Progressive EQUITY RESEARCH

INSTEM

SOFTWARE AND COMPUTER SERVICES

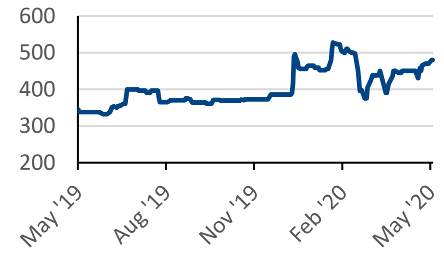
3 June 2020

INS.L

480p

Market Cap: £80m

SHARE PRICE (p)



12m high/low	528p/332p

Source: LSE Data

KEY DATA

Net (Debt)/Cash	£5.1m *(at 31/12/19)*
Enterprise value	£74.9m
Index/market	AIM
Next news	Trading update, Jul-20
Shares in Issue (m)	16.7
Chairman	David Gare
Chief Executive	Phil Reason
Finance Director	Nigel Goldsmith

COMPANY DESCRIPTION

Instem is a leading provider of IT solutions & services to the life sciences market.

www.instem.com

INSTEM IS A RESEARCH CLIENT OF PROGRESSIVE

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Solid trading, strong delivery

Instem has reported FY 19A results consistent with the March-20 trading statement and in line with our forecasts. Double-digit revenue growth was confirmed for the year, alongside margin improvement and cash generation. Furthermore, revenue visibility remains high and operationally, all three business areas continue to deliver. We make reductions to forecasts following the announcement (FY 20E EBITDA -8%, FY 21E -9%), reflecting a more prudent view on the medium/longer term outlook for the group. Having seen limited impact from COVID-19 to date and with £6m gross cash on the balance sheet, we retain our view that Instem is well positioned to weather macro-driven turbulence.

- **Double digit growth, margin improvement and cash generation:** The release confirms FY 19A revenue at £25.7m (+13% YoY) and adjusted EBITDA of £4.9m (+20% YoY, margin +110bps). With a closing cash balance of £6.0m, the business continues to deliver positive cash generation and the group's financial position remains robust.
- **Revenue visibility remains high:** Financial performance continues to benefit from the ongoing move to SaaS* service delivery, with FY 19A SaaS revenues up 16% YoY. Revenue visibility remains high, as evidenced by 9% YoY growth in recurring revenues, which contribute 58% of the total.
- **Momentum across the group:** Each of the three business areas continues to deliver positive momentum. Operational highlights of FY 19A include a doubling of revenues in the Informatics unit, a record number of client wins for Provantis (Study Management) and the group continuing to win the majority of new business in SEND services (Regulatory Solutions).
- **Positive outlook:** Instem has seen limited COVID-19 impact to date. The group has remained "very busy" over the lockdown period - as evidenced by today's announcement of a $1m contract win with Korean Clinical Research Organisation Biotoxtech in pre-clinical. Management remains confident in the longer-term outlook for the business.
- **Forecast revisions:** Our core view remains that Instem is well-placed to weather macro-driven uncertainty. However, following the release, we take a more prudent view on the medium/ longer term outlook for the business. Our FY 20E and 21E EBITDA estimates fall by 8% and 9% respectively.

* Software-as-a-Service

FYE DEC (£M)	2018	2019	2020E	2021E	2022E
Revenue	22.7	25.7	28.8	30.9	32.7
Adj EBITDA	4.1	4.9	5.8	6.3	7.0
Fully adj PBT	3.0	3.7	4.6	4.9	5.4
Fully adj EPS	15.5	18.4	22.7	23.3	25.7
EV/Sales	3.3x	2.9x	2.6x	2.4x	2.3x
EV/EBITDA	18.5x	15.4x	12.9x	11.9x	10.7x
PER	31.0x	26.1x	21.2x	20.6x	18.7x

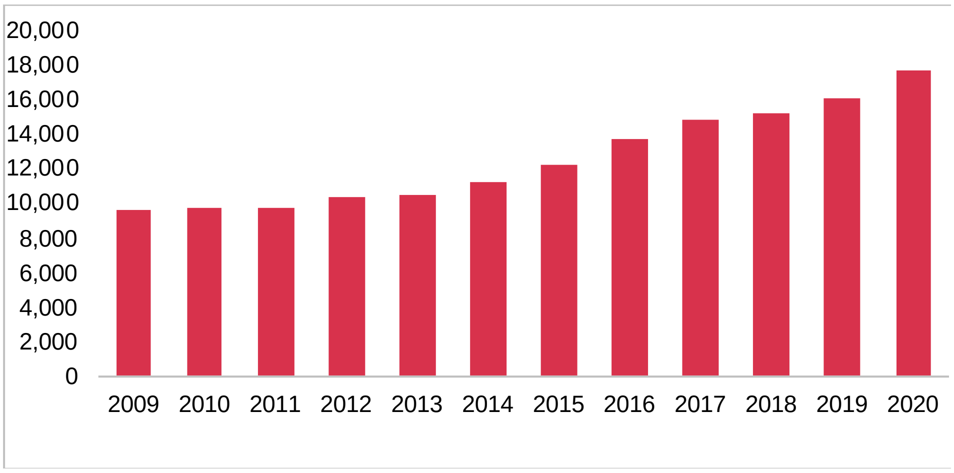
Source: Company Information and Progressive Equity Research estimates

The Pharma market remains buoyant

We continue to believe that the overall industry backdrop for Instem remains favourable. As will be demonstrated below, the number of drugs currently in development has once again reached record levels in 2020. A further positive for Instem is that early stage drug development volumes also continue to grow – this is Instem's key area of focus.

Record numbers of drugs in development…

Global pharma pipeline (Drugs in development – units)



Source: Pharmaprojects Annual Review 2020

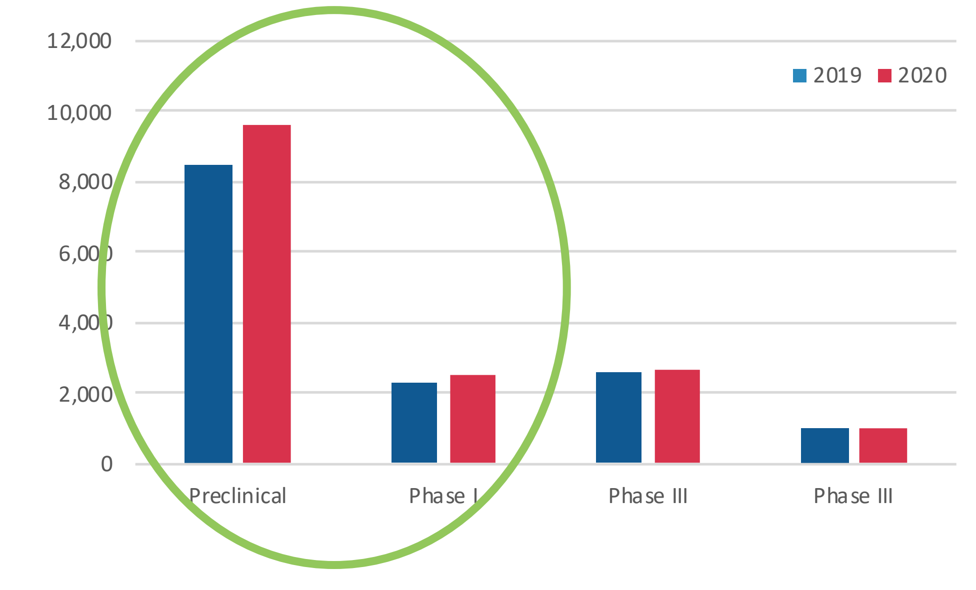
With over 17,700 drugs currently in the global drug development pipeline (+10% YoY), 2020 has seen an acceleration in growth. In our view this continues to demonstrate the resilience of the global pharma industry, despite the backdrop of global COVID-19 driven macro-economic uncertainty.

We believe the size of the pipeline is a key leading indicator of demand trends for the types of software and services provided by Instem and note that the pharma sector represents the largest proportion of the group's revenue. However, in our view growth in the pipeline provides only a general sign of industry health. We note the £3.2m impairment charge in Instem's FY 19A accounts related to a specific area / business – early phase clinical data collection, which as will be discussed on page six, is clearly experiencing headwinds.

…with good growth in early-stage drug development

Instem focuses on early stage R&D and the picture here is also positive given that early-stage drug development volumes are growing and continuing to dominate the overall development pipeline. As demonstrated in the following chart, in 2020 the pre-clinical and Phase I stages were the fastest growing segments, reporting a 13% and a 10% YoY uplift respectively.

Global pharma pipeline by stage (Drugs in development – units)



Source: Pharmaprojects Annual Review 2020

FY 19A divisional commentary

The Instem group can be broadly grouped into three areas:

- Study Management & Data Collection
- Informatics
- Regulatory solutions

Much like in 2017 and 2018, in our view 2019 results demonstrate real momentum in each of the three areas. The trend of positive performance across the group is both welcome and being demonstrably maintained. Below we present some of the operational highlights recorded during the last financial year.

Study management and data collection

Following a successful year in FY 18A, the group's Provantis offering continues to record positive momentum. With thirteen new clients signed up during the year, the suite delivered a record number of new client wins, with nine of these coming in the Asia-Pacific region.

The trend towards SaaS delivery continued during FY 19A, with a number of existing clients migrating to SaaS (including nine of the Provantis roster) and a number of new clients being signed up utilising the SaaS model. In aggregate, 28% of the Study management client roster now use this revenue model.

Informatics

Revenue from the Informatics division doubled during FY 19A versus the FY 18A. The unit saw good demand for the core Target Safety Assessment offering and encouragingly, high levels of repeat business.

Growth was primarily organic but was enhanced by the (accretive) acquisition of Leadscope, a US-based provider of software for safety assessments, announced in November 2019.

Regulatory Solutions

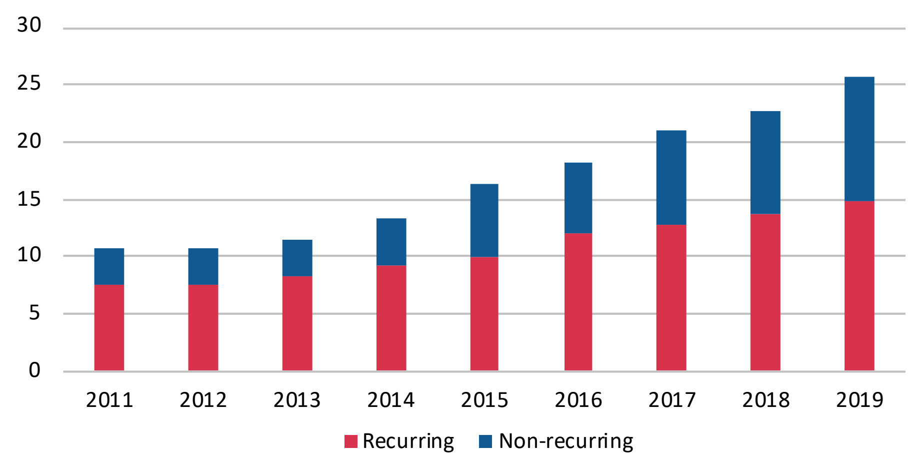
Instem recorded impressive growth in SEND outsourced revenues in FY 19A to £4.5m. Demand for SEND related services remains high, and according to management, the group continues to win the majority of new business in SEND services.

With the pharma industry continuing to suffer from a study backlog, management continued to invest in the SEND opportunity during the year. The group now has fifty revenue generating SEND services staff, representing (in management's view) the largest team in the industry solely focussed on SEND services. The team contains a number of SEND "experts", with highly qualified staff in Europe, North America – close to the largest client concentrations - but also in Pune, India.

Revenue visibility remains high

In our view revenue visibility has long been a key tenet of the Instem investment case. As shown in the following graphic, visibility levels remain high – as evidenced by Instem defining c60% of the revenue base as being recurring in nature. Although as we shall discuss below, the reported figures may actually under-estimate the actual degree of revenue repeatability.

Instem – recurring vs non-recurring revenues 2011 – 2019 (£m)



Source: Company information

As the chart demonstrates, the group has been delivering growth in both recurring and non-recurring revenues. Recurring revenues increased 9% during FY 19A to £14.9m (58% of group turnover), with SaaS revenues (+16% YoY) once again the key growth driver. Although arguably consistent with the recent trend, 2019 saw a marginal decline in the relative level of recurring revenues – the FY 18A figure was 60%.

However, we believe the Instem definition of recurring revenues understates the repeatability of certain “non-recurring” revenues. Instem defines recurring revenues as those derived from 1) annual support fees and 2) SaaS subscriptions. However, FY 19A saw stable licensing revenues (£3.5m) and impressive growth in Technology-enabled outsourced services. The latter were the group’s key revenue growth driver during the year, seeing a 67% uplift in revenues, outpacing the 9% growth in recurring revenue, albeit from a smaller base. Although not deemed as “recurring”, some of the services are delivered on an ongoing contracted basis so are therefore “repeating”.

Having grown rapidly over the past few years, Technology-enabled outsourced services are now Instem’s third largest revenue contributor, generating c22% of total revenue FY 19A. We estimate that c62% of this revenue line item are one-off in nature, with the remaining 38% being repeat/ recurring.

If these revenues are added to the official definition of recurring revenues (i.e. £14.9m + 38% * £5.6m) c66% of group turnover could be said to be recurring. Clearly this is materially higher than the 58% announced by the group and implies that revenue group visibility may be higher than the (already impressive) level disclosed by the group. Calculated on this basis, “adjusted” recurring revenues contributed 66% of the total in both FY 18 and FY 19.

Financials

Impairment charge

Instem’s FY 19A results contain a £3.2m impairment provision against the carrying value of the Alphadas early-phase clinical data collection business. This business was acquired in May 2013 via the Logos Technologies acquisition. As discussed previously, the global pharma pipeline remains robust and, in our view, this is a key lead demand indicator for Instem’s services. However, the early-phase clinical contract research market has been experiencing structural changes, with the work associated with generic drugs moving to India and other low-cost economies, resulting in reduction of demand for these types of services in North America and Europe. This has led to CRO overcapacity and clinics being reluctant to invest in early phase clinical study management software such as that from Instem.

Management envisage further slippage on new business being placed in the segment and have therefore taken a combined £3.2m impairment provision against the goodwill arising on the Logos acquisition and other intangible assets.

The release confirms that existing clients will continue to be supported, efforts continue to gain new business and that the impairment has no other impact on other areas of the business – where end-user markets remain robust.

Forecast revisions

We revise estimates following the announcement, taking a more prudent view on the medium/ longer term outlook for the business. Our new FY 20E and FY 21E forecasts are summarised in the table below and detailed overleaf. We also introduce FY 22E estimates for the first time.

Instem – forecast revisions

£m unless stated	FY 20E Old	FY 20E New	FY 20E Change (%)	FY 21E Old	FY 21E New	FY 21E Change (%)
Revenue	29.6	28.8	-2.5%	31.7	30.9	-2.5%
Adj EBITDA	6.3	5.8	-8.0%	6.9	6.3	-8.9%
Fully adj PBT	4.8	4.6	-2.3%	5.3	4.9	-7.3%
Fully adj EPS (p)	23.2	22.7	-2.3%	25.2	23.3	-7.3%

Source: Progressive Equity Research estimates

- Our revenue forecasts are reduced by 2.5% in both forecast years, primarily reflecting revised assumptions in SEND service revenues from one particular client, who will be bringing the work in-house, having been acquired by a larger CRO with a different philosophy regarding this work.
- The impact of the revenue reduction falls through to profits and this is the main driver of our reduced adjusted EBITDA estimates. However, in offset, we have reduced our expectations of marketing expenditure and business travel due to the impact of COVID19. The aggregate impact is an 8% and 9% reduction to our respective FY20E and FY21E EBITDA forecasts.
- We have also revised our forecasts for depreciation and amortisation. In particular, we have revised our expectations on amortisation charges resulting from acquired intangibles. We have also increased our forecasts for interest and tax charges.
- The group closed FY 19A with gross cash of £6.0m and net cash of £5.4m. Our new FY 20E and FY21E closing net cash forecasts of £6.1m and £9.3m respectively compare with £7.4m and £10.3m, reflecting the amended profitability estimates discussed above, and also revised expectations on working capital.

Financial Summary: Instem

Year end: December (£m unless shown)

PROFIT & LOSS	**2018**	**2019**	**2020E**	**2021E**	**2022E**
Revenue	22.7	25.7	28.8	30.9	32.7
Adj EBITDA	4.1	4.9	5.8	6.3	7.0
Adj EBIT	3.2	4.0	4.9	5.1	5.6
Reported PBT	1.7	(0.9)	3.4	3.7	4.2
Fully adj PBT	3.0	3.7	4.6	4.9	5.4
NOPAT	2.4	3.4	4.0	4.1	0.0
Reported EPS	8.7	(5.4)	16.6	17.3	19.8
Fully adj EPS	15.5	18.4	22.7	23.3	25.7
Dividend per share	0.0	0.0	0.0	0.0	0.0
CASH FLOW & BALANCE SHEET	**2018**	**2019**	**2020E**	**2021E**	**2022E**
Operating cash flow	1.8	5.7	3.6	4.9	4.8
Free Cash flow	0.6	4.1	1.3	3.5	4.3
FCF per share	3.3	23.8	7.9	20.7	25.5
Acquisitions	(0.2)	(1.3)	(0.3)	(0.3)	(0.4)
Disposals	0.0	0.0	0.0	0.0	0.0
Capex	(1.6)	(1.4)	(1.4)	(1.4)	(1.4)
Shares issued	0.1	0.6	0.0	0.0	0.0
Net cash flow	0.5	2.4	1.9	2.7	3.4
Cash & equivalents	3.6	6.0	7.9	10.6	14.1
Net (Debt)/Cash	3.6	5.1	6.1	9.3	13.2
NAV AND RETURNS	**2018**	**2019**	**2020E**	**2021E**	**2022E**
Net asset value	16.4	16.8	19.4	25.8	30.1
NAV/share	105.1	106.1	122.3	162.8	190.2
Net Tangible Asset Value	(1.0)	(1.3)	4.6	10.5	13.6
NTAV/share	(6.5)	(8.4)	28.8	66.5	86.2
Average equity	15.1	16.6	18.1	22.6	27.9
Post-tax ROE (%)	9.7%	(5.6%)	15.5%	12.9%	12.0%
METRICS	**2018**	**2019**	**2020E**	**2021E**	**2022E**
Revenue growth		13.3%	12.0%	7.2%	5.9%
Adj EBITDA growth		20.0%	19.8%	7.8%	11.4%
Adj EBIT growth		24.7%	23.6%	5.0%	9.1%
Adj PBT growth		23.4%	25.5%	5.6%	10.0%
Adj EPS growth		N/A	23.1%	3.0%	10.0%
Dividend growth		N/A	N/A	N/A	N/A
Adj EBIT margins		15.4%	17.0%	16.6%	17.1%
VALUATION	**2018**	**2019**	**2020E**	**2021E**	**2022E**
EV/Sales	3.3	2.9	2.6	2.4	2.3
EV/EBITDA	18.5	15.4	12.9	11.9	10.7
EV/NOPAT	31.5	21.8	18.7	18.3	
PER	31.0	26.1	21.2	20.6	18.7
Dividend yield	N/A	N/A	N/A	N/A	N/A
FCF yield	0.7%	5.0%	1.6%	4.3%	5.3%

Source: Company information and Progressive Equity Research estimates

Progressive EQUITY RESEARCH

3 June 2020

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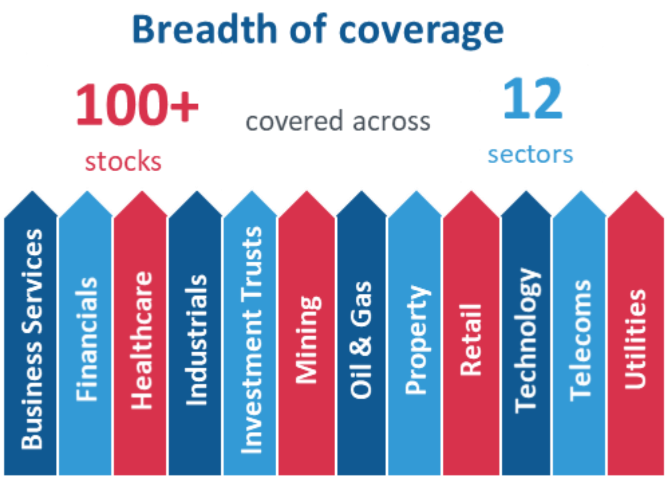

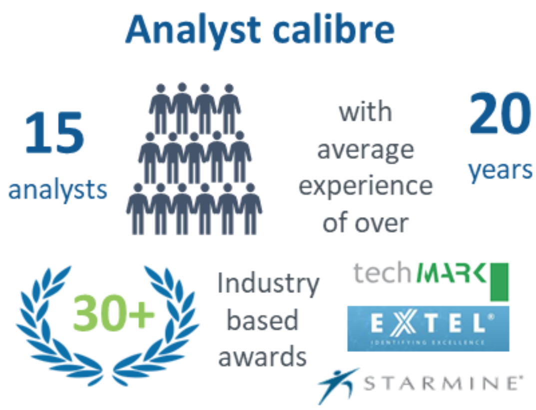

To arrange a meeting with the management team, or for further information about Progressive, please contact:
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