

# Pacific Edge

Fast growth negatively impacted by NZ IFRS 15

Financial update

Pharma & biotech

Pacific Edge recently announced that it has adopted the new revenue recognition accounting standard, NZ IFRS 15, for FY18. This means that revenue from US customers will only be recognised once cash payment is received (previously it also included tests that had been billed but not yet paid). As a result, the company restated FY17 operating revenue from NZ\$8.1m to NZ\$3.2m and reported NZ\$3.4m for FY18. Total revenue would have been up 26.3% without the accounting change but under NZ IFRS 15 this is reduced to 6.9% as the US is the main growth driver for tests. Pacific Edge is negotiating agreements with the Centers for Medicare and Medicaid (CMS) as well as private payers to provide for more timely reimbursement. Management will provide updated guidance later this year.

Year end	Revenue (NZ\$m)	PBT* (NZ\$m)	EPS* (c)	DPS (c)	P/E (x)	Yield (%)
03/17**	4.4	(22.4)	(5.9)	0.0	N/A	N/A
03/18	4.8	(19.5)	(4.4)	0.0	N/A	N/A
03/19e	7.8	(17.7)	(3.7)	0.0	N/A	N/A
03/20e	12.7	(14.2)	(2.8)	0.0	N/A	N/A

Note: \*PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments. Note: \*\*FY17 restated for IFRS15.

## Talks with CMS and Kaiser Permanente ongoing

The company continues to work with CMS (which represents approximately 50% of Cxbladder test volume) to gain inclusion in a local coverage determination (LCD) which would enable consistent payments from CMS as well as reduce the lag time between the test being performed and receipt of cash. Commercial discussions with Kaiser Permanente (which has 11.8m members) are ongoing.

## Test volume increased by 29% over FY17

The number of tests processed, which is a key measure of the underlying growth of the business, increased by 29% in FY18 to 14,400 tests, of which 82% were billable. The company estimates that approximately 23,000 tests (up 60%) will be processed in FY19 although this includes throughput from both Kaiser Permanente and CMS, organisations where the agreements are still being finalised.

## Veterans Administration launch ongoing

The Veterans Administration (VA), which covers approximately 20 million people, is under contract with Pacific Edge. The company is currently targeting a total of 14 larger VA centres and has early sales from two of the initial five targeted.

## Valuation: NZ\$348m or NZ\$0.75 per share

Our DCF-based valuation has been reduced from NZ\$434m (NZ\$0.93/share) to NZ\$348m (NZ\$0.75/share). This reflects a combination of lower near-term estimates to reflect a more conservative view of the sales ramp for the Cxbladder franchise in the US and delayed cash inflow from product sales in the US. We have also pushed back profitability to FY21 from FY20. We estimate the financing needs of the company to be NZ\$20m through FY20.

4 June 2018

**Price** **NZ\$0.26**

**Market cap** **NZ\$121m**

NZ\$1.43/US\$

Net cash (NZ\$m) at 31 March 2018 16.2

Shares in issue 466.3m

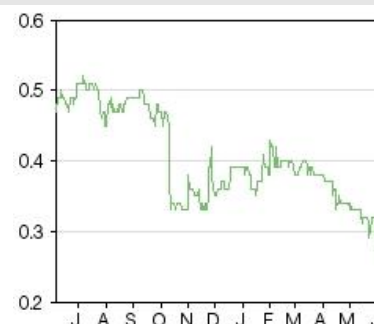
Free float 88.4%

Code PEB

Primary exchange NZX

Secondary exchange N/A

### Share price performance



% 1m 3m 12m

Abs (21.2) (32.5) (44.4)

Rel (local) (22.8) (33.9) (50.3)

52-week high/low NZ\$0.5 NZ\$0.3

### Business description

Pacific Edge develops and sells a portfolio of molecular diagnostic tests based on biomarkers for the early detection and management of cancer. Tests utilising its Cxbladder technology for detecting and monitoring bladder cancer are sold in the US, New Zealand and Australia.

### Next events

LCD inclusion CY18

Kaiser Permanente commercial agreement CY18

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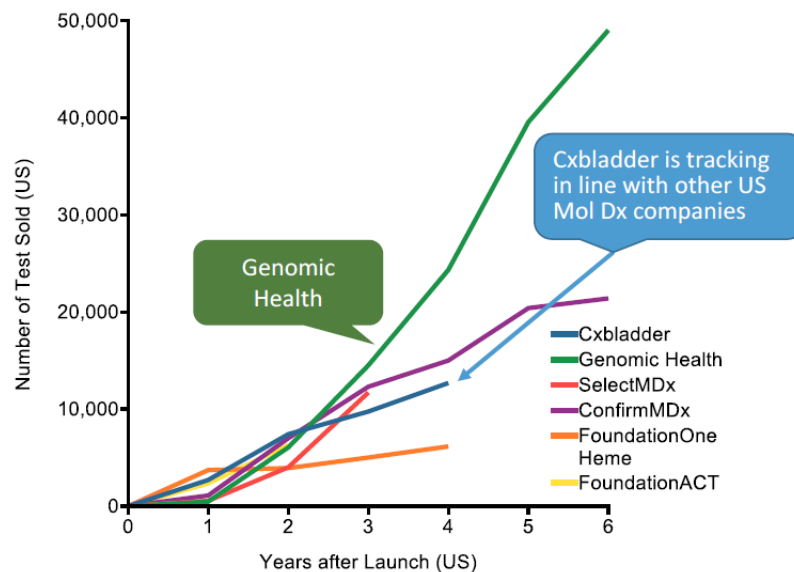
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## Strong test growth

Although the company has yet to finalise its agreement with Kaiser Permanente or gain inclusion in an LCD from CMS (which is regularly a multi-year process), test volume for Cxbladder increased by 29% in FY18 compared to the previous year, tracking well in comparison to other molecular diagnostic launches (see Exhibit 1). As a reference, Genomic Health's Oncotype DX test has annualised sales of \$340m per year.

**Exhibit 1: Molecular diagnostic test volumes post-launch**



Source: Pacific Edge

In its presentation accompanying the results, management estimates that if some tests from Kaiser Permanente and CMS are included in FY19e volumes, approximately 23,000 tests should be processed, up 60% compared to FY18.

## Negotiations with large US insurers ongoing

The company is continuing to work with CMS to gain inclusion in an LCD. An LCD is a document that includes the coverage decisions of the Medicare Administrative Contractor (MAC). An LCD would provide the conditions of the coverage as well as the price, guidance on reimbursement and coding information. Unfortunately there is no set process for achieving an LCD and in many ways it is the epitome of arbitrary bureaucracy. Most companies tend to take between three and five years to gain an LCD inclusion so while Pacific Edge has been in this process for around four years, it is within the normal timeframe.

Once an LCD inclusion is attained, reimbursement from CMS (which currently represents approximately 50% of Cxbladder test volume) should become consistent and timely. Besides this immediate benefit of new tests being covered by CMS, the company may finally receive payment for old tests previously conducted. Pacific Edge has not sought payment for tests provided to patients covered by CMS until LCD inclusion so there could be a multi-year backlog of test revenue that is recognised in a single reporting period post-inclusion. In addition, private payers often base their own coverage decisions and reimbursement levels on the coverage listed in an LCD, so a success here could lead to success nationally for the company.

Pacific Edge is also in final discussions with Kaiser Permanente regarding a commercial relationship and is working with Kaiser's staff to ensure that commercial tests can begin shortly after an agreement is reached. Commercial adoption by Kaiser could provide a significant ramp in sales. However, Management confirms that it is taking longer than anticipated to finalise the Kaiser agreements.

## Valuation

Our DCF-based valuation has been reduced from NZ\$434m (NZ\$0.93/share) to NZ\$348m (NZ\$0.75/share). This reflects a combination of a more conservative view of the sales ramp-up for the Cxbladder franchise in the US and delayed cash inflow from product sales in the US. We will revisit these estimates once agreements are completed with CMS and Kaiser Permanente and we have greater clarity on the ramp-up once reimbursement is in place.

### Exhibit 2: Valuation based on DCF

Discounted cash flow (NZ\$000)	331,996
Net cash (NZ\$000) at 31 March 2018	16,242
<b>Valuation (NZ\$000)</b>	<b>348,236</b>
Number of shares (m)	466.32
<b>Value per share (NZ\$)</b>	<b>0.75</b>

Source: Edison Investment Research

## Financials

The company recently published FY18 results. As a reminder, the company previously announced that it had adopted the new revenue recognition accounting standard, NZ IFRS 15, for FY18 which means that revenue from US customers will only be recognised once cash payment is received (previously the company recognized tests that had been billed but not yet paid). As a result, the company restated FY17 operating revenue from NZ\$8.1m to NZ\$3.2m and reported FY18 operating revenue of NZ\$3.4m. Total revenue would have been up 26.3% without the accounting change but under NZ IFRS 15 it was only up 6.9% as the US is the main growth driver for tests (see Exhibit 3). On the balance sheet the biggest impact was in receivables which had previously been reported at NZ\$6.5m in FY17 and was restated to NZ\$0.7m with NZ\$1.1m reported for FY18.

### Exhibit 3: NZ IFRS 15 changes

	FY18 NZ IFRS 15	FY18 (previous method)	FY17 NZ IFRS 15 (restated)	FY17 (previously reported, without NZ IFRS 15 impact)
Operating revenue	3.4	N/D	3.2	8.1
Other revenue	1.6	N/D	1.5	1.4
Total revenue*	5.0	12	4.7	9.5
Operating expenses	24.6	N/D	27.3	30.5
Net loss*	-19.7	N/D	-22.6	-21.0

Source: Pacific Edge. Note: N/D=not disclosed, full reconciliation expected to be available 30 June 2018 with release of full financial statements. \*Definitions may vary slightly from figures shown in Exhibit 5.

Operating expenses fell from NZ\$27.3m in FY17 (using NZ IFRS 15) to NZ\$24.6m mainly due to the elimination of expenses related to the employee equity equivalent incentive scheme.

Due to these results, we have made some changes to our forecasts (see Exhibit 4), which take into account NZ IFRS in terms of delayed cash flows from US product sales. Our revisions also reflect the delay in getting Kaiser Permanente and CMS on board. We assume that reported revenues would be 40% of what would be reported under the previous accounting system, in-line with the changes to FY17 and FY18 (our revenue estimate for FY19 would be NZ\$19.4m without the accounting change instead of NZ\$7.8m). We also introduce FY20 estimates. Meanwhile, if LCD

inclusion occurs before that, we would likely need to increase estimates materially as revenue recognition would normalise and the backlog of unpaid tests from previous years would provide a boost to revenue as they are paid.

**Exhibit 4: Financial forecast changes**

	FY19e old	FY19e new	FY20e old	FY20e new
Revenue (NZ\$m)	21.2	7.8	N/A	12.7
PBT (normalised) (NZ\$m)	(3.9)	(17.7)	N/A	(14.2)
EPS (NZ\$)	(0.0)	(0.0)	N/A	(0.0)

Source: Edison Investment Research

The company had net cash of NZ\$16.2m at 31 March 2018. We have also pushed back profitability to FY21 from FY20 mainly due to the accounting change and lower sales estimates. We estimate the financing needs of the company to be NZ\$20m through FY20 although this could all change once the company obtains reimbursement from CMS.

**Exhibit 5: Financial summary**

	NZ\$'000s	2017	2018	2019e	2020e
Year end 31 March		NZ GAAP	NZ GAAP	NZ GAAP	NZ GAAP
<b>PROFIT &amp; LOSS</b>					
Revenue		4,432	4,771	7,755	12,746
Cost of Sales		(1,446)	(2,060)	(3,102)	(3,824)
Gross Profit		2,986	2,711	4,653	8,922
EBITDA		(22,293)	(19,371)	(17,871)	(14,052)
Operating Profit (before amort. and except.)		(22,646)	(19,687)	(18,212)	(14,339)
Intangible Amortisation		(189)	(188)	(70)	(89)
Exceptionals		(43)	(83)	0	0
Operating Profit		(22,878)	(19,958)	(18,282)	(14,428)
Other		0	0	0	0
Net Interest		249	231	487	144
Profit Before Tax (norm)		(22,398)	(19,456)	(17,725)	(14,194)
Profit Before Tax (FRS 3)		(22,629)	(19,727)	(17,795)	(14,283)
Tax		0	0	0	0
Profit After Tax (norm)		(22,398)	(19,456)	(17,725)	(14,194)
Profit After Tax (FRS 3)		(22,629)	(19,727)	(17,795)	(14,283)
Average Number of Shares Outstanding (m)		382.5	438.4	482.2	501.5
EPS - normalised (c)		(5.9)	(4.4)	(3.7)	(2.8)
EPS - FRS 3 (c)		(5.9)	(4.5)	(3.7)	(2.8)
Dividend per share (c)		0.0	0.0	0.0	0.0
Gross Margin (%)		N/A	N/A	N/A	N/A
EBITDA Margin (%)		N/A	N/A	N/A	N/A
Operating Margin (before GW and except.) (%)		N/A	N/A	N/A	N/A
<b>BALANCE SHEET</b>					
Fixed Assets		1,166	1,135	1,072	1,060
Intangible Assets		329	281	355	415
Tangible Assets		837	854	717	645
Other		0	0	0	0
Current Assets		16,541	18,530	7,103	9,162
Stocks		824	752	752	752
Debtors		663	1,064	1,064	1,064
Cash		14,564	16,242	4,815	6,874
Other		490	472	472	472
Current Liabilities		(2,734)	(2,999)	(7,999)	(22,999)
Creditors		(2,734)	(2,926)	(2,926)	(2,926)
Short term borrowings		0	0	(5,000)	(20,000)
Short term leases		0	(73)	(73)	(73)
Other		0	0	0	0
Long Term Liabilities		0	(26)	(26)	(26)
Long term borrowings		0	0	0	0
Long term leases		0	(26)	(26)	(26)
Other long term liabilities		0	0	0	0
Net Assets		14,973	16,640	150	(12,803)
<b>CASH FLOW</b>					
Operating Cash Flow		(18,086)	(18,331)	(16,566)	(12,721)
Net Interest		249	231	487	144
Tax		0	0	0	0
Capex		(479)	(335)	(349)	(364)
Acquisitions/disposals		0	0	0	0
Financing		8,750	21,318	0	0
Dividends		0	0	0	0
Other		(91)	(1,261)	0	0
Net Cash Flow		(9,657)	1,622	(16,428)	(12,940)
Opening net debt/(cash)		(24,160)	(14,564)	(16,143)	284
HP finance leases initiated		0	(99)	0	0
Other		61	56	0	0
Closing net debt/(cash)		(14,564)	(16,143)	284	13,225

Source: Company data, Edison Investment Research

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