INSTEM

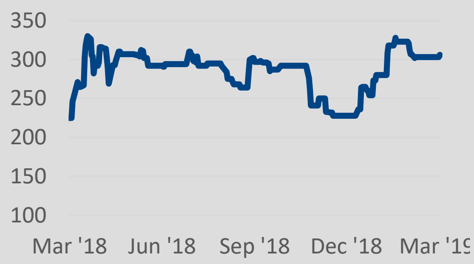
SOFTWARE AND COMPUTER SERVICES

INS.L

306p

Market Cap: £49.7m

SHARE PRICE (p)



12m high/low	330p/225p

Source: LSE Data

KEY INFORMATION

Enterprise value	£46.2m
Index/market	AIM
Next news	Investor Event - April 2
Gearing	N/A
Interest cover	N/A

INSTEM IS A RESEARCH CLIENT OF PROGRESSIVE

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Another year of solid delivery

Instem has announced FY 18 results in line with our forecasts. The group has made strong commercial progress during the year, with significant contract wins being recorded across the group. SEND performance remains a major driver of growth, and management commentary on the outlook is positive. Overall, a solid release and we make modest upward revisions following the announcement.

- **FY 18A results in line with our forecasts:** Revenue of £22.7m (+8%) and adjusted EBITDA of £3.8m (prior to IFRS 15 adjustment of £0.3m) were in line with our estimates, with financial performance benefiting from a full-year of the cost savings realised during 2017. Closing net cash of £3.6m (+£0.5 vs FY 17A) was also consistent with our forecast, reflecting slightly delayed payment for certain contracts. These debtor balances have been received since the year-end.
- **Strong commercial progress, contract wins across the group:** Instem recorded a number of significant contract wins during 2018, including two SEND outsourced service deals (see below), a win with a leading Fortune 500 company for Samarind RMS, and 500 additional Provantis users licensed by the group's largest CRO client.
- **SEND continues to perform well:** Momentum in the group's SEND business remains strong. Instem won significant SEND outsourced services contracts with two top-5 global non-clinical Contract Research Organisations ("CROs") during 2018, with each contract valued at over £1m. SEND technology-outsourced services saw 500% growth in new order volumes during the year. Instem continues to invest in SEND, having recruited an additional 29 staff to the outsourced services team during the year.
- **Positive outlook statement:** Citing the increased momentum in the business from recent contract wins and the growing pipeline, management highlight their confidence in the outlook for the business in 2019 and beyond.
- **Forecast revisions:** We make upward revisions to FY 19E and FY 20E forecasts following the announcement (detailed on page six). FY 21E estimates are introduced for the first time.

In our view 2018 was a year of solid financial advancement for Instem, with the group once again delivering growth in revenue and profits. The group is seeing momentum across all of its businesses, and the favourable market backdrop gives further confidence in the Instem growth story.

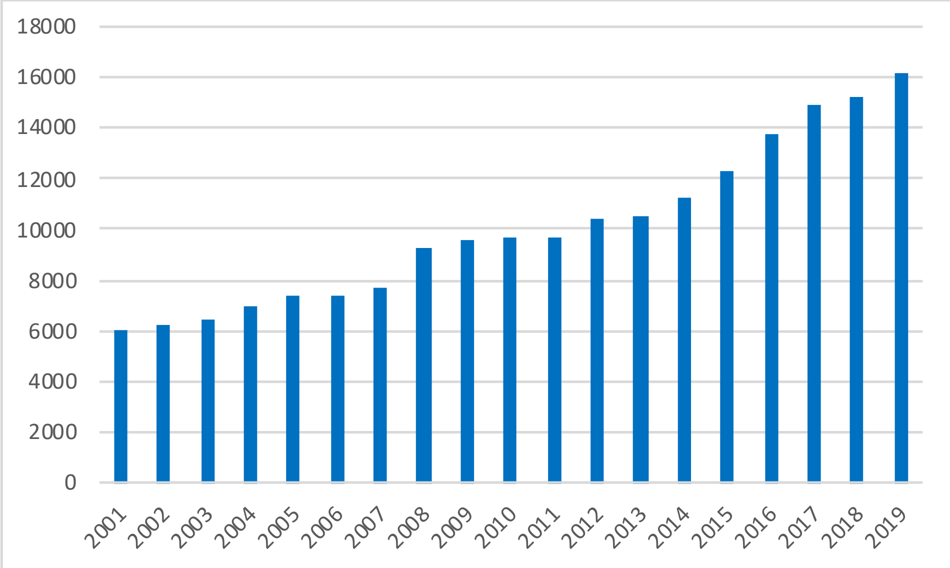
FYE DEC (£M)	2017	2018	2019E	2020E	2021E
Revenue	21.7	22.7	25.3	28.0	30.0
Adj EBITDA	2.4	4.1	4.6	5.3	5.8
Fully adj PBT	1.6	3.0	3.6	4.4	4.9
Fully adj EPS	11.0	15.5	18.8	21.4	23.3
EV/Sales	2.1	2.0	1.8	1.6	1.5
EV/EBITDA	19.1	11.4	10.1	8.7	7.9
PER	27.7	19.7	16.3	14.3	13.2

Source: Company Information and Progressive Equity Research estimates

Buoyant pharma market

We believe that the industry backdrop for Instem remains favourable. As the following chart demonstrates, the number of drugs currently in development has reached record levels.

Global pharma pipeline (Drugs in development – units)



Source: Pharmaprojects Annual Review 2019

With over 16,000 drugs currently in the global drug development pipeline, 2019 has seen 6% annual growth in the pipeline, slightly above the recent historic trend. To us, this continues to demonstrate the disconnect between the drug development landscape and the currently-troubled political and economic situations in a number of the world's regions.

The picture is also positive on a more granular basis – pre-Clinical and Early Phase Clinical drug numbers are also on the increase. These numbers are directly relevant to Instem, since it is drug numbers in these phases of development that specifically drive requirements for licences (or SEND services).

Having been for some time a "drag" on group performance, the overall pharma market's growth is now helping Instem continue to deliver strongly, even as other areas of the global economy (and financial markets) are exhibiting strain.

The partial disconnect between Instem's markets and general macro demand could, once again become a useful positive for the group in the months and quarters ahead.

Operational performance

Instem has seen a longer-term transformation from a relatively niche provider of study management systems (largely Provantis) to a much more broadly-based platform, with extended geographic reach, presence in both pre-Clinical and early-stage Clinical trials, and with a range of software and services offerings encompassing operational, reporting, compliance and data analysis.

The group can be broadly grouped into three areas, ▪

- Study Management & Data Collection
- Informatics
- Regulatory solutions

Much like 2017, 2018 saw good performances from all three areas:

Study management & Data collection

Study management and data collection generates the bulk of Instem's recurring revenue. Instem's single largest CRO client licensed 500 additional users for the Provantis suite and whilst the majority of new business was modest in size, order volumes for the suite were "generally solid".

The ongoing shift to SaaS delivery for Provantis continues. 2018 saw both a top-three chemical company client and another existing top-20 pharma client switch to a SaaS subscription model, with both upgrading to Version 10 of the suite.

Informatics

2018 saw 30% growth in new business for KnowledgeScan, Instem's Target Safety Assessment ("TSA") suite. Growth was driven primarily by existing customers, demonstrating a solid recurring revenue stream.

Regulatory solutions

In June 2018, Instem announced a $750,000 contract win with a Fortune 500 for the Samarind RMS solution. The contract includes both software licenses and a SaaS revenue component.

Instem won significant SEND outsourced services contracts with two top-5 global non-clinical CROs during 2018, with each contract valued in excess of £1m. SEND technology-outsourced services saw 500% growth in new order volumes during the year. Instem continues to invest in SEND, having recruited an additional 29 staff to the outsourced services team during 2018.

Instem is a business transformed

In our opinion, Instem has undergone a transformation over recent years. In particular, we highlight:

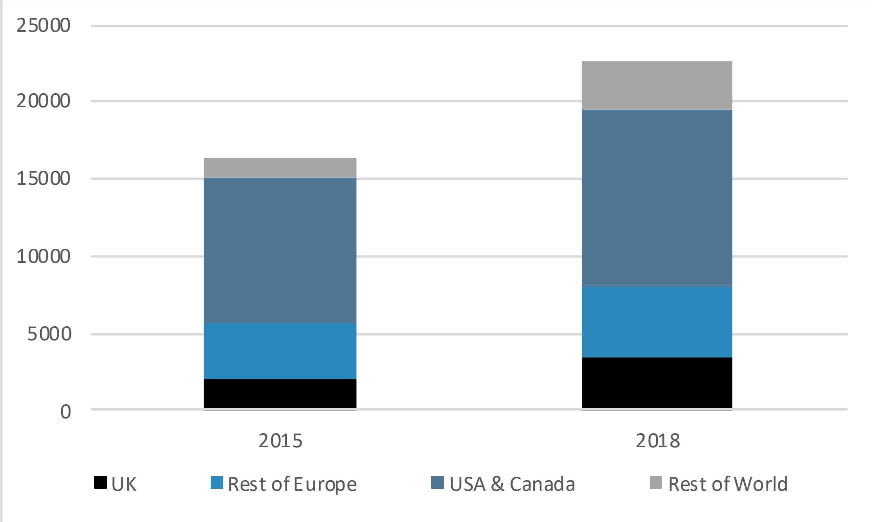
- The business has a much broader geographic spread, so has relatively lower exposure to the USA
- The product mix continues to shift towards recurring revenues
- The result is a significant improvement in revenue visibility

Each of the three points are discussed below.

Improved geographic diversity

Each of Instem's four regions has grown revenues over the past three years, with the RoW and UK being the stand-out performers. However, as the first chart demonstrates, the result has been improved revenue diversification. The US remains the group's core market. However, the region now contributes just over half of Instem's revenues

Instem – geographic exposure 2015 - 2018A

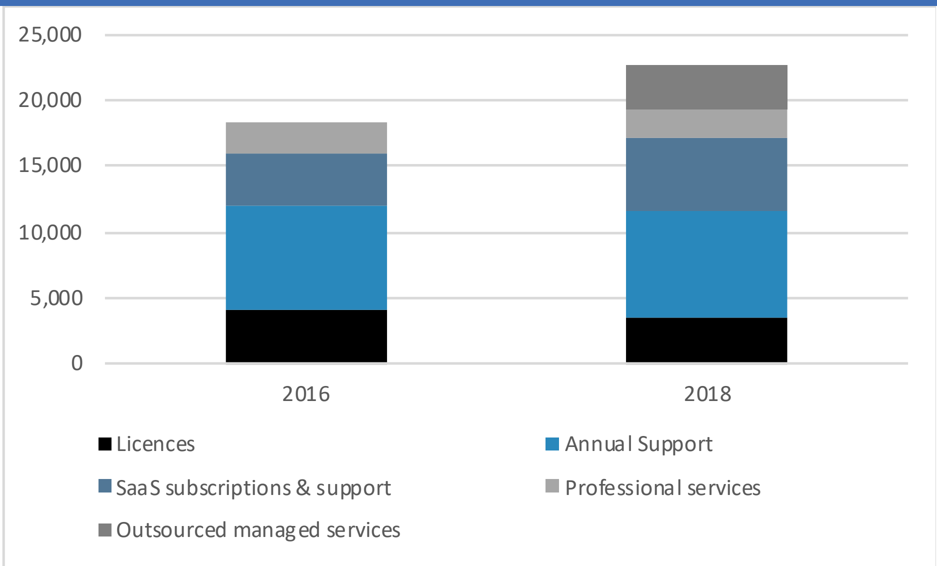


Source: Company data

Improved product mix

The business has seen a significant shift away from one-off license revenues towards recurring income streams – as demonstrated in the right-hand chart. Licence fee sales contributed 15% of group revenue in 2018, with recurring SaaS revenues contributing 24%. The business has also seen material growth in outsourced managed services, which now contribute 15% of turnover.

Instem –revenues by type 2016-2018 (£m)

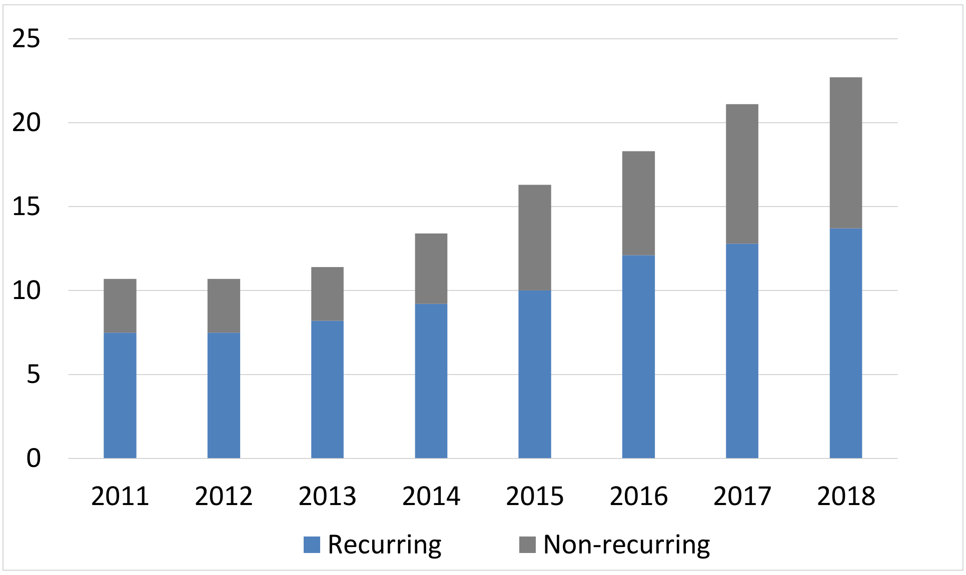


Source: Company data

Improved revenue visibility and earnings quality the result

The result of the improvements in the geographic split and revenue mix make for improvement in revenue visibility, and by definition, earnings quality.

Instem – recurring vs non-recurring revenues 2011-2018 (£m)



Source: Company data

Recurring revenues increased 6% during 2018 to £13.7m (60% of group turnover), with SaaS revenues (+25% YoY) the key growth driver. To clarify, recurring revenues are derived from annual support fees and SaaS subscriptions. Although management has indicated that it will continue to licence software to meet specific customer demand (some clients continue to prefer to buy software via a license rather than use it as a service), the SaaS model is the group's preferred route to market.

Recent revenue growth, as shown in the chart above, has been driven partly by expansion of the recurring base, and partly by additional sales of a non-recurring nature. This reflects the increased product and service range within the Group, and has allowed Instem to expand rapidly while still investing heavily in product development and service capability. Overall, this provides a steadily stronger and more-valuable earnings stream – and over time we would expect the recurring revenue element to grow, both in absolute terms, and as a proportion of the total.

Forecast revisions

Following the results release, we make revisions to earnings estimates. These are summarised in the following table.

Please note that our forecasts do not yet incorporate the likely impact of IFRS 16 (which will force the group to change the way it accounts for various items around operating leases) – we expect to incorporate these adjustments at the time of the group's H1 results, although the result is purely presentational – the net impact on bottom-line results will be nil.

Instem – earnings revisions FY 19E and FY 20E

£m unless stated	Old	FY 19E New	Change (%)	Old	FY 20E New	Change (%)
Revenue	25.2	25.3	0.2%	27.4	28.0	2.4%
Adj EBITDA	4.5	4.6	0.0%	5.0	5.3	5.5%
Fully adj PBT	3.4	3.6	5.8%	3.8	4.4	15.0%
Fully adj EPS (p)	15.3	18.8	23%	17.0	21.4	25.8%

Source: Progressive Equity Research estimates

- Our FY 19E revenue and EBITDA estimates are broadly unchanged. Our adjusted PBT forecast increases by 6%, reflecting reduced D&A and increased financial income compared with our previous forecasts.
- Our FY 19E EPS estimate increases by 23%. This is a function of higher adjusted PBT, combined with an assumed increase in the level of R&D tax credits received by the group.
- For FY 20E, we have increased our forecast of technology-enabled outsourced service revenues, which is the primary driver of the uplift in revenue and EBITDA. As in FY 19E, the increased EPS forecast is a function of the higher PBT and increased expectation of R&D tax credits.
- We introduce FY 21E forecasts for the first time. These are detailed overleaf.

Financial Summary: Instem

Year end: December (£m unless shown)

PROFIT & LOSS	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Revenue	21.7	22.7	25.3	28.0	30.0
Adj EBITDA	2.4	4.1	4.6	5.3	5.8
Adj EBIT	1.8	3.2	3.6	4.3	4.8
Reported PBT	0.3	1.7	2.6	3.4	4.1
Fully adj PBT	1.6	3.0	3.6	4.4	4.9
NOPAT	1.3	2.4	3.1	3.5	3.8
Reported EPS	4.0	8.7	14.4	16.0	19.4
Fully adj EPS	11.0	15.5	18.8	21.4	23.3
Dividend per share	0.0	0.0	0.0	0.0	0.0
CASH FLOW & BALANCE SHEET	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Operating cash flow	1.9	1.8	4.9	5.0	4.3
Free Cash flow	0.2	0.6	3.2	2.8	2.9
FCF per share	1.0	3.3	18.8	16.4	17.3
Acquisitions	(0.9)	(0.2)	0.0	0.0	0.0
Disposals	0.0	0.0	0.0	0.0	0.0
Capex	(1.6)	(1.6)	(1.6)	(1.6)	(1.6)
Shares issued	0.0	0.1	0.0	0.0	0.0
Net cash flow	(0.9)	0.5	3.2	2.8	2.9
Cash & equivalents	3.1	3.6	6.7	9.5	12.4
Net (Debt)/Cash	3.1	3.6	6.7	9.5	12.4
NAV AND RETURNS	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Net asset value	13.8	16.4	18.8	24.9	29.2
NAV/share	88.3	105.1	120.6	159.9	187.2
Net Tangible Asset Value	(3.7)	(1.0)	2.3	8.6	10.1
NTAV/share	(23.5)	(6.5)	14.8	55.3	64.6
Average equity	13.3	15.1	17.6	21.9	27.1
Post-tax ROE (%)	4.8%	9.7%	13.7%	12.3%	12.0%
METRICS	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Revenue growth		4.8%	11.3%	10.9%	7.0%
Adj EBITDA growth		67.6%	12.3%	17.0%	9.8%
Adj EBIT growth		80.3%	12.9%	20.3%	11.0%
Adj PBT growth		84.7%	20.8%	20.8%	11.4%
Adj EPS growth		N/A	21.3%	13.8%	8.7%
Dividend growth		N/A	N/A	N/A	N/A
Adj EBIT margins		14.0%	14.2%	15.3%	15.9%
VALUATION	**2017**	**2018**	**2019E**	**2020E**	**2021E**
EV/Sales	2.1	2.0	1.8	1.6	1.5
EV/EBITDA	19.1	11.4	10.1	8.7	7.9
EV/NOPAT	35.0	19.4	14.8	13.1	12.1
PER	27.7	19.7	16.3	14.3	13.2
Dividend yield	N/A	N/A	N/A	N/A	N/A
FCF yield	0.3%	1.1%	6.1%	5.4%	5.6%

Source: Company information and Progressive Equity Research estimates

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