PROGRESSIVE EQUITY RESEARCH

25 April 2016

INSTEM

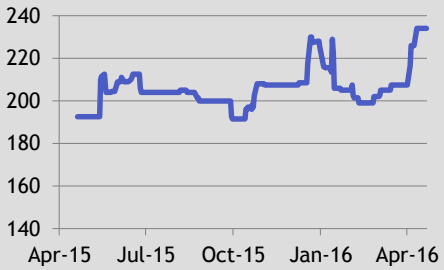
SOFTWARE AND COMPUTER SERVICES

INS.L

234p

Market Cap: £36.3m

SHARE PRICE (p)



12m high/low 234p/192p

Source: LSE Data

KEY INFORMATION

Enterprise value	£29.1m
Index/market	FTSE AIM
Next news	AGM - May 16
Gearing	N/A
Interest cover	N/A

INSTEM IS A RESEARCH CLIENT OF PROGRESSIVE

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A day to remember

On Friday, Instem held an analyst and investor event at its UK headquarters in Stone. The presentation was well attended and gave a good opportunity to meet members of the broader Instem management team, as well as some useful insight into the product suite and customer relationships. We make no changes to forecasts, but the day was reassuring in terms of both the range and applicability of the current platforms, and also the group's strategic positioning for future developments in the marketplace.

- The group held a successful and well attended analyst and investor event on Friday at its UK head office. The presentations covered all of the major aspects of the group, and we summarise overleaf the key learning points from each presentation.
- Overall, the various aspects combined to demonstrate a coherent and well-balanced suite of software products, addressing a number of customer demands across a range of client types, geographies and phases of the drug development process.
- Just as important as the software demonstrations was the opportunity to meet and interact with a number of the Instem senior team outside of the group Board. The sector knowledge and depth of understanding was clear, and the business obviously benefits from a broad array of employee backgrounds and areas of focus.

Instem has recently seen a material "return to form" with a number of its end markets recovering after several years of pressure, and with regulatory tailwinds beginning to build. Friday's event did not provide any price-sensitive or financial update, but certainly allowed attendees to flesh out their understanding of the product functionality and the senior team.

We make no changes to estimates, but take further comfort from the range of capabilities on display, and look forward to further announcements during the course of 2016, both in terms of customer and contract wins, and potentially the return to the M&A trail that the company signalled at the time of 2015 results.

FYE DECEMBER	2013	2014	2015	2016E	2017E
Revenue	11.4	13.4	16.3	17.5	18.3
Adjusted EBITDA	1.8	1.9	2.5	2.8	3.3
Adjusted PBT	1.2	1.1	1.7	2.2	2.6
Adjusted EPS (p)	8.6	8.3	12.9	10.0	11.7
EV/Sales	2.6x	2.2x	1.8x	1.7x	1.6x
EV/Adj. EBITDA	16.4x	15.7x	11.6x	10.4x	8.8x
P/E	27.1x	28.3x	18.2x	23.4x	20.0x

Source: Company Information and Progressive Equity Research estimates

Selected learnings

Friday's presentation involved a series of short demonstrations and descriptions of a number of the material parts of the group. Below we list these in turn (which followed the chronology of a drug through the development process from discovery through to clinical trials), with a couple of sentences describing our key learnings from each segment of the presentation :

Knowledgescan

This, unusually for Instem, is a service rather than software delivery to the customer, although it relies heavily on the Instem Scientific technology platform.

Still in its infancy, the offering is being marketed to pharma companies whose drug discovery departments must carry out Target Safety Assessments early in the drug development process. These desktop assessments survey all the known (public) literature around specific targets and biological pathways, and generally involve a report on the safety risks and potential adverse consequences of the drugs being considered. Traditionally this work is done in-house by a team of qualified toxicologists, over a multi-week period.

Instem's new offering, Knowledgescan, provides a software-based "sweep" of available literature, incorporating the relevant degree of knowledgeable human input and producing a standardised document in around two weeks.

The reports produced by the system benefit from the systematic and automated approach (which reduces risk and increases completeness), they are produced rapidly, and they follow a clear and pithy standardised format, which pharma customers suggest is most useful in their decision-making.

Friday's presentation provided detail on the offering as described above, together with some example outputs and screenshots to demonstrate the complexity of the source data and the scope of the projects being undertaken. Market uptake is gradually building, especially as the group is now able to price dynamically based on "data density", with smaller-scope projects attracting lower prices than larger, more complex information trawls and analyses.

Cyto Study Manager (Genetic Toxicology)

This field relates to the next stage in a drug's development. Once the available literature has been reviewed to assess any obvious known reasons to curtail a compound's development, the pharma company will arrange genetic toxicology tests – determining whether the substance is harmful to the genetic information within a cell.

There are two main groups of tests, so-called AMES tests to examine the impact of the compound on specially-prepared bacteria cultures (salmonella in fact), followed by "Comet Assay" studies which examine the DNA of cells which have been exposed to the substance – the images generated look like comets, hence the study's name.

Instem has (via the Perceptive Instruments acquisition) a market-leading and long-standing AMES Study Manager product, which is mainly to do with image analysis, counting and logging the colonies of salmonella on petri dishes which have been exposed to the substance under test. This automates, accelerates and renders more accurate a previously-manual process of slide inspection and manual data logging.

The more-exciting product is Cyto Study Manager, which builds on the existing platform in two ways – firstly expanding the range of tests covered from AMES tests to the full gamut of genetic toxicology testing (e.g. AMES, Comet, Micronucleus and Chromosome Aberration), and secondly incorporating more complex workflow methodology to manage the study process. This study management challenge is non-trivial and involves systematic testing of dozens or hundreds of dishes on a randomised and "blind" basis where the operator is unaware of whether or not a given slide has been exposed to the compound or is a "control" sample.

The AMES Study Manager product is already present in around 50 of the world's largest pharma companies, and the potential is clear in terms of up-sell to the full Cyto Study Manager platform.

Provantis (pre-Clinical Study Management)

The next four elements of the day's presentation all related to aspects of Provantis – the group's study management software and historically the core of Instem's revenue. Provantis targets the so-called pre-clinical study market, which involves substances which have passed muster in terms of both desktop analysis of expected side-effects and the subsequent genetic toxicology tests. Such substances are then tested on animals to highlight any side-effects or unanticipated outcomes prior to the clinical trial phases (where the drugs are tested on human subjects).

Provantis - Toxicology Resource Planning

This software product helps customers managing the logistics of high-capacity facilities, which run and monitor significant numbers of studies at any one time. Toxicology studies involve a difficult logistical challenge of managing large numbers of:

- animal subjects
- housing and treatment rooms
- specialist equipment
- skilled staff

A single facility may require the management of hundreds of staff, large numbers of subject animals, and dozens of rooms and items of equipment. Each animal must be given certain doses of the substance, as well as being measured and observed at precise times and in specified ways. Failure to adhere to the regime, either in terms of timing or methodology, results in the study potentially becoming useless.

Provantis Toxicology Resource Planning (TRP) is a software platform which provides a database-driven scheduling and resource management system, allowing users to plan and optimise the utilisation of the available resources. It can suggest feasible start dates for a given study, checking all required assets and people are available at the appropriate times.

Provantis - Dispense

As part of pre-clinical safety assessment studies, most of Instem's customers must prepare the relevant "doses" – the test material being delivered into the test animals. Provantis has a "Dispense" module which manages and tracks the test material to absolutely ensure the correct weight is used, mixed into the correct amount of "vehicle" (to carry the substance into the subject) and then made available within the study to dose the animals correctly during the subsequent days or weeks.

The platform keeps track (via barcodes) of the various different stocks of the different compounds within the mix, and carefully ensures that an audit trail is retained to prove that the correct dosages have been prepared. This is crucial both for the trial manager to report back to their "sponsor" customer, and also for the laboratory to adhere to its GLP (Good Laboratory Practice) methodologies.

Provantis - Data Collection

The next element of Provantis that we saw was, arguably, the backbone of the product – Data Collection, the part of the suite that records and collates the information assimilated during the course of the (normally animal-based) safety study.

The demonstration showed the use of a balance (set of scales) and a pair of measurement calipers, both of which were electronically linked to the software platform, accelerating the data collection process and completely removing any risk of data entry or transposition error.

A study involves large numbers of subject animals over multiple weeks or months, and at regular (sometimes daily) intervals, a number of measurements and observations must be recorded to monitor the effect (or lack of effect) that the substance has. These measurements include some visual observations (hair loss, scarring or other outwardly-visible conditions) as well as the more quantifiable metrics – animal weight, temperature and size, or the size of a particular feature. High volumes of data are also routinely automatically collected from sophisticated analytical instruments (e.g. blood and urinalysis).

The Provantis platform creates and manages, through a complex and organised workflow system, large numbers of tables of such data – prompting the users for the relevant comments or measurements, and tabulating them into the system in a logical and ordered way.

Provantis - Report Assembly

"Report Assembly" was the final part of the Provantis suite that we saw. As the name suggests, this software helps automate the creation of reports and summaries of the study information.

The platform collated information from the study database, and populated a pre-designed template which may run to thousands of pages, and which contains all the relevant study information. The document must then be manually reviewed, edited, amended where necessary and then signed-off for release – clearly these are manual processes, but the creation of the report in an automated and systematic way appears to be a very useful acceleration of the process. It also allows for the tracking and creation of an audit trail for the entire review and editing process.

Provantis – overall findings

The impression we gained from the Provantis element of the demonstration was of a system highly functional, extremely detailed and totally focussed on delivering exactly what the customer needs. From the careful management of weights and measures in the Dispense system, through to the flexibility of display and analysis within the Report Assembly, the database-driven system does all that it can to both ensure absolute adherence to standards and processes, and at the same time provide a flexible and intelligible view to the user.

Equally evident was the value of the ability to link directly to the measurement devices from within the Provantis system; this sped up the manual processes dramatically – simply pressing a button to take and record a measurement – and clearly removes a significant source of risk when staff must take a reading from a device and manually enter it into the system.

SENDView

In addition to the Provantis report creation toolset, we also saw a demonstration of SENDView, the Instem system for the viewing of information collated into the FDA's now-proscribed SEND format (Standard for Exchange of Non-clinical Data).

This platform is capable of including data from any system, not just Provantis, and allows customers, study sponsors and others to view and manipulate the large volumes of data required by the SEND regime. This flexible platform, along with Instem's submit™ product, enables the group's in-house teams to deliver SEND report preparation services to customers in a cost-effective and differentiated way.

Instem Clinical Solutions (ALPHADAS)

The final part of the day's demonstrations related to ALPHADAS, the group's relatively-recent push into the Clinical (human) study management market.

ALPHADAS (acquired through the Logos Technologies deal) is focussed on the Phase 1 Clinical Study market, where a small number of healthy volunteers are given the substance after successful and safe animal trials, and they are monitored to ensure that the drugs appear to be safe, and not producing unduly concerning or serious side effects. The Phase 1 study is not directly concerned with monitoring the drug's effectiveness at combating the target condition or illness, it is simply aiming to determine drug safety. Such trials may be conducted on small numbers of people (sometimes 8, 12 or 24) but large numbers of observations and measurements must be taken, at very precise times, to ensure both the safe running of the trial, and the correct recording of relevant information.

The ALPHADAS platform that we saw demonstrated allows the management and collection of all the relevant pieces of information – Phase 1 trial locations resemble hospitals or clinics, and measurement of various metrics must be undertaken at very precise time intervals; in some cases even a 30-second error in the taking of a measurement can render it (and potentially the trial) flawed.

Software allows for comprehensive data management, with controlled workflow through the whole process, from volunteer recruitment (to populate the study) through resource scheduling and administration (to plan facilities, staff etc) through the electronic collection of bedside measurements, through to report creation and information analysis. The examples we were given demonstrated that the platform appears robust and highly scalable, capable of managing significant volumes of data and scheduling measurements (such as blood pressure, temperature etc) within a controlled and clear calendar and workflow environment.

Summary and conclusion

Overall, the day provided the audience with a good level of insight into what appeared to be a high-quality and balanced portfolio of software offerings. The Instem staff all came across as knowledgeable about their own specialised areas, but aware of each others' products and services within the group context. We gained a very positive impression of the strength and depth of both the product offering and the Instem team.

It is reassuring that, after several years of difficult market conditions, Instem is beginning to see signs of increased spend and greater levels of activity amongst its customers. The acquisitions have bedded down well and been integrated successfully, and the group appears very well placed to benefit from the new SEND standards as well as a more general improvement in the drug discovery and study market.

We make no changes to our forecasts based on Friday's event, but take a significant amount of comfort from what we learned.

INSTEM – Summary Financials

Year ended December	FY-13A	FY-14A	FY-15	FY-16E	FY-17E
£m unless stated					
Profit & Loss					
Revenue	**11.4**	**13.4**	**16.3**	**17.5**	**18.3**
Adj EBITDA	1.8	1.9	2.5	2.8	3.3
Adj EBIT	**1.1**	**1.1**	**1.7**	**1.7**	**2.1**
Reported PBT	0.7	0.2	(0.4)	1.5	2.1
PBT before exceptionals and AAG	1.2	0.9	0.3	2.2	2.9
Fully adj PBT	**1.2**	**1.1**	**1.7**	**2.2**	**2.6**
NOPAT	0.8	0.8	1.2	1.2	1.5
Reported EPS (p)	4.5	1.2	(3.5)	6.1	8.8
EPS before exceptionals and AAG (p)	7.3	4.9	1.5	10.0	13.1
Fully adj EPS (p)	**8.6**	**8.3**	**12.9**	**10.0**	**11.7**
Dividend per share (p)	0.0	0.0	0.0	0.0	0.0
Cash flow & Balance sheet					
Operating cash flow	2.4	1.3	2.7	1.9	3.0
Free Cash flow £m	1.9	0.9	2.3	0.7	1.6
FCF per share p	15.7	7.2	17.7	4.5	9.9
Acquisitions	(1.6)	(0.3)	(0.9)	(0.4)	(0.4)
Disposals	0.0	0.0	0.0	0.0	0.0
Shares issued	0.0	0.0	0.0	4.7	0.0
Net cash flow	**0.3**	**0.6**	**1.0**	**5.0**	**1.2**
Overdrafts / borrowings / other	0.0	0.0	0.0	0.0	0.0
Cash & equivalents	**2.1**	**1.7**	**2.2**	**7.2**	**8.3**
Net (Debt)/Cash	**2.1**	**1.7**	**2.2**	**7.2**	**8.3**
NAV and returns					
Net asset value	5.0	5.4	6.6	12.3	13.6
NAV/share (p)	**0.4**	**0.5**	**0.5**	**0.8**	**0.9**
Net Tangible Asset Value	(7.9)	(7.0)	(5.4)	1.7	3.2
NTAV/share (p)	**(0.7)**	**(0.6)**	**(0.4)**	**0.1**	**0.2**
Average equity	5.0	5.2	6.0	9.4	13.0
Post-tax ROE (%)	**10.6%**	**2.9%**	**-7.1%**	**10.0%**	**10.7%**
Metrics	**FY-13A**	**FY-14A**	**FY-15**	**FY-16E**	**FY-17E**
Adj EBIT growth		*-4.6%*	*56.8%*	*1.9%*	*21.5%*
Adj PBT growth		*-9.7%*	*59.2%*	*30.1%*	*18.4%*
Adj EPS growth		*-4.3%*	*55.7%*	*-22.2%*	*17.1%*
Dividend growth		*n/a*	*n/a*	*n/a*	*n/a*
Adj EBIT margins	*10.1%*	*8.1%*	*10.5%*	*9.9%*	*11.6%*
Valuation	**FY-13A**	**FY-14A**	**FY-15**	**FY-16E**	**FY-17E**
EV/Sales	2.6	2.2	1.8	1.7	1.6
EV/EBITDA	16.4	15.7	11.6	10.4	8.8
EV/NOPAT	36.4	38.2	24.4	23.9	19.7
PER	27.1	28.3	18.2	23.4	20.0
Dividend yield	0.0%	0.0%	0.0%	0.0%	0.0%
FCF yield	6.7%	3.1%	7.6%	1.9%	4.2%

Source: Company Data and Progressive Equity Research estimates.

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