

**stock update**

RECOMMENDATION:

HOLD

# Cogstate Limited

The perils of lumpy contracts

 Stock Code: CGS  
 Last Price: \$1.10  
 Market Cap (fd): \$138.3m  
 Risk Level: High

**20 July 2017**
**EVENT**

- Cogstate Limited (CGS) released its 4Q17 Business Update and an Earnings Update on 11 July 2017.

**KEY HIGHLIGHTS**

Paul Bates

- Clinical trial contract signings in Q4 disappointed with US\$3.0m secured, being the weakest quarterly result since 3Q15. For the year, new contracts totalled US\$29.6m (+3.9%) well below our estimate for 33% growth. Lower than expected revenue and a higher expense profile (due to new growth initiatives) has pushed the company to an unaudited PBT loss of \$1.0m in FY17.

Mark Southwell-Keely

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- The company has reiterated the lumpy and unpredictable nature of contract signings with ~US\$12.0m of sales contracts earmarked for Q4 being delayed.
- CGS's subdued demand and delays in new trial commencement appears to be stemming from pharmaceutical companies assessing the path forward following unsuccessful Alzheimer's trials by leading pharmaceutical firms including Eli Lilly (Solanezumab, November 2016) and Merck (Verubecestat, February 2017). There were fewer Phase 1 Alzheimer's trials in progress as at January 2017 when compared to the year prior.
- The critical question that will determine CGS's FY18 result is how quickly trials will recommence. The company has stated that the value of clinical trial sales pipeline opportunities have doubled since this time last year and that the average value of each contract has risen by 50%. This opens up the possibility for record quarterly contract signings if trials recommence promptly, or a period of prolonged stagnation. In 4Q16, there was a lull in contact wins that was followed by a strong rebound in 1Q17, a pattern that could repeat this year.
- Given the strong start to the year, FY17 revenue recorded from clinical trials was \$35.0m (+28%) (excluding pass through cost recoveries). Precision Recruitment was, as expected, a small contributor to FY17 revenue (\$0.5m) due to the initiative being placed on hold.
- The company maintains a healthy cash balance with \$9.3m on hand as at 30 June 2017 and no debt.
- The company intends to provide further detail as to the current market climate and outlook at the time of the release of the FY17 result on 22 August 2017.

**SELECT EQUITIES RECOMMENDATION**

- Select Equities rates CGS as a HOLD in light of 1) uncertainty surrounding the contract delays and short term demand and 2) the valuation being priced for strong revenue growth. We view management and the company's track record favourably and will look to reassess our recommendation as more information is released as part of the FY17 result.

June Year End	FY16A	FY17E	FY18E	FY19E
Net Profit (\$m) (norm.)	1.0	-0.7	0.4	2.8
Revenue (\$m)	27.3	35.0	37.9	52.5
EBITDA (\$m)	1.3	-0.7	0.9	4.6
EPS (¢)	0.9	-0.6	0.3	2.3
DPS (¢)	0.0	0.0	0.0	0.0
PER (x)	127.7	n/a	363.0	48.7
PER Rel Small Ords (%)	n/a	n/a	n/a	292%
Ent. Value/ Revenue (x)	4.7	3.7	3.4	2.5
Ent. Value/ EBITDA (x)	100.5	n/a	141.0	28.2
# Shares fd (m)				126.3
Avg. Mthly Volume (m)				1.4
Diluted Mkt Cap (\$m)				138.3
Net Debt (\$m)				-9.3
Enterprise Value (\$m)				129.0

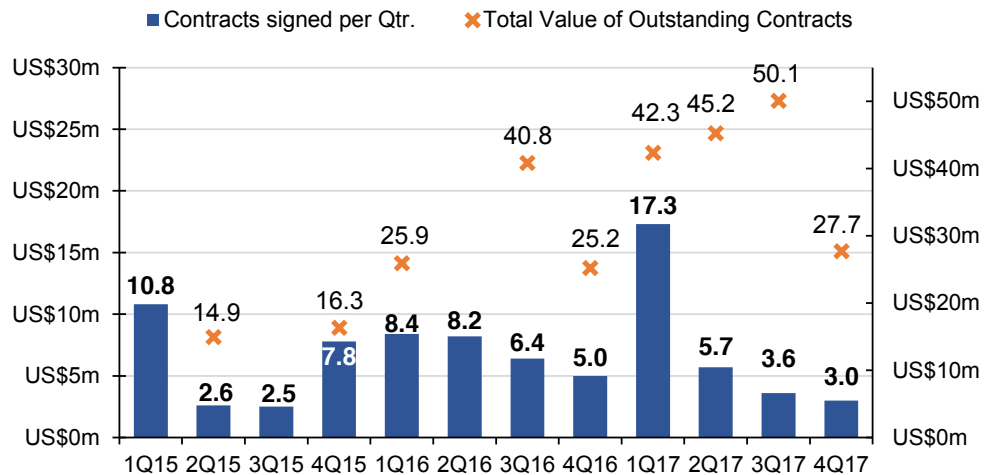


Source: Select Equities Research

Source: IRESS

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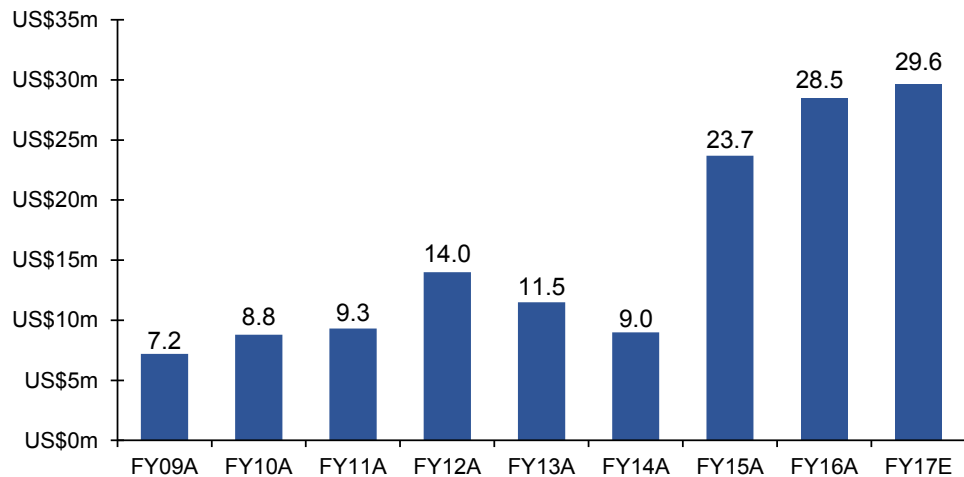
## QUARTERLY CONTRACTS SIGNED & TOTAL VALUE OF OUTSTANDING CONTRACTS



Source: Company Reports

- Q417 contract signings were US\$3.0m (-40% pcp). CGS stated that \$12.0m of sales contracts expected to be signed in FY17 have been delayed to FY18.
- We note that a comparatively weaker 4Q result followed by a strong Q1 also occurred in FY16 and there is potential for this pattern to be repeated in in FY18.

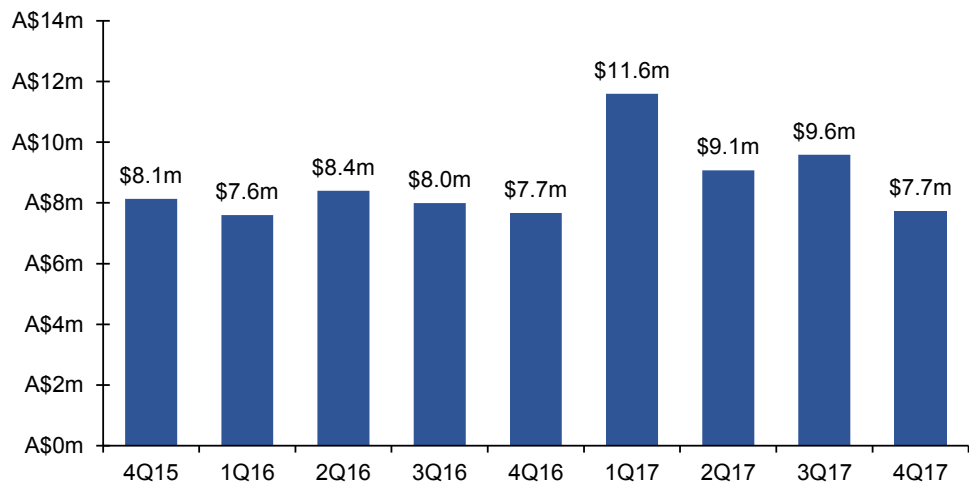
## YEARLY CLINICAL TRIALS CONTRACTS SIGNED



Source: Company Reports & Select Equities Research

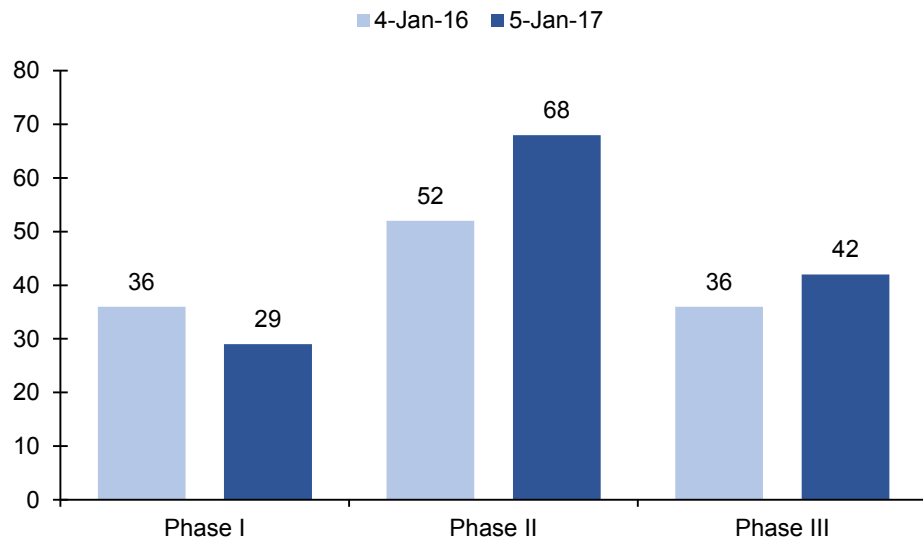
- Contracts signed in FY17 were \$29.6m (+4%). Growth in annual contract signings was disappointing being \$9.0m lower than our estimate.

## QUARTERLY REVENUE



Source: Company Reports and Select Equities Research

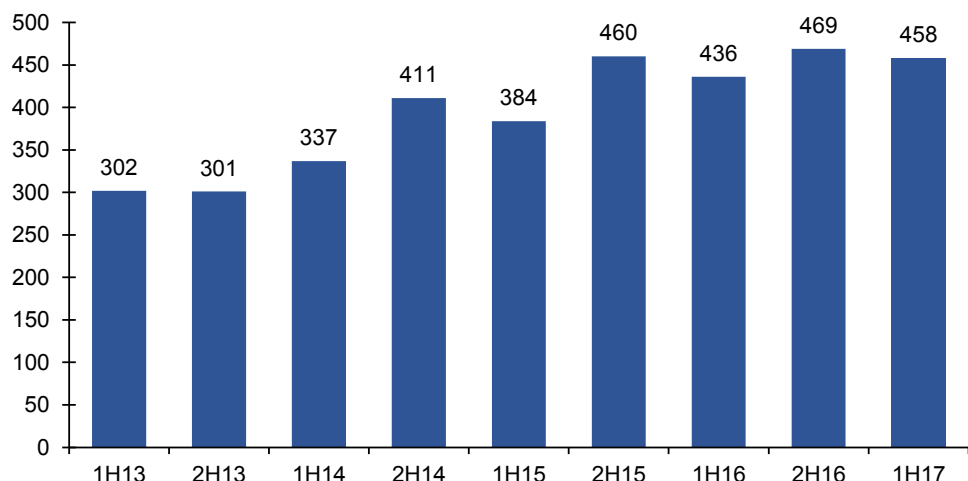
### NUMBER OF US ALZHEIMER CLINICAL TRIALS BY PHASE



Source: Cummings, J et al; Alzheimer's & Dementia: Translational Research & Clinical Interventions 3 (2017), 'Alzheimer's disease drug development pipeline: 2017' and Cummings J et al; Alzheimer's Dement 'Alzheimer's drug development pipeline: 2016' & Select Equities Research

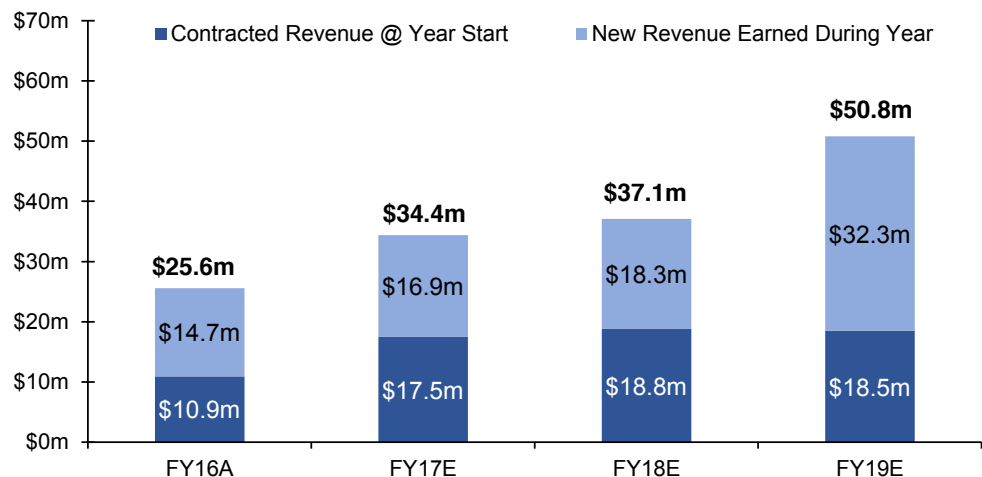
- As at January 2017, there were fewer US Alzheimer's disease phase I clinical trials when compared to the prior year however there was an increase in the number of phase II and III trials. The authors state **"the small number of phase I compounds is a concern for the overall health of the Alzheimer's disease pipeline"**. It should be noted that phase I trials are not the only source of compounds for later stage clinical trials as agents used in other studies could be applied to Alzheimer's applications.
- The company has reported delays in the commencement of clinical trial contracts and cancellations valued at US\$2.6m during 2H17. The extent of the decline will be able to be better assessed as more data becomes available.
- In FY16, 45% of sales contracts by value were derived from Alzheimer's disease clinical trials.
- There are 44 million people worldwide with Alzheimer's disease with this number projected to be 100 million by 2050. A treatment is yet to be found.

### NUMBER OF US ONCOLOGY CLINICAL TRIALS COMMENCING

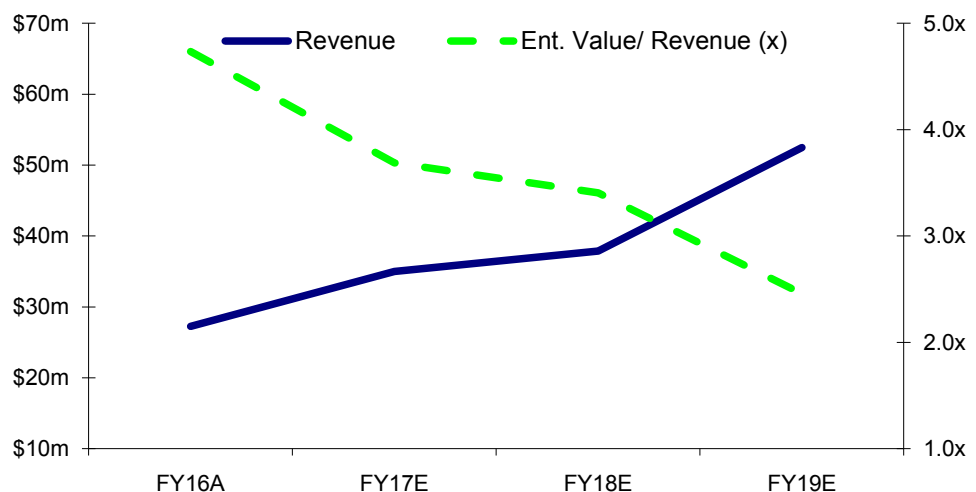


Source: ClinicalTrials.gov and Select Equities Research

- Growth in the number of oncology trials has been stable over the last two years.
- Cogstate's solutions are being increasingly used as a measure of cognition for clinical trials in the oncology space with this representing 20% of FY16 sales contracts.

**CLINICAL TRIALS REVENUE FORECAST**


Source: Company Reports and Select Equities Research

**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	20-Jul-17
<b>Event</b>	Initiation	4Q16	FY16	1Q17	1H17	4Q17
Price (\$)	\$0.60	\$0.60	\$0.80	\$1.03	\$1.05	\$1.10
AUD/USD	0.766	0.750	0.768	0.763	0.753	0.796
Revenue (\$m)	37.7	37.1	36.1	41.8	38.7	35.0
Gross Profit (\$m)	22.0	21.3	20.3	23.1	21.5	19.5
EBITDA (\$m)	5.8	4.5	2.9	5.1	3.5	-0.7
EBIT (\$m)	5.4	4.0	2.4	4.6	3.1	-1.1
NPAT (\$m)	3.8	2.9	1.7	3.3	2.2	-0.7
EPS (¢)	3.1¢	2.4¢	1.4¢	2.7¢	1.8¢	-0.6¢
EV/Revenue (x)	1.8x	1.8x	2.5x	2.8x	3.1x	3.7x
P/E (x)	19.5x	25.5x	56.8x	38.1x	58.4x	n/a
Recommendation	BUY	BUY	LTB	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.

**RISK FACTORS**

- Uncontracted pipeline conversion makes up a significant portion of our revenue forecasts.
- Demand from clinical trials in the Alzheimer's focus area may be subdued while future studies are reassessed as a result of the failure of promising drug trials in this area.
- 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				Financial Model				
Last sale (\$)	20-Jul-17				June Year End	FY16A	FY17E	FY18E	FY19E
# Shares (m)	\$1.10				Financial Position (\$m)				
# Options (m)	113.6				Cash	7.5	9.3	8.9	12.2
Diluted Mkt Cap (\$m)	12.7				Accounts Receivable	6.2	7.7	8.3	11.2
Net Debt (\$m)	138.3				PPE	1.7	2.6	3.2	4.1
Enterprise Value (\$m)	-9.3				Deferred Tax Assets	3.8	4.2	4.0	2.8
June Year End	FY16A	FY17E	FY18E	FY19E	Intangibles	0.4	0.4	0.4	0.4
Financial Performance (\$m)					Total Assets	19.6	24.2	24.9	30.7
Revenue	27.3	35.0	37.9	52.5	Accounts Payable	3.1	4.7	4.5	5.4
Gross Profit	15.3	19.5	21.9	30.8	Borrowings	0.0	0.0	0.0	0.0
OpEx	-14.0	-20.2	-21.0	-26.2	Provisions	1.7	2.7	3.0	4.0
EBITDA	1.3	-0.7	0.9	4.6	Unearned Revenue	0.3	2.6	2.8	3.9
D & A	-0.3	-0.4	-0.5	-0.6	Other Liabilities	0.7	0.0	0.0	0.0
EBIT	1.0	-1.1	0.5	4.0	Total Liabilities	5.8	10.0	10.3	13.3
PBT	1.0	-1.0	0.5	4.1	Net Assets	13.8	14.2	14.6	17.4
NPAT (pre-NCI & abs)	1.0	-0.7	0.4	2.8	Issued Capital	27.9	28.3	28.3	28.3
NCI	0.0	0.0	0.0	0.0	Reserves	0.6	1.3	1.3	1.3
Normalised NPAT	1.0	-0.7	0.4	2.8	Retained Earnings	-14.7	-15.4	-15.0	-12.2
Abnormals	1.6	0.0	0.0	0.0	NCI	0.0	0.0	0.0	0.0
Reported NPAT	2.6	-0.7	0.4	2.8	Total Equity	13.8	14.2	14.6	17.4
EPS (¢)	0.9	-0.6	0.3	2.3	Cash Flows (\$m)				
DPS (¢)	0.0	0.0	0.0	0.0	Net Receipts	2.0	2.6	0.6	4.7
NTA / Share (¢)	11.0	10.9	11.2	13.5	Net Interest	0.1	0.1	0.1	0.1
Book Value / Share (¢)	11.3	11.3	11.6	13.8	Tax Received/(Paid)	0.5	0.0	0.0	0.0
Valuation/Performance Ratios					Operating Cash Flow	2.6	2.7	0.7	4.7
PER (x)	127.7	n/a	363.0	48.7	Acquisitions & Investments	0.0	0.0	0.0	0.0
Ent. Value/ Revenue (x)	4.7	3.7	3.4	2.5	Net Purchase of PPE	-1.6	-1.3	-1.1	-1.5
Ent. Value/ EBITDA (x)	100.5	n/a	141.0	28.2	Net Purchase of Intangibles	0.0	0.0	0.0	0.0
Revenue Growth (%)	69.5%	28.4%	8.3%	38.5%	Investing Cash Flow	-1.6	-1.3	-1.1	-1.5
Gross Profit Growth (%)	93.7%	27.3%	12.2%	40.9%	Net Change in Equity	0.9	0.4	0.0	0.0
OpEx Growth (%)	32.1%	44.2%	3.5%	25.2%	Net Change in Debt	0.0	0.0	0.0	0.0
EBITDA Growth (%)	n/a	n/a	n/a	401%	Dividends	0.0	0.0	0.0	0.0
NPAT Growth (%)	n/a	n/a	n/a	646%	Financing Cash Flow	0.9	0.4	0.0	0.0
EPS Growth (%)	n/a	n/a	n/a	646%	Net Inc/Dec Cash	1.9	1.8	-0.4	3.3
P/NTA (x)	10.0	10.0	9.7	8.1	Cash at Beginning of Year	5.5	7.5	9.3	8.9
P/BV (x)	9.7	9.7	9.5	7.9	Net FX Effect on Cash	0.1	0.0	0.0	0.0
Yield (%)	0.0%	0.0%	0.0%	0.0%	Cash at End of Year	7.5	9.3	8.9	12.2
Payout Ratio (%)	0.0%	0.0%	0.0%	0.0%	Free Cash Flow (\$m)				
Franking (%)	0.0%	0.0%	0.0%	0.0%	Operating Cash Flow	2.6	2.7	0.7	4.7
Gross Margin (%)	56.2%	55.7%	57.7%	58.7%	Δ Working Capital	0.0	-2.4	0.6	0.9
EBITDA Margin (%)	4.7%	-2.1%	2.4%	8.7%	Normalised OCF	2.6	0.3	1.3	5.7
EBIT Margin (%)	3.5%	-3.1%	1.2%	7.6%	Less Maintenance CapEX	-0.9	-1.1	-1.3	-1.6
NPAT Margin (%)	3.8%	-2.1%	1.0%	5.4%	Free Cash Flow	1.8	-0.8	0.0	4.1
Current Ratio (x)	2.7	1.7	1.7	1.8	FCF/NPAT Conversion (%)	172%	116%	-6%	143%
Interest Cover (x)	-12.0	15.0	-5.3	-46.8	P/FCF (x)	77.6	-166.5	-5802.1	33.9
Net Debt/Equity (%)	-54.2%	-65.4%	-61.3%	-70.1%	Revenue Breakdown (\$m)				
ROE (%)	8.7%	-5.1%	2.6%	17.7%	Clinical Trials (inc cost rec.)	25.6	34.4	36.5	50.0
ROIC (%)	18.0%	-13.7%	6.1%	24.1%	<i>Growth (%)</i>	68.4%	34.3%	6.3%	37.0%
Interim Results (\$m)					US Healthcare	n/a	n/a	0.5	1.5
Revenue	13.0	14.3	18.5	16.5	<i>Growth (%)</i>	n/a	n/a	n/a	200.0%
Gross Profit	7.4	7.9	10.5	9.0	Precision Recruitment	1.6	0.5	0.8	0.9
EBITDA	1.2	0.1	1.7	-2.4	<i>Growth (%)</i>	206.8%	-65.4%	45.7%	12.5%
D & A	-0.1	-0.2	-0.2	-0.2	Other	0.1	0.1	0.1	0.1
EBIT	1.1	-0.1	1.5	-2.6	Contracted Revenue YTD				
PBT	1.1	-0.1	1.5	-2.5				18.8	18.5
Normalised NPAT	1.0	0.0	1.0	-1.7	Substantial Shareholders				
Reported NPAT	2.6	0.1	1.0	-1.7			No. (m)	%	
					Dagmar Dolby (Director)			19.8	17.4%
					Martyn Myer (Chairman)			19.5	17.2%
					Alan Finkel			9.0	7.9%
					Fidelity			↑ 9.3	8.2%

Source: Company Reports and Select Equities Research

6

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