INSTEM

SOFTWARE AND COMPUTER SERVICES

15 May 2023

INS.L

660p

Market Cap: £150.9m

SHARE PRICE (p)

12m high/low	805p/590p

Source: LSE Data (priced as at prior close)

KEY DATA

Net (Debt)/Cash	£6.9m *(at 31/12/22)*
Enterprise value	£144m
Index/market	AIM
Next news	Trading Update, July
Shares in Issue (m)	22.9
Chairman	David Gare
Chief Executive	Phil Reason
CFO	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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Strong FY22 results and a positive start to FY23

Instem's FY22 results demonstrate the benefits of the strategic acquisitions made during 2021. Revenue growth was an impressive 28% YoY (+20% cc), with all four divisions making a positive contribution. Margins improved during the year, as once again did earnings quality. Management's outlook commentary is positive, with the release signalling that the order book and current trading are both 'strong'. We revise FY23E and FY24E earnings estimates following today's release and introduce FY25E forecasts.

- **Strong top-line growth and margin expansion.** Group revenue increased 28% to £58.9m (FY21: £46.0m), including first full-year contributions from the three acquisitions made during 2021. All four business lines reported strong growth, with Study Management and Clinical Trial Acceleration – the two largest segments – being the stand-out performers (revenue +27% and +37%, respectively). Adjusted EBITDA grew 32% to £10.9m (FY21: £8.3m), with the margin +52bp. This is a solid performance, in our view, given ongoing investment in the platform, plus salary inflation.

- **Positive cash performance; financial position remains robust.** Cash performance was strong once again, with net cash generated from operations of £9.9m representing 91% of adjusted EBITDA. The group's financial position remains robust, with a net cash position as at 31 December 2022 of £6.9m, including £5.8m deferred and contingent acquisition payments and £1.3m of right-of-use liabilities.

- **Earnings quality continues to improve.** The ongoing transition to SaaS delivery is driving growth in recurring revenues, which increased 43% during the year to £34.5m. Recurring revenues now represent 59% of the total (+7pp YoY), with the change in revenue mix in the Clinical Trial Acceleration business away from consulting services a key driver of the improvement.

- **Confident outlook.** The release highlights a 'strong' order book and a 'strong' start to current-year trading. Against a buoyant pharma market backdrop, we believe the new contracts won post period-end and the essential price increases implemented during 2022 provide further grounds for confidence in the outlook.

- **Forecast commentary.** We revise FY23 and FY24 estimates following today's release, and to reflect the ToxHub acquisition and Samarind disposal. The result is a reduction to adjusted EBITDA of 17% in FY23E, followed by a 10% reduction in FY24E.

FYE DEC (£M)	2021	2022	2023E	2024E	2025E
Revenue	46.0	58.9	65.0	73.4	81.0
Adj EBITDA	8.3	10.9	12.0	14.6	17.5
Fully adj PBT	5.9	8.2	8.7	11.1	13.9
Fully adj EPS (p)	20.4	31.3	30.9	39.5	49.5
EV/Sales	3.1x	2.4x	2.2x	2.0x	1.8x
EV/EBITDA	17.5x	13.3x	12.0x	9.9x	8.2x
PER	32.4x	21.1x	21.4x	16.7x	13.3x

Source: Company Information and Progressive Equity Research estimates.

Favourable industry tailwinds

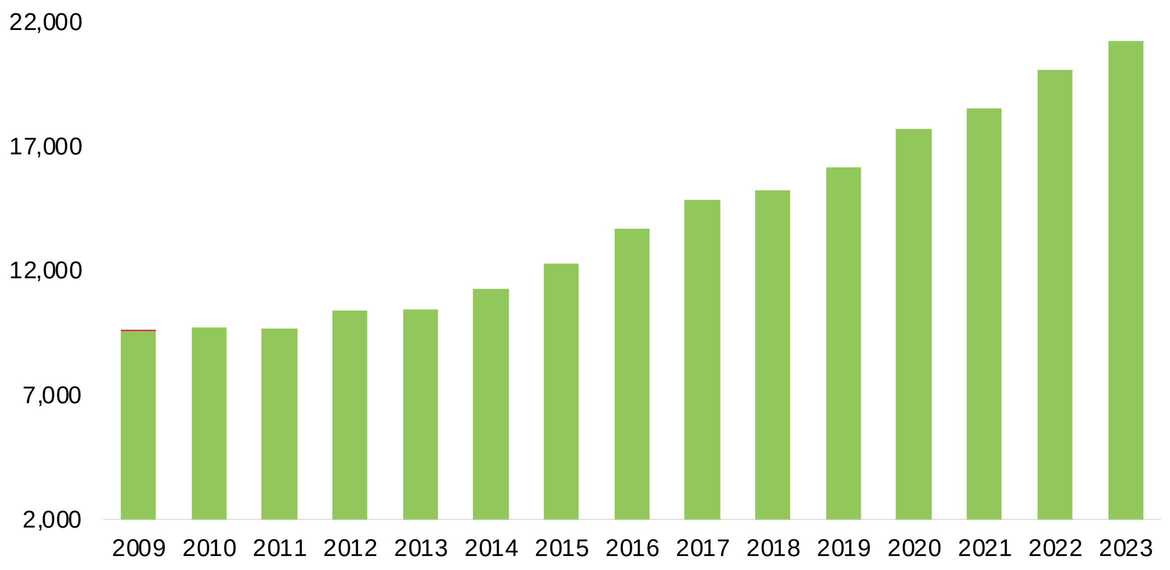
We continue to believe that the overall industry backdrop for Instem remains favourable. Our positive view is supported by two major factors:

- A record number of drugs are currently in the development pipeline.
- The cost of drug development remains high, with returns uncertain.

Record number of drugs in development…

Global population growth and increasing life expectancy continue to drive demand for innovative life science solutions. A key indicator of general industry health is the size of the drug development pipeline, as illustrated in the following chart.

Global pharma pipeline (drugs in development – units)



Source: Pharmaprojects Annual Review, January 2023

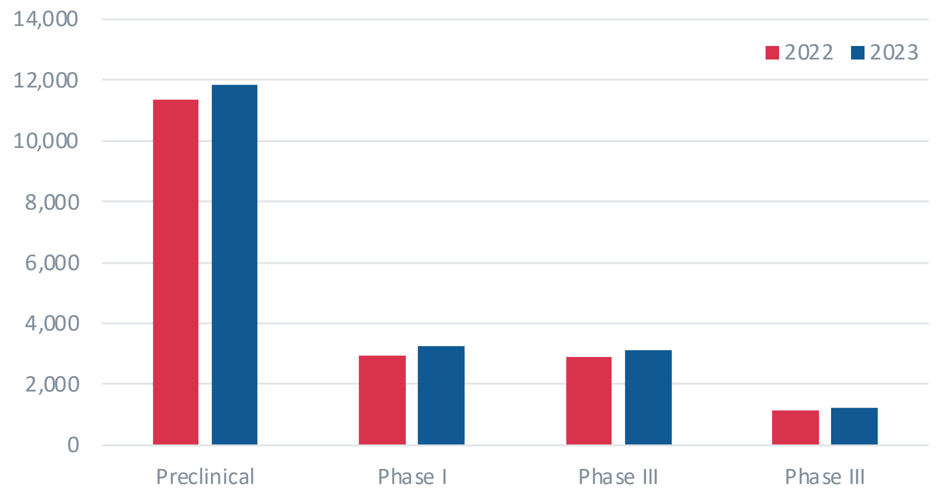
More than 21,000 drugs are currently in the global drug development pipeline (+6% YoY), with the pipeline having more than doubled over the past decade. In our view, this continues to demonstrate the resilience of the global pharma industry, despite the backdrop of global macroeconomic uncertainty. Although a slight decline on the Covid-boosted 8% reported in 2022, the 6% annual growth figure for 2023 is consistent with the five-year historical trend.

Instem's solutions allow clients to bring products to market more rapidly and at lower cost. The pharma sector continues to represent the largest proportion of the group's revenue and, as highlighted in our previous research, we believe the size of the pipeline is a key leading indicator of demand trends for the types of software and services provided by the group.

…with good growth in early-stage drug development

Although Instem provides services along the entire drug development lifecycle, the business is more centred on early-stage R&D. The picture here also remains positive. As the following chart demonstrates, early-stage drug development volumes are both growing and continuing to dominate the overall development pipeline. The Preclinical stage and Phases I-III continue to represent over 90% of the current global pipeline in aggregate, and each of the four segments reported solid growth in 2023, maintaining the positive historical trend.

Early-stage global pharma pipeline (drugs in development – units)



Source: Pharmaprojects Annual Review, January 2023

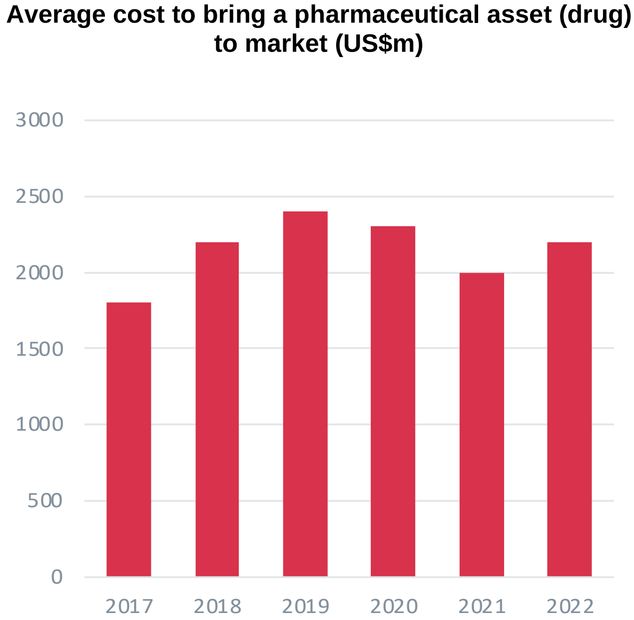
Note: Pharmaprojects divides drug development into 10 stages. We have presented the first four in the chart as, in our view, these are the stages most relevant to Instem.

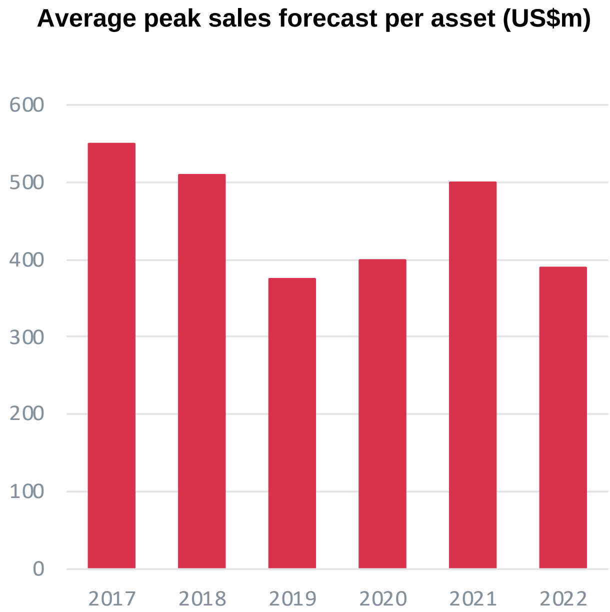
The cost of drug development remains high

To quote the US Congressional Budget Office: "Developing new drugs is a costly and uncertain process, and many potential drugs never make it to market."[1] As shown in the following charts, estimates[2] of the average cost of drug development across the industry remains high and forecast returns have suffered.

[1] *Research and Development in the Pharmaceutical Industry*, US Congressional Budget Office, April 2021
[2] *Seize the digital momentum*, Deloitte, January 2023

Key pharmaceutical industry return drivers, 2017-22





Source: Seize the Digital Momentum, Deloitte, January 2023

The Deloitte report focuses on the 20 largest pharma companies. In our view, the charts demonstrate a double whammy on drug development returns. On the cost side, the average cost to bring an asset to market rose during 2022 to almost pre-pandemic levels. Deloitte estimates the average cost to develop a drug rose to $2.28bn in 2022, an increase of $0.3bn vs 2021. On the revenue side, forecast peak revenues are materially lower than the previous year, and the level of five years ago.

In addition, the drug development failure rate is estimated to be as high as 90%[3], so the probability of success is very low. As the Deloitte report highlights: “Our 2022 analysis shows a return to the IRR experienced before the pandemic, reflecting the ongoing realities of the challenges to the industry – increasing costs with declining returns.”

We believe these trends represent additional positive industry tailwinds for Instem. The group’s solutions are specifically designed to lower the cost of, and thereby improve the returns on, drug development. In our view, the backdrop of high costs and uncertain returns further improves the attractions of the Instem offering.

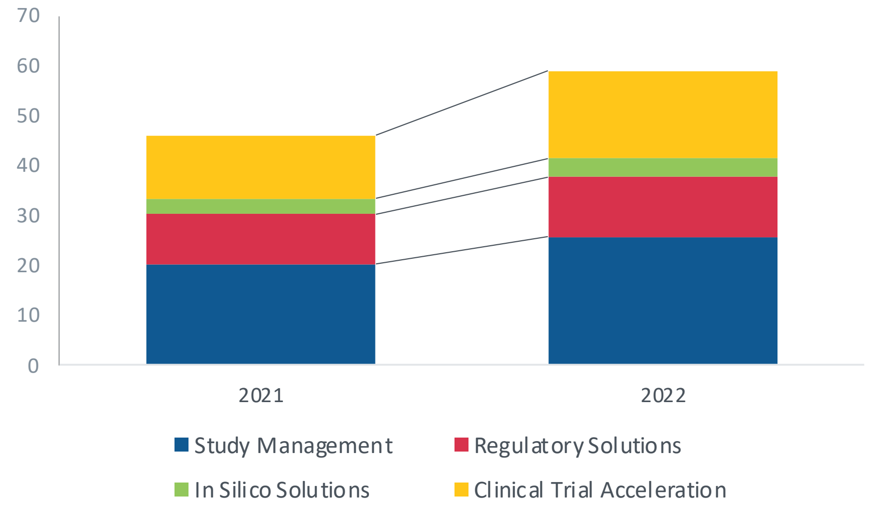
[3] https://www.science.org/content/blog-post/latest-drug-failure-and-approval-rates

FY22 results

Divisional performance

As summarised in the following chart, FY22 saw impressive growth in all four of Instem's business lines.

Instem – FY22 revenue trends (£m)



Source: Company data

Study Management *(44% of revenue FY22, +27% YoY)*

Instem's Study Management suite has been a focus of recent investment in the business and was enhanced via two of the three acquisitions made during 2021.

The group's largest business line continues to benefit from the market growth in non-clinical research and development (discussed above). Intrinsically, the greater the number of drugs in the pipeline, the greater the number of research studies and the greater the need for study management.

Operational highlights during 2022 include:

- The $1.4m contract extension signed in December 2022 for over 900 users of the Provantis non-clinical study management platform. See our note *Major license fee underpins full-year result, 22 December 2022.*
- The licensing of over 3,000 additional Provantis users during 2022. This is a new record.

Clinical Trial Acceleration *(37% of revenue FY22, +37% YoY)*

The group recorded a number of significant new business wins during the year in the Clinical Trial Acceleration unit, including its largest ever contract win. The deal is a five-year $12m agreement with a leading global contract research organisation (CRO). Instem is deploying its new Aspire statistical computing environment solution to over 2,000 users worldwide.

As we commented in our research note (*Largest ever contract validates growth strategy*, 5 September 2022), we believe there are a number of positives to this announcement. The deal is both material and profitable. In our view, it also further demonstrates Instem's inherent M&A ability. The group's Clinical Trial Acceleration business was formed in 2021 following the d-Wise acquisition in March of that year. Less than 18 months later, the acquisition had already been leveraged to sign the group's largest ever single contract.

Regulatory Solutions *(20% of revenue FY22, +20% YoY)*

The release signals strong growth in SEND services, which grew 24% YoY to £10.8m. To recap, SEND is the standard for sending non-clinical datasets for approval to the US Food and Drug Administration. The business is benefitting from the growing pipeline of drugs in development, and also the extension of SEND to cover a broader range of study types.

The announcement confirms the sale on 1 April of the Samarind regulatory information management business to Ennov Solutions. This was a small part of the group, contributing just 2% of FY22 revenue. FY22 proved challenging for Samarind, with the unit reporting a 7% YoY decline in revenue. The consideration was £0.8m paid in cash upon completion, with an additional £0.2m in cash contingent on Samarind's future financial performance.

With Samarind now sold, the SEND business has been transferred into Study Management, which has a greater overlap in terms of clients and workflows.

In Silico Solutions *(6% of revenue FY22, +24% YoY)*

Instem has seen growing demand for reliable alternatives to traditional (animal and human based) pharmaceutical testing methods. In silico models are one alternative, posing no potential harm to animals or humans as research is conducted via computer. Instem established the In Silico Solutions division in 2019 in order to capture emerging growth opportunities in this market. FY22 saw significant investment in the group's offerings in this area, with operational progress during the year:

- In November 2022, Instem announced the latest edition of the Leadscope Model Applier Computational Toxicology Solution.
- 2022 also saw a number of improvements to the Knowledgescan Target Safety Assessment Platform.
- Growth in demand for alternative testing methods was a key factor in the acquisition of the ToxHub suite. This has been combined with Instem's existing in silico offerings to form the Centrus product suite (see below).

ToxHub acquisition

Alongside the results (post-period-end), Instem has announced that it has been granted exclusive rights from the eTRANSAFE consortium to transition the ToxHub Platform into the group's Centrus (In Silico) suite.

The consortium began development of ToxHub in 2017 and has spent c.€41m on the platform to date. The platform includes valuable data from around 10,000 non-clinical research studies and a small number of clinical studies.

With Instem accelerating investment in the platform, and continuing to work with the partners, the consortium has agreed that the transfer of ToxHub to Instem will require no consideration. The release also confirms ToxHub has received a first SaaS subscription order from pharma giant Bayer AG.

Group performance

Revenue

FY22 **revenue** increased by £12.9m to £58.9m, a 28% YoY improvement. Revenue growth was +20% YoY on a constant currency basis, with the consolidated revenue figure reflecting first full-year contributions from The Edge, PDS and d-Wise to group financials (all were acquired during 2021). The release confirms that all three acquisitions have been successfully integrated into the Instem group. As discussed, all four business lines made a positive contribution to growth during the year. It is also worth noting that this revenue growth was reported against a backdrop of the ongoing transition to SaaS delivery, where revenues are typically recorded over a longer timeframe and are initially lower.

Recurring revenues (support & maintenance, SaaS subscriptions) grew by an impressive £10.4m to £34.5m (+43% YoY) during the period, representing 59% of total revenue (FY22: 52%). The key driver of the improvement was a shift away from consulting services in the d-Wise business.

Instem implemented a number of price increases during H2 22. Despite this, the retention rate for recurring SaaS and Annual support revenues remained ahead of the company's 98% KPI. We welcome confirmation that price increases have not been accompanied by revenue churn.

Operating expenses and margins

Opex grew 27% during the period, slower than the 28% growth in revenue. The increase reflects ongoing investment in operational teams and the integration of The Edge, PDS and d-Wise into the group.

Adjusted EBITDA grew 32% YoY to £10.9m, giving a margin of 18.4% (FY21: 17.9%). This is a solid performance, in our view, given ongoing investment in the Instem platform, plus salary inflation.

Cash flow and financial position

Operating cash flows remain strong, with net cash generated from operations of £9.9m, broadly stable on the £10.3m reported for FY21. Although profits saw a material uplift during the year, operating cash flow was impacted by adverse working capital movements and the settling of a historical contract dispute.

The group continues to invest in the platform, with capex £0.8m higher than the comparable period at £3.0m.

The group closed FY22 with a net cash position of £6.9m. We note that this includes £5.8m deferred and contingent acquisition payments and c.£1.3m of right-of-use liabilities.

Forecast commentary

Following today's announcements, we make changes to forecasts as shown in the table below. Fuller financials are detailed on page 10.

Instem – Estimate changes

£m unless stated	FY23E Old	FY23E New	FY23E Change (%)	FY24E Old	FY24E New	FY24E Change (%)
Revenue	68.2	65.0	-5%	75.1	73.4	-2%
Adj EBITDA	14.4	12.0	-17%	16.2	14.6	-10%
Fully adj PBT	10.0	8.7	-13%	12.2	11.1	-9%
Fully adj EPS (p)	35.6	30.9	-13%	43.5	39.5	-9%
Net cash/(debt)	12.5	12.9	3%	25.0	18.4	-27%

Source: Progressive Equity Research estimates

- With the industry backdrop remaining favourable and a significantly enhanced platform and product set following the three 2021 acquisitions, we continue to expect the business to deliver solid growth over our forecast period.
- However, our revised estimates reflect the ToxHub acquisition and the disposal of the Samarind business, together with modified assumptions of the future revenue mix (as detailed below). ToxHub is in early-stage revenues, and our revised forecasts include c.2.5m of start-up costs across FY23E and FY24E. Samarind is included in forecasts for one month of FY23E, and fully removed from FY24E onwards.
- The overall result is that FY23E and FY24E adjusted PBT estimates are reduced by 22% and 13%, respectively.
- We are introducing FY25E estimates, as detailed on page 10. In summary, we forecast another year of solid revenue and profit growth, with margin expansion and positive cash flow.

Instem – Revenue breakdown, FY21A - FY25E

£m unless otherwise stated	FY21A	FY22E	FY23E	FY24E	FY25E	CAGR
Annual support fees	14.4	20.8	23.7	22.7	20.7	*10%*
SaaS subscription fees	9.7	13.7	18.1	24.9	32.6	*35%*
Licences	4.6	6.0	3.0	3.0	2.9	*-11%*
Professional services	3.7	3.2	3.3	4.5	5.8	*12%*
Technology-enabled outsourced services	6.4	8.5	10.8	11.9	12.5	*18%*
Consulting	7.3	6.6	6.1	6.4	6.4	*-3%*
TOTAL	**46.0**	**58.9**	**65.0**	**73.4**	**81.0**	***15%***
Growth %		*28.0%*	*10.4%*	*12.9%*	*10.3%*	
% of total						
Annual support fees	31%	35%	36%	31%	26%	
SaaS subscription fees	21%	23%	28%	34%	40%	
Licences	10%	10%	5%	4%	4%	
Professional services	8%	5%	5%	6%	7%	
Technology-enabled outsourced services	14%	14%	17%	16%	15%	
Consulting	16%	11%	9%	9%	8%	
TOTAL	**100%**	**100%**	**100%**	**100%**	**100%**	
Revenue % Recurring*	**52%**	**59%**	**64%**	**65%**	**66%**	

Source: Progressive Equity Research estimates

- Our FY23E and FY24E revenue estimates are lower than previously forecast because of the corporate activity discussed above.
- However, we have also revised assumptions of the revenue mix. For FY23E, we have increased our forecasts of support fee revenue, offset by reductions in the other business lines. SaaS sales are expected to remain the key growth driver over our forecast period.
- For FY24E, our revised estimates reflect increased support fee, SaaS and outsourced services revenues versus previous estimates.
- In FY25E, we expect SaaS and professional services to be the key growth drivers.
- The improved business mix from growth in SaaS and support fees benefits revenue visibility, which we expect to significantly improve over our forecast period.

Financial Summary: Instem

Year end: December (£m unless shown)

PROFIT & LOSS	2021	2022	2023E	2024E	2025E
Revenue	46.0	58.9	65.0	73.4	81.0
Adj EBITDA	8.3	10.9	12.0	14.6	17.5
Adj EBIT	7.1	9.4	8.8	11.2	14.1
Reported PBT	3.0	5.5	6.1	8.5	11.3
Fully adj PBT	5.9	8.2	8.7	11.1	13.9
NOPAT	5.5	8.5	7.0	9.0	11.3
Reported EPS (p)	7.4	19.8	20.2	28.3	37.7
Fully adj EPS (p)	20.4	31.3	30.9	39.5	49.5
Dividend per share (p)	0.0	0.0	0.0	0.0	0.0
CASH FLOW & BALANCE SHEET	**2021**	**2022**	**2023E**	**2024E**	**2025E**
Operating cash flow	10.3	9.9	10.3	11.4	16.7
Free Cash flow	6.8	4.4	5.2	5.7	10.2
FCF per share (p)	30.0	18.4	23.3	25.2	45.2
Acquisitions	(17.5)	(5.4)	(5.0)	(0.2)	0.0
Disposals	0.0	0.0	0.0	0.0	0.0
Capex	(2.4)	(3.5)	(3.5)	(3.5)	(3.5)
Shares issued	0.0	0.0	0.0	0.0	0.0
Net cash flow	(11.6)	(2.0)	0.3	5.5	10.2
Cash & equivalents	15.0	14.0	14.2	19.7	29.9
Net (Debt)/Cash	3.7	6.9	12.9	18.4	28.6
NAV AND RETURNS	**2021**	**2022**	**2023E**	**2024E**	**2025E**
Net asset value	47.7	53.4	56.1	70.1	86.5
NAV/share	222.2	244.8	257.5	321.8	396.6
Net Tangible Asset Value	(10.6)	(5.0)	(1.6)	9.9	23.7
NTAV/share	(49.3)	(22.9)	(7.5)	45.3	108.8
Average equity	40.5	50.5	54.7	63.1	78.3
Post-tax ROE (%)	4.1%	9.3%	8.3%	10.1%	10.8%
METRICS	**2021**	**2022**	**2023E**	**2024E**	**2025E**
Revenue growth		28.0%	10.4%	12.9%	10.3%
Adj EBITDA growth		31.7%	10.6%	21.4%	20.2%
Adj EBIT growth		33.0%	(7.2%)	28.5%	25.5%
Adj PBT growth		37.7%	6.3%	27.9%	25.2%
Adj EPS growth		N/A	(1.1%)	27.9%	25.2%
Dividend growth		N/A	N/A	N/A	N/A
Adj EBIT margins		16.0%	13.5%	15.3%	17.4%
VALUATION	**2021**	**2022**	**2023E**	**2024E**	**2025E**
EV/Sales	3.1	2.4	2.2	2.0	1.8
EV/EBITDA	17.5	13.3	12.0	9.9	8.2
EV/NOPAT	26.1	16.9	20.6	16.0	12.8
PER	32.4	21.1	21.4	16.7	13.3
Dividend yield	N/A	N/A	N/A	N/A	N/A
FCF yield	4.5%	2.8%	3.5%	3.8%	6.8%

Source: Company information and Progressive Equity Research estimates

15 May 2023

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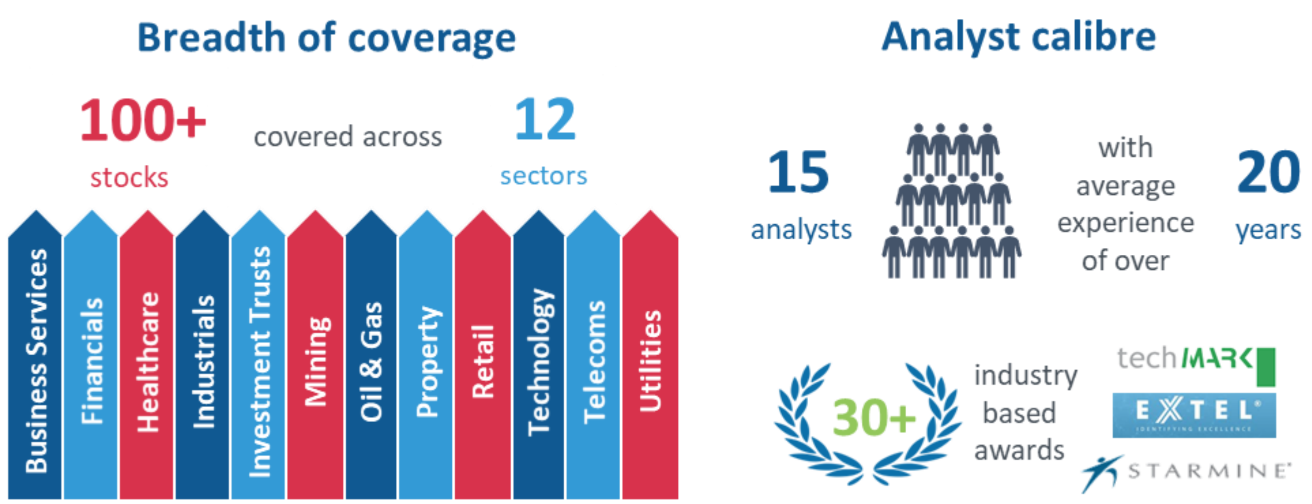

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