INSTEM

SOFTWARE AND COMPUTER SERVICES

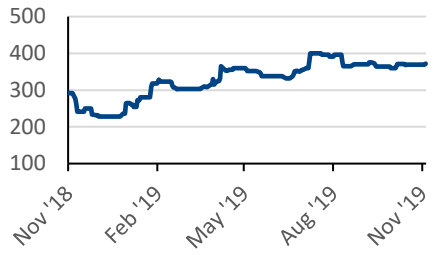
18 November 2019

INS.L

372p

Market Cap: £60.4m

SHARE PRICE (p)



12m high/low	400p/228p

Source: LSE Data

KEY DATA

Net (Debt)/Cash	£3.6m
Enterprise value	£56.9m
Index/market	AIM
Next news	Trading Update - Jan '20
Shares in Issue (m)	16.2
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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Acquisition in safety assessment

Instem has announced the acquisition, for up to $4.6m, of a US-based provider of software for safety assessments. Leadscope's software provides computer models that predict toxicity of chemical compounds – the systems are so advanced that the FDA allows them to replace animal testing in certain limited situations. A strong fit with Instem's existing safety assessment business and its KnowledgeScan offering, this deal appears a well-considered and useful extension to the group's position.

- **Deal structure** Instem has acquired Leadscope, a safety assessment software provider in Columbus, Ohio. The consideration is $3.35m initially, $0.75m deferred but not contingent, and $0.5m contingent on performance. This equates to around 2.3x sales and 11.5x EBITDA on a trailing twelve-month basis.
- **Leadscope** The acquired business offers subscription-based access to advanced AI or machine-learning algorithms which can predict any potential safety issues for specific chemicals that are being considered as part of a drug development process. The platforms are so effective that the FDA has approved them to replace certain animal-based testing.
- **Potential for growth** Currently, the FDA has approved just one of a possible two or three dozen use cases for this "in silico" testing…clearly, as the testing software improves, and as the FDA widens the applicability of this approach, there is dramatic scope for material revenue upside, all at very high margin and on a recurring-revenue basis.
- **Accretive deal; forecasts increased** With the acquisition completing towards the end of FY 2019E, we expect a minimal contribution from Leadscope to current- year financials. For FY 2020E, we upgrade revenue, EBITDA and adjusted EPS by 5.2%, 6.5% and 8.1% respectively. FY 2021E, the same metrics increase by 5.2%, 6.4% and 7.8%.

Overall, we see Leadscope as an exceptionally good fit with Instem – the acquired business will benefit from Instem's global sales muscle, and Instem will add a useful and high-end software offering to its already-fast-growing informatics business.

The price appears reasonable, the Instem team has demonstrable track record of successful integration, and the strategic fit is clear. We look forward to watching the post-acquisition progress.

FYE DEC (£M)	2017	2018	2019E	2020E	2021E
Revenue	21.7	22.7	25.8	29.6	31.7
Adj EBITDA	2.4	4.1	4.9	6.3	6.9
Fully adj PBT	1.6	3.0	3.4	4.8	5.3
Fully adj EPS	11.0	15.5	17.5	23.2	25.2
EV/Sales	2.6x	2.5x	2.2x	1.9x	1.8x
EV/EBITDA	23.5x	14.0x	11.7x	9.0x	8.3x
PER	33.7x	24.0x	21.2x	16.0x	14.8x

Source: Company Information and Progressive Equity Research estimates

Background on Leadscope

Founded in 1997 and based in Columbus, Ohio, USA, Leadscope is a leading provider of in-silico safety assessment software, which is used to enhance and accelerate life sciences R&D. Clients use the group's tools to predict toxicity and perform expert reviews for a wide range of toxicity types, as shown in the image below.

The company currently has seven employees. All are based in Columbus and all are expected to remain with the Instem group post-acquisition.

The business is profitable. For the twelve months ending July 2019, it delivered sales of $1.9m and EBITDA of $0.4m. In the year ending December 2018, the company reported PBT of $0.5m. Leadscope had net assets of $0.4m as at 31 July 2019 and is being acquired debt-free.

The business model is primarily subscription-driven and can be deployed in the cloud (SaaS) or on site. The company has c65 clients, including 10 of the world's top 20 pharmaceutical companies.

Leadscope's software uses AI and machine-learning algorithms to predict potential safety outcomes from a database of over 500,000 toxicity studies for over 200,000 chemicals covering all major safety-related risks. Clients can extract knowledge from both public and in-house data.

Operationally, this is similar to Instem's KnowledgeScan informatics suite – however a) the focus is on chemical substances not gene targets, and (b) Leadscope licenses the software for clients to use to create the scientific report, whereas Instem provides a full service, leveraging the KnowledgeScan software platform to deliver a full scientific report.

Toxicity use cases

- Easy-to-use tool to predict toxicity and perform expert review for:
  - genetic toxicity
  - skin sensitization
  - carcinogenicity
  - acute toxicity
  - reproductive and developmental toxicity
  - organ toxicity (liver, kidney, cardiac)
  - environmental toxicity

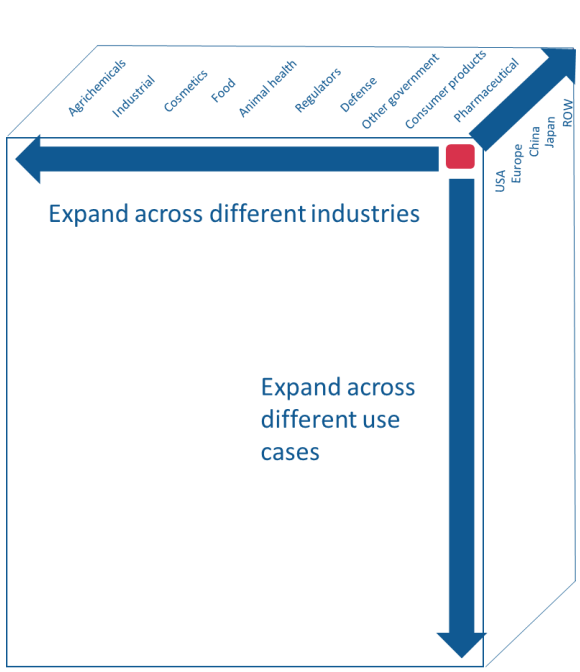
Source: Company data

Major growth opportunity

The mandate of the FDA is not to slow/impede progress in pharmaceutical research, but to allow progress as fast as possible - but only in a totally safe manner. The FDA has concluded that in silico toxicology testing is an increasingly important part of toxicology testing and made public statements to that effect[1].

Although the FDA has expressed positive views on in-silico research, currently only the "assessment of genotoxic impurities" is approved by both the FDA and ICH (The International Council for Harmonisation of Technical Requirements for Pharmaceuticals for Human Use). According to Instem, there are between 20 and 30 additional potential areas that could be licenced and each one could lead to $millions of revenues. The following image summarises the key opportunities

In silico use cases for toxicology testing – only the first is currently FDA approved…



Expand across different regions

Product Quality
- Assessment of genotoxic impurities (ICH M7)
- Evaluation of extractables and leachables
- Evaluation of food contact materials
- Metabolites
- Residues of plant protection products
- Assessment of mixtures

Manufacturing and shipping
- Classification and labelling for transportation
- Workers' safety
- Ecotoxicology
- Green chemistry
- Assessing hazard of contaminants

Emergency responses
- Emergency response situations
- Environmental contaminants/pollutants

Regulatory submissions
- Industrial chemicals (ECHA, TSCA)
- Regulation of cosmetics
- Regulation of plant protection products
- Regulation of ENDS products
- Regulation of animal health products
- Regulation of pesticides
- Regulation of food
- Pharmaceutical - cardiac arrythmia
- Pharmaceutical – carcinogenicity
- Pharmaceutical - developmental toxicity
- Pharmaceutical - non-proarrythmia
- Pharmaceutical - repeated dose and organ toxicity
- Pharmaceutical - off-target profiling

Product discovery
- Prioritizing chemicals
- Prioritizing testing of chemicals
- Setting dose levels
- Rationalization of in vivo or in vitro study results
- Understanding (pre-)clinical signals
- Informing experimental design

Now Future

Source: Company information

As the chart shows, there are a very large number of different applications to which this type of approach could be applied. The FDA has concluded that in silico toxicology testing is acceptable as part of the development process, even going as far to say that more than half of all clinical trial data will come from computer simulation[2]. We therefore believe that it is only matter of time before the next use case is opened up – from discussions with management we understand that Leadscope's view is that the next area of focus may be the classification and labelling for transportation of various compounds – an off-beat area of the process, but an important one, and potentially amenable to in silico analysis.

[1] https://www.fda.gov/science-research/about-science-research-fda/how-simulation-can-transform-regulatory-pathways

[2] https://www.theatlantic.com/sponsored/vmware-2017/virtual-body/1625/

Strong fit with Instem's existing business

We believe there is a strong strategic fit between Leadscope and Instem's Informatics business, particularly with the group's KnowledgeScan platform. Put simply, Leadscope expands Instem's technology, customer base and geography. We also note:

- Although small in group terms, Instem's Informatics unit is already progressing well. Order volumes have been growing (£0.84m for the first nine months of 2019 +58% YoY) and revenues have been building. The Leadscope acquisition should provide a major boost to the Informatics division, adding scale and presence, as well as bringing leading and exciting technologies to the group.
- Leadscope itself is a smaller company, with just seven employees. We expect the business to benefit from being part of the (much larger) Instem group, particularly with a greater sales push and the ability to use the Instem platform for further expansion.
- We understand that over 75% of Leadscope's turnover is subscription- based, so recurring in nature. With c60% of Instem's revenues being recurring (H1 2019A), the Leadscope acquisition will further improve revenue visibility.

For further analysis of Instem's Informatics division, see our recent research report: Informatics in Focus: Progressive Equity Research, 16 October 2019

Structure of the deal

The initial consideration for the deal was $2.25m in cash, funded from existing resources. A further $1.1m was paid via the issuance of 231,966 new ordinary shares in Instem Plc.

The transaction also includes deferred and contingent considerations. The deferred consideration involves the cash payment of $0.375m in both November 2020 and November 2021. The contingent element (earnout) of $0.5m becomes payable in Q1 2022 should Leadscope's EBITDA exceed $0.5m in financial year 2021.

The maximum possible consideration for the Leadscope acquisition is therefore $4.6m - £3.6m at the current 1.27 £: $ exchange rate. Of that figure, c73% is payable upfront, 27% is deferred, with 11% contingent on Leadscope's 2021 financial performance.

We make three key observations on the deal structure:

- With c73% of the consideration paid upfront, cash outflow on the deal in FY2020E and FY 2021E will be relatively modest.
- Leadscope reported EBITDA of $0.4m in the twelve months ending July 2019. The 2021E $0.5m EBITDA earnout target appears somewhat unchallenging, feeling more like an insurance policy than a major element of the consideration.
- The price paid appears to be reasonable. Instem is paying c2.3x sales and 11.5x trailing EBITDA multiples for a business in an exciting area and one, we believe, which is growth constrained by a small team. Leadscope's strategic focus is on promoting the next area for FDA approval (easier), rather than pushing hard on sales for the first one (more difficult).

Changes to estimates

Following the Leadscope deal, we make changes to forecasts as shown in the table below. Note fuller financials are detailed overleaf. The acquisition completed just weeks before the 2019 financial year end. Aside from the initial cash consideration, the impact on current year financials is therefore somewhat limited. Note, we have made no changes to estimates on the underlying Instem business from those published in our previous research note (October 2019).

Changes to forecasts following the Leadscope acquisition

	FY 19E			FY 20E			FY 21E		
£m unless stated	**Old**	**New**	**Change (%)**	**Old**	**New**	**Change (%)**	**Old**	**New**	**Change (%)**
Revenue	25.7	25.8	0.5%	28.1	29.6	5.2%	30.2	31.7	5.2%
Adj EBITDA	4.9	4.9	0.5%	6.0	6.3	6.5%	6.5	6.9	6.4%
Fully adj PBT	3.4	3.4	0.4%	4.4	4.8	8.3%	4.9	5.3	8.0%
Fully adj EPS (p)	17.5	17.5	0.4%	21.5	23.2	8.1%	23.3	25.2	7.8%

Source: Progressive Equity Research estimates

Financially accretive, Leadscope is a relatively small acquisition in group terms, with 5.2%, 6.5% and 8.1% respective increases in revenue, EBITDA and EPS in the first full- year of consolidation (FY 2020E).

Our new forecasts assume a closing FY 2019E cash position of £4.5m, vs a previous expectation of £6.5m. The reduction reflects the initial consideration payment for Leadscope. In both FY 2020E and FY 2021E, we assume payments for the deferred consideration will be made, leaving an assumed £0.4m liability on the FY 2021E closing balance sheet for the contingent consideration.

Summary

Although relatively small in group terms, we believe the Leadscope acquisition is a strategically sensible deal, with excellent operational fit – particularly with Instem's Informatics division. The deal is accretive, and in our view, the price paid is reasonable.

Leadscope itself is an attractive business, and one that has potentially been held back by its small scale and historic focus on working to expand FDA/ICH acceptance of the practice. Instem will allow that work to continue but will also provide a major sales boost and global reach.

Lastly, having made a number of successful acquisitions over the recent past – including BioWisdom (2011), Logos (2013), Perceptive Instruments (2013), Notocord (2016) and Samarind (2016), we believe the Instem Management team has a strong track record on M&A. We look forward to further news post the acquisition, and as the business benefits from its position within the larger group.

Financial Summary: Instem

Year end: December (£m unless shown)

PROFIT & LOSS	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Revenue	21.7	22.7	25.8	29.6	31.7
Adj EBITDA	2.4	4.1	4.9	6.3	6.9
Adj EBIT	1.8	3.2	3.3	4.7	5.2
Reported PBT	0.3	1.7	2.5	3.7	4.5
Fully adj PBT	1.6	3.0	3.4	4.8	5.3
NOPAT	1.3	2.4	2.9	3.9	4.2
Reported EPS	4.0	8.7	14.0	17.8	21.3
Fully adj EPS	11.0	15.5	17.5	23.2	25.2
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	4.3	5.3	4.6
Free Cash flow	0.2	0.6	2.5	2.9	3.1
FCF per share	1.0	3.3	14.6	17.3	18.7
Acquisitions	(0.9)	(0.2)	(1.9)	(0.3)	(0.3)
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	1.0	2.6	2.8
Cash & equivalents	3.1	3.6	4.5	7.2	10.0
Net (Debt)/Cash	3.1	3.6	4.5	7.2	10.0

NAV AND RETURNS	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Net asset value	13.8	16.4	18.3	21.1	28.2
NAV/share	88.3	105.1	115.7	133.3	178.1
Net Tangible Asset Value	(3.7)	(1.0)	2.4	6.0	10.9
NTAV/share	(23.5)	(6.5)	15.2	37.9	68.7
Average equity	13.3	15.1	17.4	19.7	24.6
Post-tax ROE (%)	4.8%	9.7%	13.5%	15.2%	14.6%

METRICS	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Revenue growth		4.8%	13.5%	14.7%	7.3%
Adj EBITDA growth		67.6%	20.3%	30.0%	8.8%
Adj EBIT growth		80.3%	5.7%	40.4%	10.9%
Adj PBT growth		84.7%	12.8%	40.4%	11.3%
Adj EPS growth		N/A	13.2%	32.1%	8.6%
Dividend growth		N/A	N/A	N/A	N/A
Adj EBIT margins		14.0%	13.0%	15.9%	16.4%

VALUATION	**2017**	**2018**	**2019E**	**2020E**	**2021E**
EV/Sales	2.6	2.5	2.2	1.9	1.8
EV/EBITDA	23.5	14.0	11.7	9.0	8.3
EV/NOPAT	43.1	23.9	19.5	14.8	13.6
PER	33.7	24.0	21.2	16.0	14.8
Dividend yield	N/A	N/A	N/A	N/A	N/A
FCF yield	0.3%	0.9%	3.9%	4.7%	5.0%

Source: Company information and Progressive Equity Research estimates

Progressive EQUITY RESEARCH

18 November 2019

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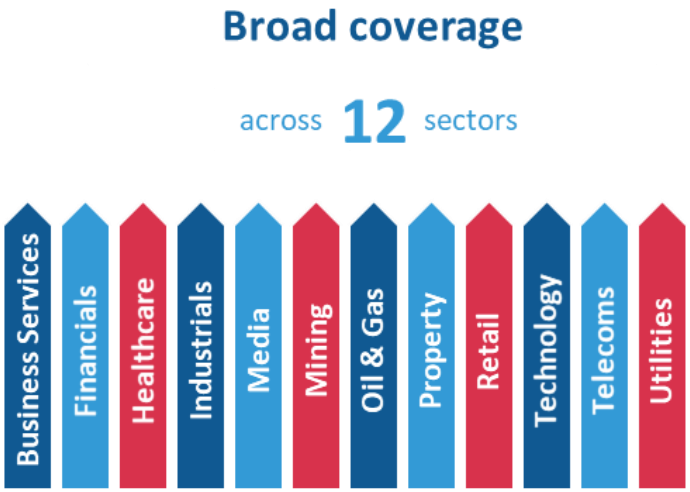

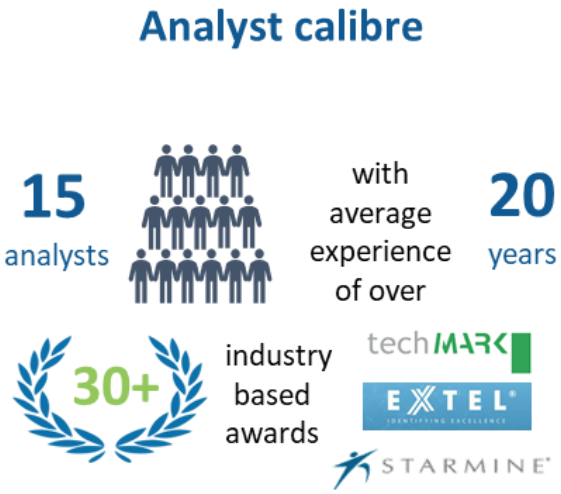

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