

stock update

RECOMMENDATION: LONG TERM BUY

Cogstate Limited

Achieving Strong Revenue Growth

 Stock Code: CGS
 Last Price: \$1.05
 Market Cap (fd): \$132.3m
 Risk Level: High

9 March 2017
EVENT

- Cogstate Limited (CGS) released its 1H17 result on 23 February 2017.

KEY HIGHLIGHTS

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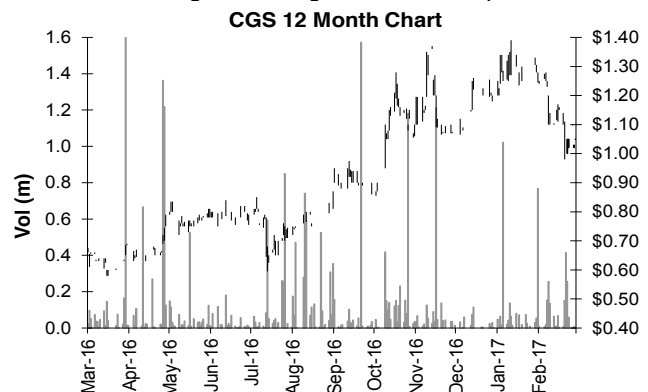
- CGS reported operating revenue of \$18.5m (+42.8% pcp), EBITDA of 1.7m (+38.4% pcp) and PBT of \$1.5m (+37.5% pcp). NPAT was \$1.0m (-62.2%) with the reduction due to a tax benefit (\$1.5m) from US carry forward losses not being repeated in the half.
- Clinical Trials revenue (excl. Precision Recruitment) was \$18.3m (+49.4% pcp). 1H17 contract signings were US\$23.0m (+38.6% pcp) with US\$17.3m and US\$5.7m signed in Q1 and Q2 respectively. Repeat clients represented 76% of clinical trial contracts signed (40% - 50% is the standard for CRO partners according to CGS).
- CGS's client base includes multinationals with large presences in the US and Europe however currently the focus is on clinical trials conducted in the US. Management considers Europe as a growth opportunity and intends to leverage their existing client relationships with these companies to provide solutions for clinical trials conducted in Europe. To further this goal, an office in London is being considered.
- CGS is seeking to enter into the US healthcare market to provide cognitive assessment tools to hospitals, physicians and consumer health applications. Regulatory approvals are expected to occur during FY18.
- In October 2016, Cogstate announced a partnership with Clinical Ink, a US technology company to deliver tablet based neuropsychological assessments for clinical trials focused on the central nervous system. CGS's primary contribution is its scientific expertise while Clinical Ink will bring the technology. The first combined sale is yet to be made. CGS has seven outstanding proposals valued at \$62m in relation to this opportunity.
- Revenue in 1H17A from Precision Recruitment, the startup phase computerised clinical trial pre-screening tool was ~\$0.1m (-86.8% pcp). A small amount of revenue was earned from an on-site Precision Recruitment project that was reported in the clinical trials segment. The company has elected not to promote this product until more data around its ability to reduce screening costs is available.
- Lower revenue from Precision Recruitment has led us to make a downward revision to our FY17E forecasts while investment in the US healthcare growth initiative is expected to result in more modest EBITDA growth in FY18E.
- The company expects the strong momentum to continue and expects the 2H to be an improvement on 1H17. We note that the FY16 result benefited from \$1.6m in tax benefits that will not be repeated in FY17.

SELECT EQUITIES RECOMMENDATION

- Select Equities rates CGS as a LONG TERM BUY. Although the valuation is relatively full, demand for clinical trials requiring cognitive assessment remains robust, the company is likely to achieve strong revenue growth and it is profitable.

June Year End	FY16A	1H17A	FY17E	FY18E
Net Profit (\$m) (norm.)	1.0	1.0	2.2	2.4
Revenue (\$m)	27.3	18.5	38.7	47.7
EBITDA (\$m)	1.3	1.7	3.5	3.8
EPS (¢)	0.9	0.8	1.8	1.9
DPS (¢)	0.0	0.0	0.0	0.0
PER (x)	122.4	58.4	58.4	56.1
PER Rel Small Ords (%)	713%	340%	340%	327%
Ent. Value/ Revenue (x)	4.4	3.1	3.1	2.5
Ent. Value/ EBITDA (x)	94.3	34.4	34.4	31.5
# Shares fd (m)				126.0
Avg. Mthly Volume (m)				2.5
Diluted Mkt Cap (\$m)				132.3
Net Debt (\$m)				-11.2
Enterprise Value (\$m)				121.1

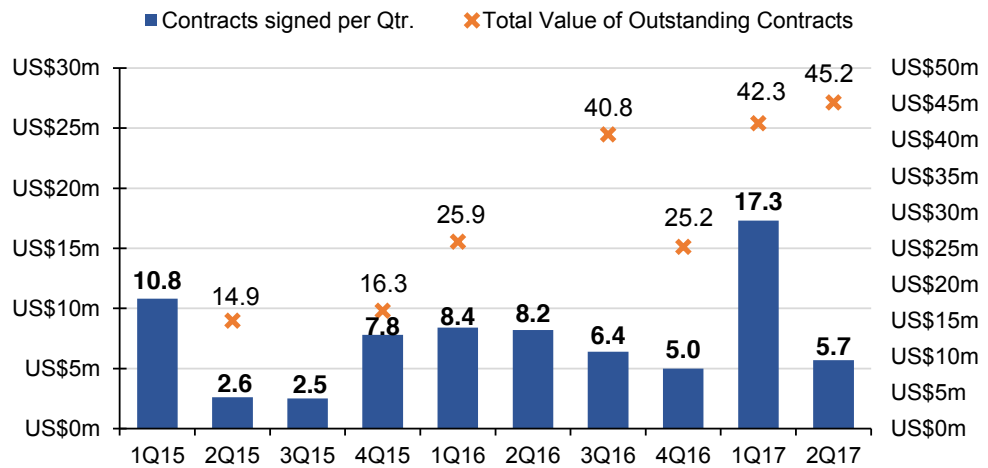
Source: Select Equities Research



Source: IRESS

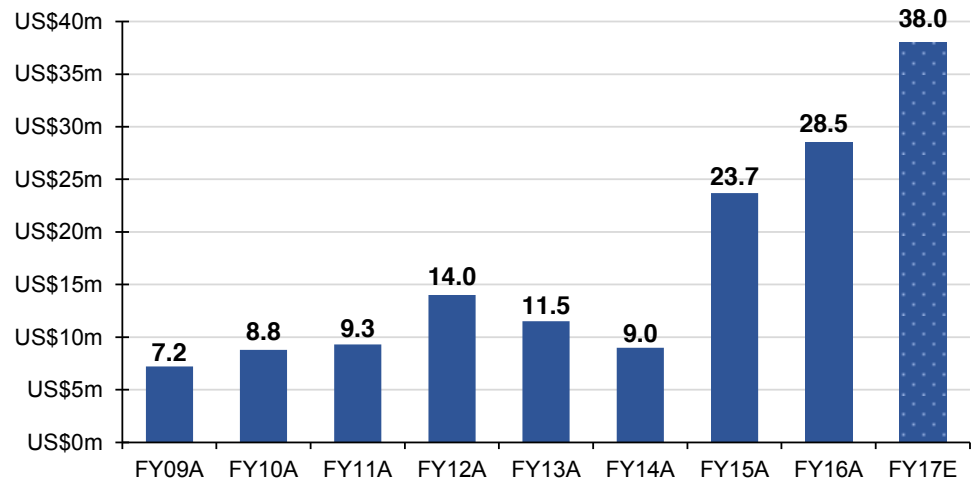
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QUARTERLY CONTRACTS SIGNED & TOTAL VALUE OF OUTSTANDING CONTRACTS



Source: Company Reports

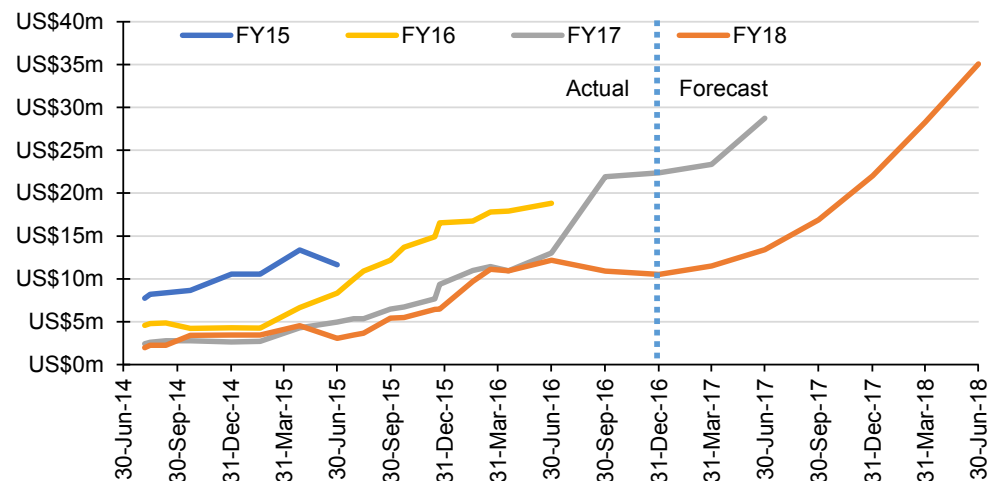
YEARLY CLINICAL TRIALS CONTRACTS SIGNED



Source: Company Reports & Select Equities Research

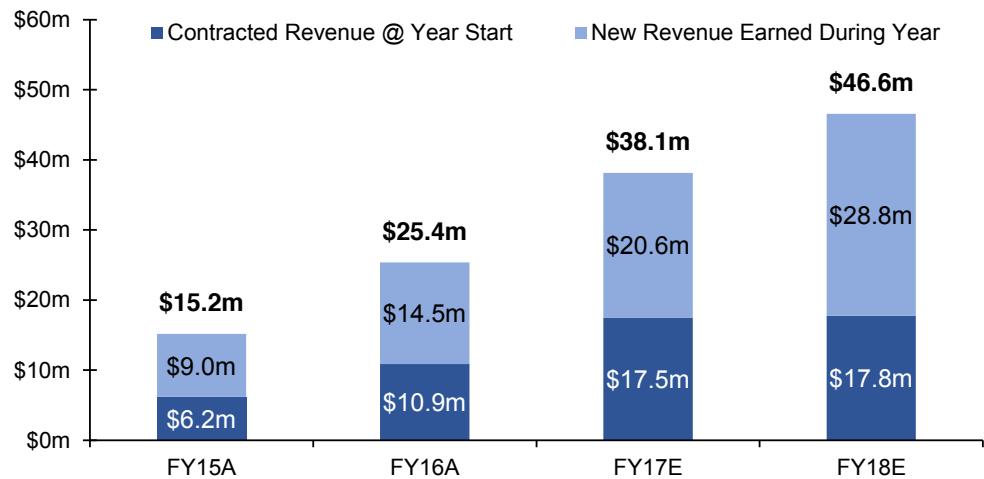
- Contracts signed in FY17 YTD are US\$23.0m.
- For the remainder of FY17E, our financial model forecasts assume that contract wins totalling US\$15.0m occur, bringing total contact wins in FY17E to US\$38.6m (+33.3%).

CONTRACTED CLINICAL TRIALS REVENUE



Source: Company Reports and Select Equities Research

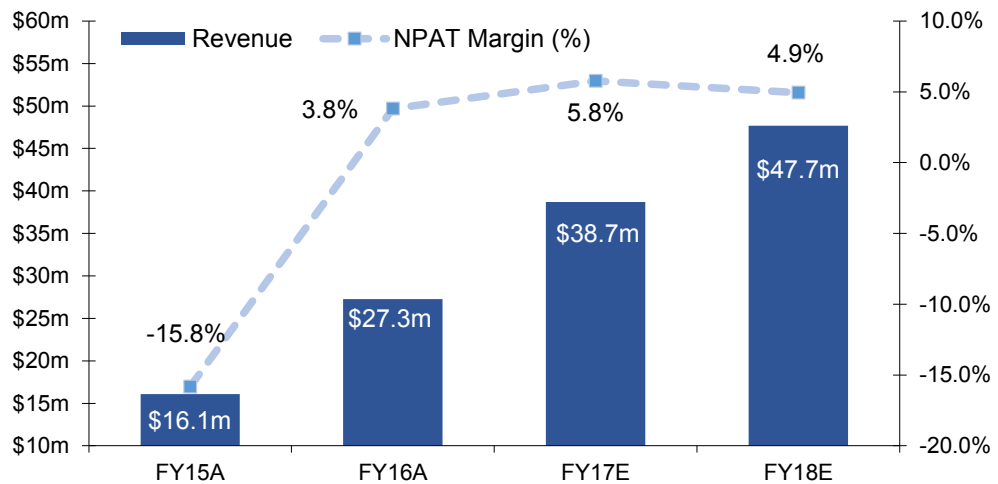
CLINICAL TRIALS REVENUE FORECAST



Source: Company Reports and Select Equities Research

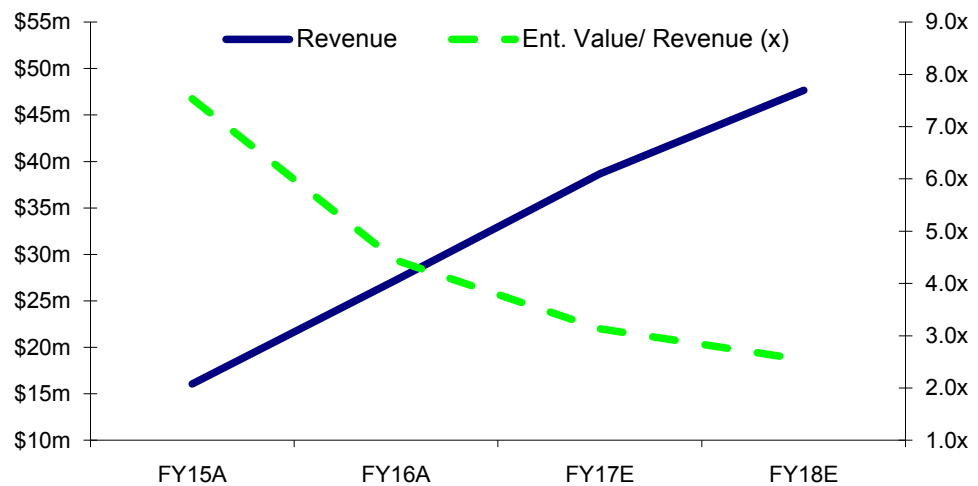
- 1H17 revenue derived from Clinical Trials (excl. Precision Recruitment) was \$18.3m (+49.4% pcp).
- Contracted revenue at the start of year increases over time as CGS announces new clinical trials revenue.

OPERATING LEVERAGE



Source: Company Reports and Select Equities Research

- The decline in NPAT margin in FY18E is attributable to investment in the US healthcare market.
- We expect that between \$2m to \$3m will be invested during FY18 in building this new business (staffing, regulatory approvals and R&D).
- CGS sees market potential for 25m cognition tests to occur each year in the US. The development of a drug for Alzheimer's disease, something that has yet to be achieved remains a key catalyst to accelerate this opportunity.

**VALUATION:
EV / REVENUE**


Source: Company Reports and Select Equities Research

**SER FORECAST
REVISIONS**

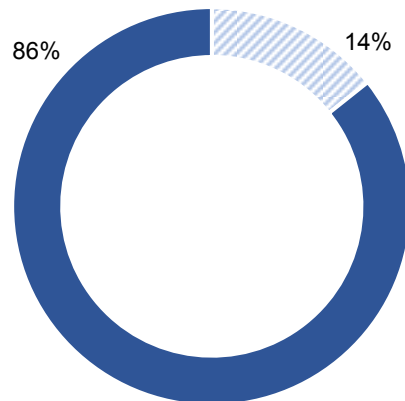
Date	31-Mar-16	22-Jul-16	7-Sep-16	18-Oct-16	8-Mar-17
Event	Initiation	4Q16	FY16	1Q17	1H17
Price (\$)	\$0.60	\$0.60	\$0.80	\$1.03	\$1.05
AUD/USD	0.766	0.750	0.768	0.763	0.753
Revenue (\$m)	37.7	37.1	36.1	41.8	38.7
Gross Profit (\$m)	22.0	21.3	20.3	23.1	21.5
EBITDA (\$m)	5.8	4.5	2.9	5.1	3.5
EBIT (\$m)	5.4	4.0	2.4	4.6	3.1
NPAT (\$m)	3.8	2.9	1.7	3.3	2.2
EPS (¢)	3.1¢	2.4¢	1.4¢	2.7¢	1.8¢
EV/Revenue (x)	1.8x	1.8x	2.5x	2.8x	3.1x
P/E (x)	19.5x	25.5x	56.8x	38.1x	58.4x
Recommendation	BUY	BUY	LTB	LTB	

**BUSINESS
DESCRIPTION**

- Cogstate Limited (CGS) is a niche CRO (contract research organisation) specialising in cognitive assessment that services global pharmaceutical and biotechnology companies.
- The company's core expertise are its proprietary computerised tests originally developed in 2001. Computerised cognition tests are not difficult to replicate, the barrier to entry is clinical acceptance. The efficacy of CGS's computerised tests is supported by over 400 peer review articles and they have been used in over 255 clinical trials.
- Cognitive assessment is used in the diagnosis and monitoring of patients suffering a range of conditions including chronic disorders like Alzheimer's disease, Depression and temporary conditions such as sports-related concussions.
- CGS is seeking to enter into the US Healthcare Market in FY17/FY18 to provide cognitive assessment tools to hospitals, physicians and consumers. The company estimates that there is potential for over 25m tests to be conducted per annum in the US. Frank Cheng was appointed in November 2016 to lead this initiative.
- The Precision Recruitment segment is an emerging part of the business that was launched in 2014. This product is a self-administered pre-screening assessment tool that lets pharmaceutical and biotech firms filter volunteers who are more likely to be recruited as candidates into a clinical trial enabling cost savings for the end client. Further promotion of this product is currently on hold.
- CGS is at present investing in opportunities to generate revenue in the healthcare segment by providing primary health physicians access to Cogstate's products.
- The company is headquartered in Melbourne and Connecticut, US and listed on the ASX in 2004. As at 31 December 2016, CGS had 152 full time equivalent employees.

CORPORATE GOVERNANCE

Executive Directors Non-Executive Directors



Source: Company Reports

- The company's board is comprised of six directors. The chairman, Martyn Myer is not involved in the day to day operations of the company however holds 17.3% of the shares on issue.
- Jane McAloon will be appointed as a non-executive director and chair of the Audit & Compliance Committee of CGS on 23 February 2017. She was previously the President of Governance & Group Company Secretary of BHP Billiton. Other non-executive director roles include Healthscope Ltd (member of the Audit, Risk & Compliance Committee and Nomination Committees) and Energy Australia.
- On 20 January 2017, it was announced that Dr Richard Mohs has been appointed as a non-executive director. Dr Mohs has a scientific background and has previously held senior rolls at Eli Lilly with a focus on Alzheimer's drug development and was a psychiatry professor at the Mount Sinai School of Medicine NY.
- We welcome the recent focus on increasing the independence of the board.

RISK FACTORS

- Uncontracted pipeline conversion makes up a significant portion of SER's revenue forecasts.
- Entering the fragmented Healthcare market may prove to be more costly and difficult than anticipated.
- CGS is a net exporter (~98% of revenue and ~78% of expenses are denominated in USD) and is negatively exposed to a rising AUD.
- Failure to adequately protect the company's intellectual property.
- Inability to maintain scientific/technological competitive advantage of the company's proprietary computerised tests and clinical trial knowhow.
- CGS's competitors have more academic recognition and/or are bigger.
- The company's expansion initiatives may require the company to undertake a capital raising.
- Inability of the commercial pilots of Precision Recruitment to lead to broader adoption.
- Reduction in the size of the clinical trials market for indications where cognition assessment plays a part.
- Regulatory approval and reimbursement risk for Cognigram.

Cogstate Limited

Select Equities Research

Financial Model

Code	CGS				June Year End	FY16A	1H17A	FY17E	FY18E	
Last sale (\$)	09-Mar-17				\$1.05					
# Shares (m)					113.2					
# Options (m)					12.9					
Diluted Mkt Cap (\$m)					132.3					
Net Debt (\$m)					-11.2					
Enterprise Value (\$m)					121.1					
June Year End	FY16A	1H17A	FY17E	FY18E	Financial Position (\$m)					
Financial Performance (\$m)					Cash	7.5	11.2	12.1	15.0	
Revenue	27.3	18.5	38.7	47.7	Accounts Receivable	6.2	7.8	8.5	10.2	
Gross Profit	15.3	10.5	21.5	27.0	PPE	1.7	1.9	2.5	3.3	
OpEx	-14.0	-8.8	-18.0	-23.2	Deferred Tax Assets	3.8	3.5	2.9	1.9	
EBITDA	1.3	1.7	3.5	3.8	Intangibles	0.4	0.4	0.4	0.4	
D & A	-0.3	-0.2	-0.4	-0.6	Total Assets	19.6	24.8	26.3	30.8	
EBIT	1.0	1.5	3.1	3.3	Accounts Payable	3.1	4.0	4.2	4.8	
PBT	1.0	1.5	3.2	3.4	Borrowings	0.0	0.0	0.0	0.0	
NPAT (pre-NCI & abs)	1.0	1.0	2.2	2.4	Provisions	1.7	1.9	2.4	3.3	
NCI	0.0	0.0	0.0	0.0	Unearned Revenue	0.3	2.6	2.6	3.2	
Normalised NPAT	1.0	1.0	2.2	2.4	Other Liabilities	0.7	0.8	0.0	0.0	
Abnormals	1.6	0.0	0.0	0.0	Total Liabilities	5.8	9.4	9.2	11.3	
Reported NPAT	2.6	1.0	2.2	2.4	Net Assets	13.8	15.4	17.1	19.4	
EPS (¢)	0.9	0.8	1.8	1.9	Issued Capital	27.9	28.3	28.2	28.2	
DPS (¢)	0.0	0.0	0.0	0.0	Reserves	0.6	0.7	1.3	1.3	
NTA/ Share (¢)	11.0	11.9	13.2	15.1	Retained Earnings	-14.7	-13.7	-12.4	-10.1	
Book Value / Share (¢)	11.3	12.2	13.6	15.4	NCI	0.0	0.0	0.0	0.0	
Valuation/Performance Ratios					Total Equity	13.8	15.4	17.1	19.4	
PER (x)	122.4	58.4	58.4	56.1	Cash Flows (\$m)					
Ent. Value/ Revenue (x)	4.4	3.1	3.1	2.5	Net Receipts	2.0	4.1	5.4	4.2	
Ent. Value/ EBITDA (x)	94.3	34.4	34.4	31.5	Net Interest	0.1	0.0	0.1	0.1	
Revenue Growth (%)	69.5%	42.8%	41.9%	23.2%	Tax Received/(Paid)	0.5	0.0	0.0	0.0	
Gross Profit Growth (%)	93.7%	40.9%	40.7%	25.4%	Operating Cash Flow	2.6	4.2	5.5	4.3	
OpEx Growth (%)	32.1%	41.4%	28.5%	28.6%	Acquisitions & Investments	0.0	0.0	0.0	0.0	
EBITDA Growth (%)	-147.2%	38.4%	174.1%	9.1%	Net Purchase of PPE	-1.6	-0.6	-1.2	-1.3	
NPAT Growth (%)	-140.9%	-4.7%	115.0%	5.6%	Net Purchase of Intangibles	0.0	0.0	0.0	0.0	
EPS Growth (%)	-139.0%	-7.0%	109.8%	4.0%	Investing Cash Flow	-1.6	-0.6	-1.2	-1.3	
P/NTA (x)	9.6	8.9	7.9	7.0	Net Change in Equity	0.9	0.3	0.3	0.0	
P/BV (x)	9.3	8.6	7.7	6.8	Net Change in Debt	0.0	0.0	0.0	0.0	
Yield (%)	0.0%	0.0%	0.0%	0.0%	Dividends	0.0	0.0	0.0	0.0	
Payout Ratio (%)	0.0%	0.0%	0.0%	0.0%	Financing Cash Flow	0.9	0.3	0.3	0.0	
Franking (%)	0.0%	0.0%	0.0%	0.0%	Net Inc/Dec Cash	1.9	3.9	4.6	2.9	
Gross Margin (%)	56.2%	56.5%	55.7%	56.7%	Cash at Beginning of Year	5.5	7.5	7.5	12.1	
EBITDA Margin (%)	4.7%	9.0%	9.1%	8.1%	Net FX Effect on Cash	0.1	-0.2	0.0	0.0	
EBIT Margin (%)	3.5%	8.0%	8.1%	6.9%	Cash at End of Year	7.5	11.2	12.1	15.0	
NPAT Margin (%)	3.8%	5.2%	5.8%	4.9%	Free Cash Flow (\$m)					
Current Ratio (x)	2.7	2.2	2.2	2.2	Operating Cash Flow	2.6	4.2	5.5	4.3	
Interest Cover (x)	-12.0	-41.0	-42.5	-32.5	Δ Working Capital	0.0	-1.7	-1.2	0.6	
Net Debt/Equity (%)	-54.2%	-73.0%	-70.6%	-77.1%	Normalised OCF	2.6	2.5	4.3	4.8	
ROE (%)	8.7%	14.5%	14.5%	12.9%	Less Maintenance CapEX	-0.9	-0.6	-1.2	-1.4	
ROIC (%)	18.0%	38.5%	38.5%	48.3%	Free Cash Flow	1.8	1.9	3.1	3.4	
Interim Results (\$m)					FCF/NPAT Conversion (%)	172%	197%	137%	145%	
Revenue	9.9	13.0	14.3	18.5	P/FCF (x)	74.2	43.2	43.2	38.8	
Gross Profit	5.7	7.4	7.9	10.5	Revenue Breakdown (\$m)					
EBITDA	0.0	1.2	0.1	1.7	Clinical Trials	25.6	18.3	38.1	46.6	
D & A	-0.3	-0.1	-0.2	-0.2	Growth (%)	68.4%	49.4%	49.2%	22.1%	
EBIT	-0.2	1.1	-0.1	1.5	Precision Recruitment	1.6	0.1	0.4	0.5	
PBT	-0.2	1.1	-0.1	1.5	Growth (%)	206.8%	-86.8%	-72.3%	13.6%	
Normalised NPAT	-0.1	1.0	0.0	1.0	Other Revenue	0.1	0.0	0.1	0.6	
Reported NPAT	-2.4	2.6	0.1	1.0	Contracted Revenue YTD	29.7			14.0	
					Substantial Shareholders					
									No. (m)	%
					Dagmar Dolby (Director)				19.8	17.5%
					Martyn Myer (Chairman)				19.5	17.2%
					Alan Finkel				9.0	8.0%
					Fidelity				↑ 9.3	8.3%

Source: Company Reports and Select Equities Research

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