a result, our FY18, FY19 and FY20 revenue estimates were reduced by c £1m, c £1m and c £3m respectively. We may have underestimated R&D tax credits in later years on our valuation since none were received in H118, but will update this in our model after the full-year results. The three-phase DCF for the services businesses and risk-adjusted royalties from existing and future licensed products have all been adjusted. For future royalty revenues, we estimate peak sales, launch dates, probabilities of success and small royalties (up to 1%) for the programmes in clinical development. We have estimated better deal economics from the ADC candidates and as a result we model a 2.5% royalty. Further newsflow from the progression toward royalties from its Abzena *Inside* products, further service contract deals and/or ThioBridge deals may provide additional upside to our current estimates. After Abzena's full-year results we will be looking to incorporate the more accurate estimates of its increased capacity and margins in the later years.

Building better biologics

Abzena provides biological research services aimed at creating more effective and safer biological products. The group initially evolved through the combination of three key businesses: PolyTherics, Antitope and Warwick Effect Polymers prior to its IPO. After its listing, during 2015 the group acquired PacificGMP (contract, development and manufacturing) and TCRS (specialist contract chemistry and bioconjugation). This enables Abzena to offer a comprehensive and integrated biologics offering.

The significant service aspect to Abzena's business model provides investors with a lower-risk exposure to the biotech sector than a pure-play product development company where most of the risk resides in the success or failure of one molecule. The Abzena *Inside* portfolio also provides investors with a diversified product royalty exposure. While the pharmaceutical services sector is growing and fragmented, with the trend towards pharmaceutical companies outsourcing this type of work, a public standalone integrated biopharmaceutical services business is uncommon.

Abzena listed on AIM in July 2014 (raising £20m) and in 2015, from a secondary placement, raised £20m net of expenses from the sale of 35m new shares at 60p. The group is primarily based on the Babraham Research Campus in Cambridge (UK) and, following two acquisitions in 2015, now has operations in San Diego (PacificGMP) and Philadelphia (TCRS). The company employs c 220 staff.

Exhibit 1: Financial summary

	£000s	2016	2017	2018e	2019e
Year end 31 March		IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue		9,854	18,654	21,566	31,023
of which: Biology		5,299	5,719	4,525	5,875
Manufacturing		2,096	5,316	8,958	15,253
Chemistry		2,174	6,961	7,733	9,152
Total Service revenues		9,569	17,996	21,216	30,280
Licenses/milestones/royalties		285	658	350	743
Cost of Sales		(5,319)	(10,547)	(12,730)	(16,654)
Gross Profit		4,535	8,107	8,836	14,369
R&D expenses		(4,216)	(3,849)	(3,984)	(4,183)
SG&A expenses		(9,047)	(14,611)	(18,994)	(20,894)
EBITDA		(6,817)	(7,450)	(10,792)	(6,377)
Operating Profit (before amort. and except.)		(7,618)	(8,607)	(13,075)	(9,701)
Intangible Amortisation		(588)	(723)	(666)	(607)
Depreciation		(801)	(1,157)	(2,284)	(3,324)
Exceptionals		(2,542)	0	0	0
Other		(155)	(412)	(400)	(400)
Operating Profit		(10,903)	(9,742)	(14,142)	(10,708)
Other		0	0	0	0
Net Interest		244	277	9	31
Profit Before Tax (norm)		(7,374)	(8,330)	(13,066)	(9,670)
Profit Before Tax (reported)		(10,659)	(9,465)	(14,133)	(10,677)
Tax		961	347	431	384
Profit After Tax (norm)		(6,413)	(7,983)	(12,635)	(9,286)
Profit After Tax (reported)		(9,698)	(9,118)	(13,702)	(10,293)
Average Number of Shares Outstanding (m)		109.4	137.2	213.6	213.6
EPS - normalised (p)		(5.86)	(5.82)	(5.91)	(4.35)
EPS - reported (p)		(8.86)	(6.65)	(6.41)	(4.82)
Dividend per share (p)		0.0	0.0	0.0	0.0
BALANCE SHEET					
Fixed Assets		27,347	33,494	41,052	40,630
Intangible Assets		23,177	25,882	25,224	24,625
Tangible Assets		4,170	7,612	15,828	16,004
Other		0	0	0	0
Current Assets		22,108	11,267	15,233	4,630
Stocks		1,379	1,876	1,876	1,876
Debtors		5,436	4,982	4,982	4,982
Cash		13,724	4,135	8,375	(2,228)
Other		1,569	274	0	0
Current Liabilities		(5,850)	(6,319)	(6,319)	(6,319)
Creditors		(5,488)	(6,032)	(6,032)	(6,032)
Short term borrowings		0	0	0	0
Short term leases		0	(169)	(169)	(169)
Other		(362)	(118)	(118)	(118)
Long Term Liabilities		(2,549)	(2,508)	(2,455)	(2,402)
Long term borrowings		0	0	0	0
Long term leases		0	(494)	(441)	(388)
Other long term liabilities		(2,549)	(2,014)	(2,014)	(2,014)
Net Assets		41,056	35,934	47,511	36,539
CASH FLOW					
Operating Cash Flow		(11,330)	(8,100)	(11,013)	(6,620)
Net Interest		244	277	115	137
Tax		371	1,665	705	384
Capex		(2,047)	(3,320)	(10,508)	(3,508)
Acquisitions/disposals		(9,357)	0	0	0
Financing		20,013	(89)	23,800	0
Dividends		0	0	0	0
Other		31	(22)	62	84
Net Cash Flow		(2,075)	(9,589)	3,161	(9,524)
Opening net debt/(cash)		(15,799)	(13,724)	(4,135)	(7,296)
HP finance leases initiated		0	0	0	0
Other		0	0	(0)	0
Closing net debt/(cash)		(13,724)	(4,135)	(7,296)	2,228

Source: Abzena accounts, Edison Investment Research

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