PROGRESSIVE
EQUITY RESEARCH

23 September 2019

INSTEM

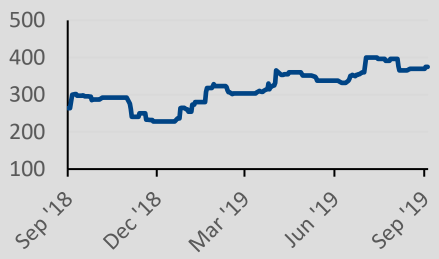
SOFTWARE AND COMPUTER SERVICES

INS.L

375p

Market Cap: £60.9m

SHARE PRICE (p)



12m high/low	400p/228p

Source: LSE Data

KEY INFORMATION

Enterprise value	£57.4m
Index/market	AIM
Next news	Trading Update - Jan '20
Gearing	N/A
Interest cover	N/A

INSTEM IS A RESEARCH CLIENT OF PROGRESSIVE

ANALYSTS

Gareth Evans

+44 (0) 20 7781 5301

gevans@progressive-research.com

Blaine Tatum

+44 (0) 20 7781 5309

btatum@progressive-research.com

Building momentum

Instem has announced solid H1 2019A results in our view. All three business areas performed well during the period, with the group once again reporting strength across the board. The Provantis and Notocord suites recorded impressive growth, as did SEND services. We make minor revisions to estimates following the announcement, reflecting the adoption of IFRS16, the ongoing transition to SaaS delivery and revised cost expectations.

- **Solid H1 2019 results:** Group revenue for the six months ending June 2019 increased by 11% to £11.7m. EBITDA was £1.7m, including a £0.3m IFRS 16 adjustment. Cash performance was strong. The net operating cash inflow of £3.2m reflected cash inflow from key contracts, outsourced services, tight working capital management and the R&D tax credit. With a closing cash balance of £6.0m the group's financial position remains solid, having grown by £2.3m vs H1 2018.
- **Momentum remains good, strength across the board:** All three business areas performed well during the period. Provantis reported a record performance for a six-month period, having won nine new clients across the world. Post-period end, Instem was awarded four Provantis contracts, worth an aggregate £1.7m. The KnowledgeScan informatics suite saw five new orders during the period, with four existing clients placing repeat orders. The SEND business continues to perform well, with material growth in order volumes for technology-enabled SEND services and 100% YoY growth in SEND revenues overall.
- **Positive outlook statement:** Financial performance continues to benefit from the twin effects of historic restructuring and the increased efficiency of the group's technology and services. At a more macro-level, there are a record number of drugs in the global development pipeline – a key demand driver for Instem's services.
- **Forecast revisions:** We make minor revisions to earnings estimates following the announcement, reflecting the adoption of IFRS 16 and revised assumptions on both the business mix and certain costs. On an underlying basis, we reduce 2019E EBITDA by £0.3m but upgrade modestly our 2020E and 2021E estimates.

Instem continues to see momentum across all of its businesses, and the favourable market backdrop gives further confidence in the growth story. Second half performance has traditionally been stronger than the first, and as we show overleaf, the H2 2019E "requirement" appears consistent with prior years.

FYE DEC (£M)	2017	2018	2019E	2020E	2021E
Revenue	21.7	22.7	25.7	28.1	30.2
Adj EBITDA	2.4	4.1	4.9	6.0	6.5
Fully adj PBT	1.6	3.0	3.4	4.4	4.9
Fully adj EPS	11.0	15.5	17.5	21.5	23.3
EV/Sales	2.6x	2.5x	2.2x	2.0x	1.9x
EV/EBITDA	23.7x	14.2x	11.8x	9.6x	8.9x
PER	34.0x	24.2x	21.5x	17.5x	16.1x

Source: Company Information and Progressive Equity Research estimates

Operational Performance

Instem reported an 18% YoY increase in the level of new bookings across the group in H1 2019 and 11% revenue growth. The release reveals that all three business areas performed well during the period, and below we discuss some of the operational highlights from each.

Study Management

Instem's Study Management business performed particularly strongly during H1 2019, with growth primarily driven by an increased volume of orders for the group's pre-clinical software suite.

Provantis (*pre-clinical study management software*) delivered a record performance for a six-month period, having won nine new clients across North America, Asia-Pacific and mainland Europe. Whilst management flag this level of performance is unlikely to be repeated in the second half, the pipeline remains strong and additional contracts are expected to be closed in H2 2019E.

Post period-end, Instem was awarded four new contracts for Provantis, with an aggregate value of £1.7m. Of this, c£1m is expected to contribute to H2 2019E revenues. A further highlight was that two of the contracts are with new clients, one of them being a global top-3 chemical company.

Notocord (*software for the acquisition, display and analysis of physiological signals for applications across safety pharma)* reported a 63% uplift in the number of new-business bookings during the period and a corresponding 211% YoY increase in order values.

Informatics

Although the smallest of Instem's business lines, Informatics reported impressive 47% YoY revenue growth during the period and good levels of repeat business. Growth was driven by both new and existing customers for Instem's KnowledgeScan Target Safety Assessment ("TSA") suite. Five new clients adopted the service during the half, and four existing customers placed new orders. Of that four, one particular client, a global top-10 pharma company placed multiple orders during the year.

With momentum in the unit strong, two new members were added to the KnowledgeScan team in Cambridge during the half, with a total of six – primarily in Pune, expected to be added before year-end.

For the unfamiliar, KnowledgeScan uses proprietary Artificial Intelligence (AI) and big data solutions to deliver TSA solutions to a growing client base. Industry sources (Accenture) estimate that utilising Artificial Intelligence (AI) could save the pharma industry $150bn annually in drug development costs. With a positive market backdrop and cutting-edge technology, we believe Instem's Informatics unit offers the potential for material value creation and will revisit this story in an upcoming research note.

Regulatory Solutions

The SEND business continues to perform well, with material growth in order volumes for technology-enabled SEND services and 100% YoY growth in SEND revenues.

Six additional staff were hired by the SEND services team in the first half of 2019. The results release reveals that investment will continue in the second half.

Executing the strategy

Instem's strategic focus is the delivery of strong organic revenue growth, expanding operational gearing and improving positive cash flow. As discussed in the 2018 Annual Report, management has identified three key growth drivers for the business. These are listed below, along with the evidence supporting our view that the group has delivered good progress in all three areas in H1 2019.

- A focus on materially increasing SaaS based revenues through a combination of new business wins and accelerating the migration of existing customer to SaaS delivery:
  - SaaS bookings exceeded management expectations during the period, having more than doubled during H1 2019 to £1.1m (2018 £0.5m). This was a key driver of the £0.5m increase in group recurring revenue to £7.0m – c60% of total sales.
- The expansion of "technology enabled outsourced services":
  - H1 2019 saw material growth in order volumes for technology-enabled SEND services. SEND revenues saw 100% YoY growth during the period, with increased contributions from both new and repeat customers.
  - Instem's Informatics division also reported impressive growth, delivering a 47% YoY improvement in revenues.
- Expansion of the group's market penetration across the existing client base, cross selling additional software and services:
  - The group's Provantis (non-clinical) suite had its best-ever performance in a six-month period, winning nine new clients across the world. Four additional contracts were signed post period-end.
  - Study management and data collection delivered further penetration in the APAC region. The unit also reported high renewal levels.
  - Five new clients adopted the KnowledgeScan service during the first half of 2019, and four existing customers placed new orders.

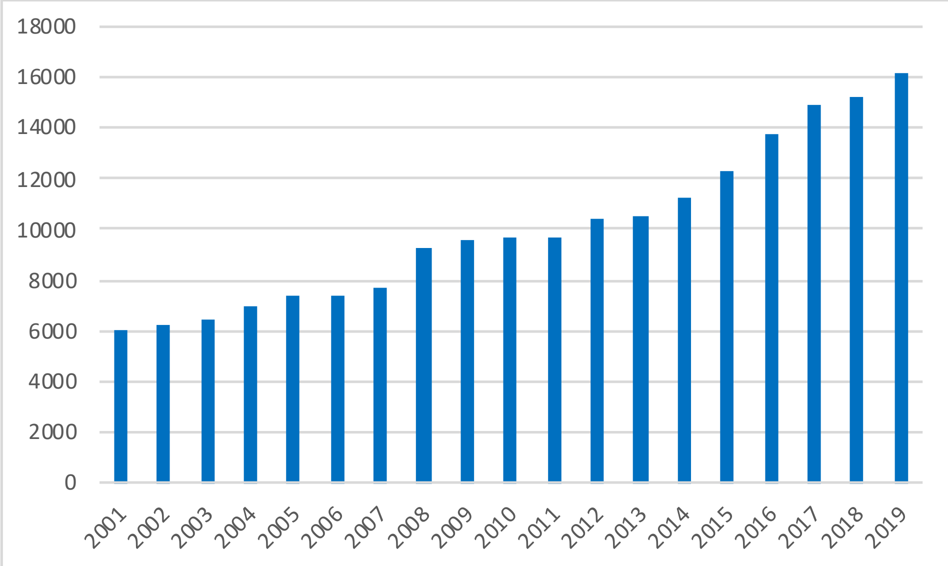
In our view the H1 2019 results demonstrate strong execution against all three financial metrics mentioned above - revenue growth, improved operational gearing and positive cash flow. We highlight:

- The group delivered double-digit (11%) topline growth *(Revenue growth)*
- Net operating cash inflow doubled to £3.2m *(Cash flow)*
- Underlying EBITDA was stable at £1.4m. Obviously this means that opex grew in line with turnover. However, H1 2019 saw significant investment in the business – notably with headcount additions in the Informatics and Regulatory solutions businesses. We view this a strategically sensible investment in growth. However, the investment undoubtedly came at the expense of margin, which would have otherwise been higher. Although the company has not disclosed an underlying EBITDA figure for the period, we note that Instem's average cost per employee was £51k in FY 2018 (£12.2m staff costs, 238 average monthly employees). With eight additions to the headcount discussed on the previous page, the impact on profitability from the investment may have been material. *(Operational gearing)*

The pharma market remains buoyant

We continue to 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% YoY growth. This is slightly above the recent historic trend. To us, this continues to demonstrate the resilience of the drug development industry. The pipeline is continuing to grow, against a backdrop of macro-driven economic uncertainty in a number of the world's regions – for example Brexit and issues with Chinese trade. We maintain our view that 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.

The picture is also positive on a more granular basis – the volumes of pre-Clinical and Early Phase Clinical drugs in the pipeline is also on the increase. This is directly relevant to Instem, since it is the size of the pipeline in these phases of development that drive demand for licenses (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.

Estimates

We make revisions to estimates following the announcement. These are summarised in the following table.

Estimate changes

£m unless stated	FY 19E Old	FY 19E New	FY 19E Change (%)	FY 20E Old	FY 20E New	FY 20E Change (%)	FY 21E Old	FY 21E New	FY 21E Change (%)
Revenue	25.3	25.7	1.5%	28.0	28.1	0.2%	30.0	30.2	0.5%
Adj EBITDA (excl. IFRS16 adjustments)	4.6	4.3	-6.6%	5.3	5.4	0.5%	5.8	5.9	0.5%
Adj EBITDA (Incl. IFRS16 adjustments)	4.6	4.9	6.6%	5.3	6.0	11.7%	5.8	6.5	10.8%
Fully adj PBT	3.6	3.4	-7.0%	4.4	4.4	0.3%	4.9	4.9	0.4%
Fully adj EPS (p)	18.8	17.5	-7.0%	21.4	21.5	0.3%	23.3	23.3	0.4%

Source: Progressive Equity Research estimates

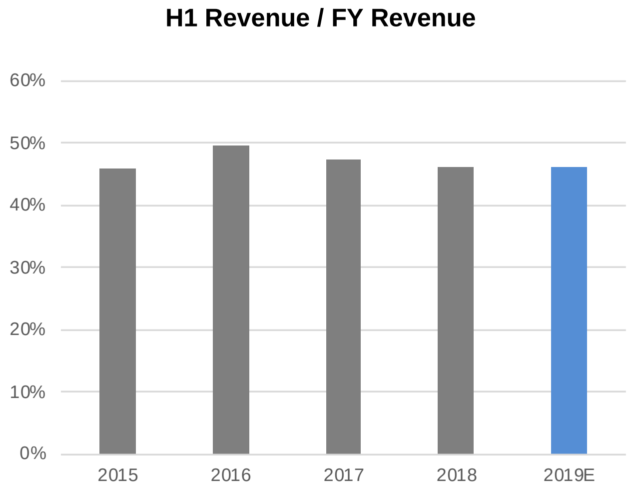
- In all three years, we have made minor revisions to our expectations for the mix of SaaS/ perpetual licence contract wins. The result is that revenues increase by small amounts in each year. This change in mix also drives the uplift in EBITDA shown in our revised forecasts for FY 2020E and FY 2021E.
- As a result of the group's adoption of IFRS 16, we assume a £0.6m uplift to Adjusted EBITDA in each of the three years. This is offset by a £0.6m increase in the amortisation charge. Ceteris paribus, we forecast the impact of IFRS 16 to be profit-neutral.
- Our FY 2019E adjusted EBITDA estimate (pre IFRS 16 adjustments) is reduced by £0.3m to £4.3m. Note, given our £0.4m increase in the revenue forecast, the actual opex delta vs our prior forecast is £0.7m. The increase reflects the increases in headcount discussed on previous pages (KnowledgeScan, SEND) and also an assumed increase in certain third-party costs.
- Our FY 2019E cash forecast also sees a £0.2m reduction to £6.5m. We anticipate a slight improvement in cash collections, offset by a £0.3m impact from the EBITDA reduction described above, so this is actually a small improvement in terms of cash conversion compared to previous forecasts. We are not altering our net cash calculation to include the new "liability" recognised for operating leases under IFRS 16. Had we done so; the net cash balance would be some £3m lower.

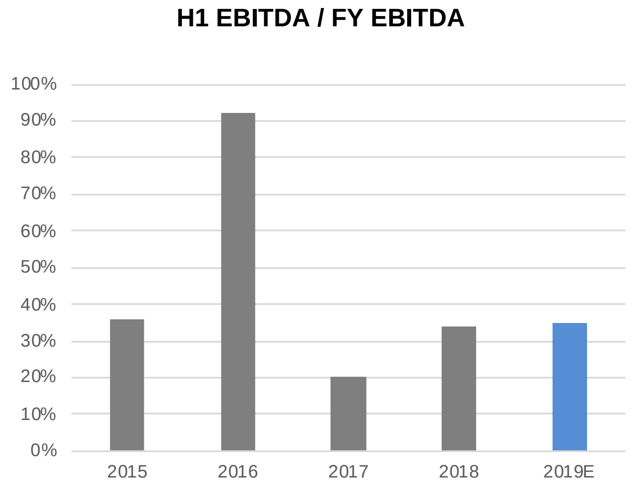
On track for revised FY 2019E expectations

We believe Instem's H1 2019 results demonstrate that the business is on track to deliver our revised FY 2019E estimates. In the first half, Instem has delivered 46% and 34% of our respective FY 2019E revenue and EBITDA forecasts. Both of these compare favourably with historic levels. We believe the following points support our positive stance:

- Instem has historically demonstrated seasonality in revenues, with the second half usually being slightly ahead of the first. This has been a stable trend over recent reporting periods – the group has delivered between 46% and 50% of FY revenues in the first half (46% FY 2019E)
- With the exception of FY 2016 where specific issues in the Clinical business impacted second half performance, the trend for EBITDA is more pronounced. Excluding 2016, Instem has reported between 20% and 39% of FY EBITDA in the first half over recent years. Based on our (revised) estimates, Instem has already delivered some 34% of the FY 2019E total.

Instem – H1 revenue and EBITDA vs full-year outcome 2015 - 2019E





Source: Company data

Summary and conclusion

The group has delivered, in our view, a solid H1 2019. Strength is evident across all parts of the business, including an exceptional contribution from Provantis which, for many years has been seen as perhaps the most "mature" Instem business – clearly new market expansion is driving good growth from this de facto world leading product.

There have also been two factors which cause the modest EBITDA reduction for the full-year forecasts – an increasing proportion of revenue delivered via SaaS rather than licence sale, and a modest uplift in Opex as the group invests for further growth. Overall, we see this as a good H1, likely to deliver a reasonable FY19, but more importantly the group is extremely well positioned for 2020 and beyond.

Financial Summary: Instem

Year end: December (£m unless shown)

PROFIT & LOSS	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Revenue	21.7	22.7	25.7	28.1	30.2
Adj EBITDA	2.4	4.1	4.9	6.0	6.5
Adj EBIT	1.8	3.2	3.3	4.3	4.8
Reported PBT	0.3	1.7	2.5	3.4	4.1
Fully adj PBT	1.6	3.0	3.4	4.4	4.9
NOPAT	1.3	2.4	2.9	3.5	3.8
Reported EPS	4.0	8.7	13.9	16.1	19.5
Fully adj EPS	11.0	15.5	17.5	21.5	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	4.2	5.0	4.3
Free Cash flow	0.2	0.6	2.5	2.8	2.9
FCF per share	1.0	3.3	14.7	16.7	17.4
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	0.4	0.0	0.0
Net cash flow	(0.9)	0.5	2.9	2.8	2.9
Cash & equivalents	3.1	3.6	6.5	9.3	12.2
Net (Debt)/Cash	3.1	3.6	6.5	9.3	12.2
NAV AND RETURNS	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Net asset value	13.8	16.4	19.2	25.3	29.6
NAV/share	88.3	105.1	122.9	162.2	189.6
Net Tangible Asset Value	(3.7)	(1.0)	3.3	10.2	12.3
NTAV/share	(23.5)	(6.5)	21.0	65.4	78.7
Average equity	13.3	15.1	17.8	22.2	27.4
Post-tax ROE (%)	4.8%	9.7%	13.1%	12.2%	11.9%
METRICS	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Revenue growth		4.8%	13.0%	9.5%	7.3%
Adj EBITDA growth		67.6%	19.7%	22.7%	8.9%
Adj EBIT growth		80.3%	4.9%	29.8%	11.1%
Adj PBT growth		84.7%	12.4%	30.2%	11.6%
Adj EPS growth		N/A	12.8%	22.7%	8.8%
Dividend growth		N/A	N/A	N/A	N/A
Adj EBIT margins		14.0%	13.0%	15.4%	15.9%
VALUATION	**2017**	**2018**	**2019E**	**2020E**	**2021E**
EV/Sales	2.6	2.5	2.2	2.0	1.9
EV/EBITDA	23.7	14.2	11.8	9.6	8.9
EV/NOPAT	43.5	24.1	19.8	16.2	15.0
PER	34.0	24.2	21.5	17.5	16.1
Dividend yield	N/A	N/A	N/A	N/A	N/A
FCF yield	0.3%	0.9%	3.9%	4.5%	4.6%

Source: Company information and Progressive Equity Research estimates

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