

**stock update**

RECOMMENDATION:

HOLD

# Cogstate Limited

Worth some thought

 Stock Code: CGS  
 Last Price: \$1.09  
 Market Cap (fd): \$136.1m  
 Risk Level: High

**8 September 2017**
**EVENT**

- Cogstate Limited (CGS) released its FY17 result on 22 August 2017.

**KEY HIGHLIGHTS**

- FY17 Operating Revenue was \$34.9m (+28.2%), EBITDA was \$0.1m (\$1.3m pcp) and NPAT was -\$0.8m (\$1.0 norm. pcp).
- 1Q17 delivered a record number of clinical trial contracts but the momentum did not continue as the year progressed. Contracted revenue at the beginning of FY18 was \$18.9m, 8.0% higher than contracted revenue at the start of FY17. As a result we are forecasting FY18 revenue growth at a modest 9.4%.
- The principal reason for the slowdown was the failure of two advanced Alzheimer's trials by leading pharmaceutical companies (Eli Lilly, Solanezumab, November 2016 & Merck Verubecestat, February 2017). In response, several new studies were placed on hold pending the release of additional data explaining why the compounds were unsuccessful. The absence of a treatment for the 44 million people worldwide suffering Alzheimer's Disease along with the market opportunity for the developer of the first drug to market gives us confidence that investment in clinical trials will resume in the near future.
- In December 2017, the 28<sup>th</sup> International Symposium on ALZ/MND in Boston will take place which could act as a catalyst that leads to the resumption of Alzheimer's trials as more information becomes available.
- The Cognigram system, the core component of the company's US Healthcare initiative received US regulatory approval in July 2017, slightly earlier than expected. The cloud based technology allows individuals to self-assess their cognition with the results enabling medical professionals to identify cognitive impairment and changes over time. Initially the company will use its sales force to target hospitals offering unlimited access to the technology for a flat fee. Over time the intention is to move to a transactional (per test) revenue model. Our estimate of FY18 revenue to be derived from this segment is \$0.7m increasing to \$1.9m in FY19.
- Investment in the Healthcare segment was \$1.3m in FY17 comprising FDA submissions and the launch of Cognigram. The company expects to spend ~\$3.1m in FY18.
- CGS was not eligible for the R&D Tax Incentive in FY17 (pcp rebate \$0.6m) and is likely to remain ineligible going forward. This was because the company's FY16 revenue exceeded \$20m.
- Due to the US market being the driver of the company's earnings and is the growth focus for the business, the company will report its results in USD in future periods.

Paul Bates

Mark Southwell-Keely

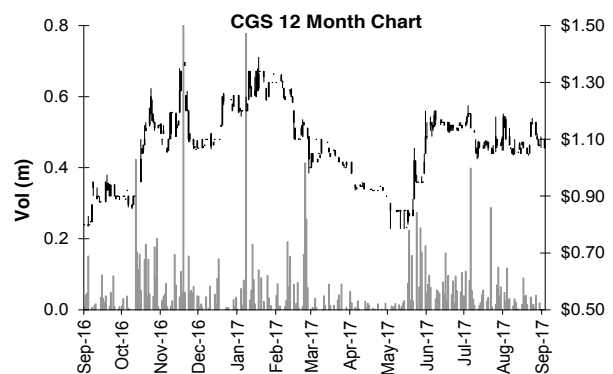
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**SELECT EQUITIES RECOMMENDATION**

- We rate the stock as a HOLD. Based on the current outlook, we would look to acquire shares at \$1.00 or below (3x FY18 EV/Revenue), or upon evidence of a resumption of clinical trials into Alzheimer's Disease.

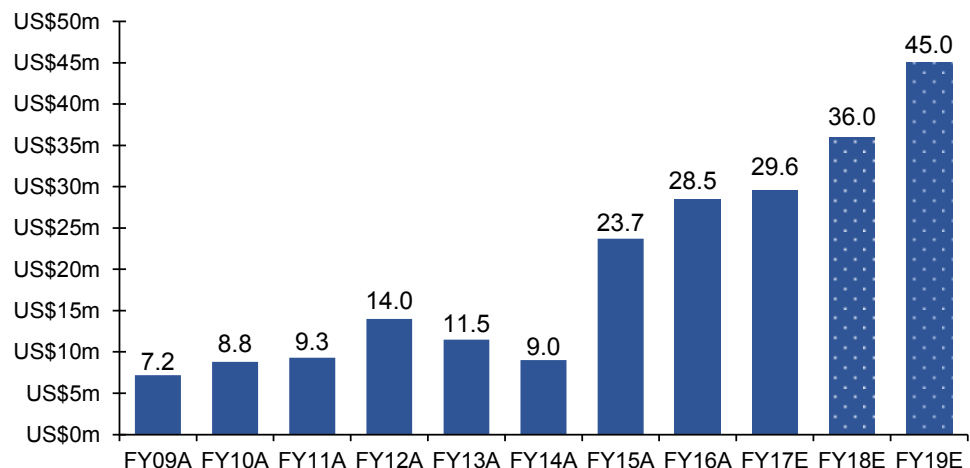
June Year End	FY16A	FY17A	FY18E	FY19E
Net Profit (\$m) (norm.)	1.0	-0.8	0.8	1.5
Revenue (\$m)	27.3	34.9	38.2	47.0
EBITDA (\$m)	1.8	0.1	2.2	3.4
EPS (¢)	0.9	-0.7	0.7	1.2
DPS (¢)	0.0	0.0	0.0	0.0
PER (x)	126.5	n/a	165.1	91.1
PER Rel Small Ords (%)	776%	n/a	1013%	559%
Ent. Value/ Revenue (x)	4.7	3.6	3.3	2.7
Ent. Value/ EBITDA (x)	69.4	n/a	58.7	36.9
# Shares fd (m)				125.5
Avg. Mthly Volume (m)				1.4
Diluted Mkt Cap (\$m)				136.1
Net Debt (\$m)				-9.3
Enterprise Value (\$m)				126.8

Source: Select Equities Research



Source: IRESS

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**YEARLY  
CLINICAL  
TRIALS  
CONTRACTS  
SIGNED**


Source: Company Reports & Select Equities Research

- We expect FY18 growth in clinical trial wins will be 21.6% positioning the company to deliver a strong FY19 result.
- One clinical trial valued at US\$2.4m was placed on hold in Q417 and is expected to recommence during FY18. Our forecasts assume this will occur.
- Uncertainty regarding the timing for the recommencement of Alzheimer's clinical trials that have been placed on hold present a risk to our forecasts and is a variable outside management's control. We note that the company provides solutions to clinical trials requiring cognitive assessments in other disciplines such as oncology which is not impacted.

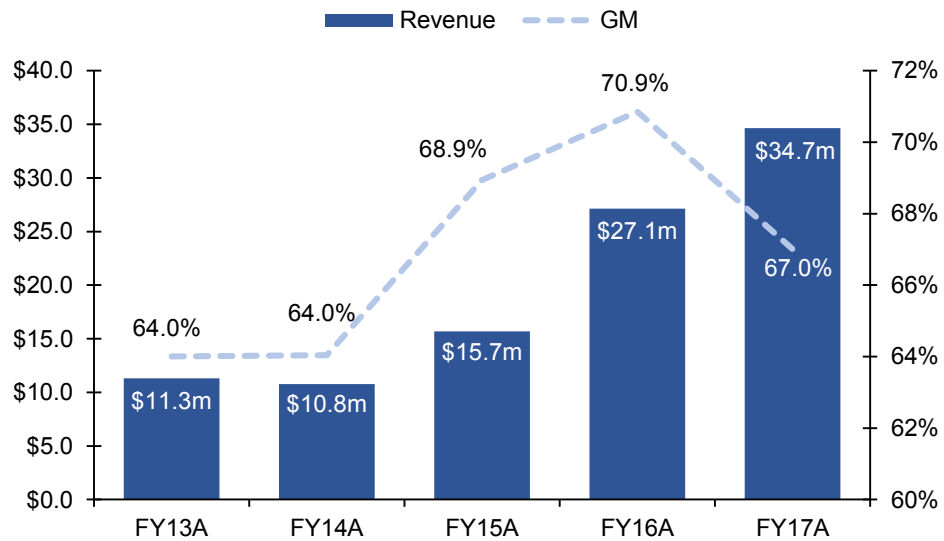
**CLINICAL  
TRIALS:  
CONTRACT &  
REVENUE  
GROWTH**

	FY15A	FY16A	FY17A	FY18E	FY19E
Contract Growth	163.3%	20.3%	3.9%	21.6%	25.0%
Revenue Growth	45.7%	72.8%	27.7%	7.5%	20.1%

Source: Company Reports & Select Equities Research

- Contracts signed in the year prior, are a useful leading indicator of future revenue. Phase one contracts generally run for around nine months (higher margin) while a phase three trial can last four to five years.
- The company started FY17 with a similar level of secured contracts as the prior year and as a result we expect the revenue growth rate to be below what was achieved in FY17.

### CLINICAL TRIALS REVENUE & GROSS MARGIN

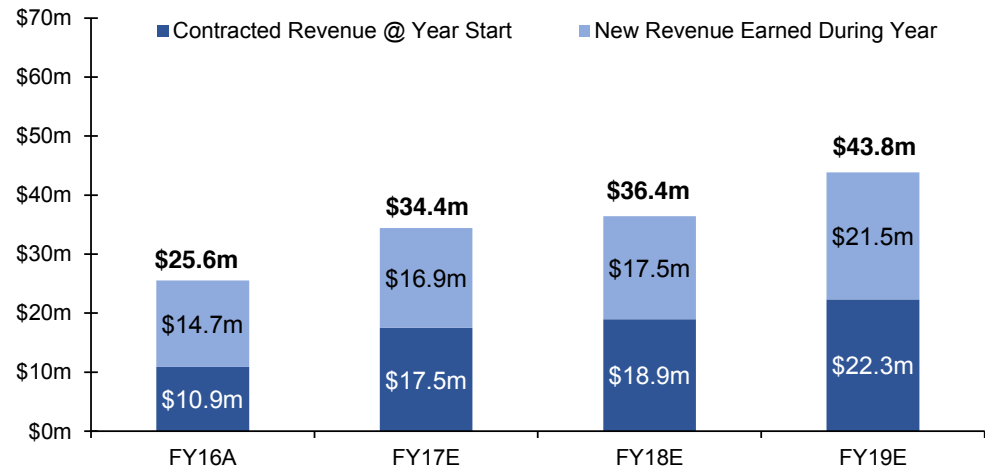


Source: Company Reports and Select Equities Research

Note: Gross Margin includes direct costs relating to the delivery of clinical trials excluding costs associated with the development of software.

- Gross Margin in the company's clinical trials segment suffered in FY17 due to an increase in headcount (75 FTE) without the corresponding uplift in revenue anticipated by management materialising.
- Looking to FY18, we expect improvements in Gross Margin as the company has at present, sufficient resources to deliver a higher volume of clinical trials.

### CLINICAL TRIALS REVENUE FORECAST

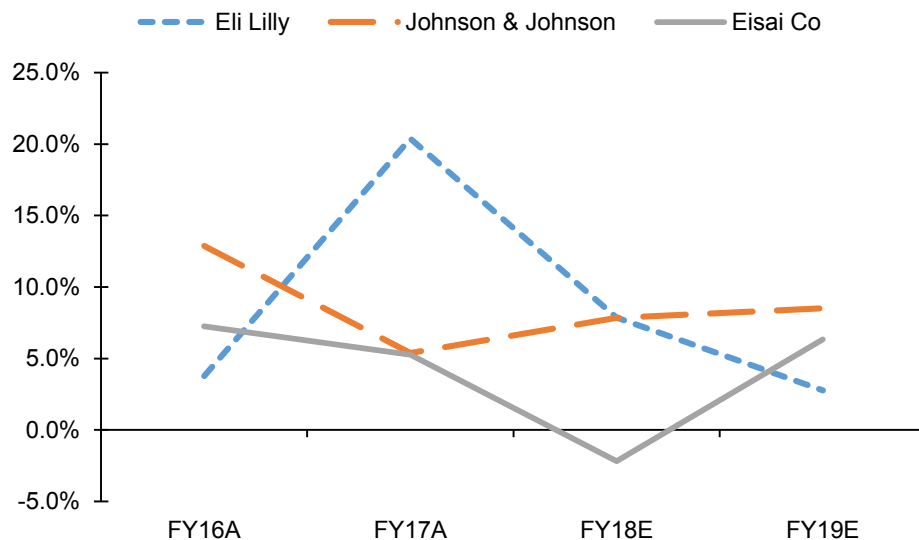


Source: Company Reports and Select Equities Research

Note: At 30 June 2017, contracted revenue was as follows FY18: \$18.9m, FY19 \$8.7m & FY20-25: \$9.9m.

- As at 30 June 2017, the company had \$37.5m of contracted revenue to be recognised in future periods.
- FY17 revenue from Eli Lilly was \$10.0m (+112.8%) with further upside now that Eli Lilly has chosen CGS as its preferred provider for its traditional, non-computerised cognitive assessments.

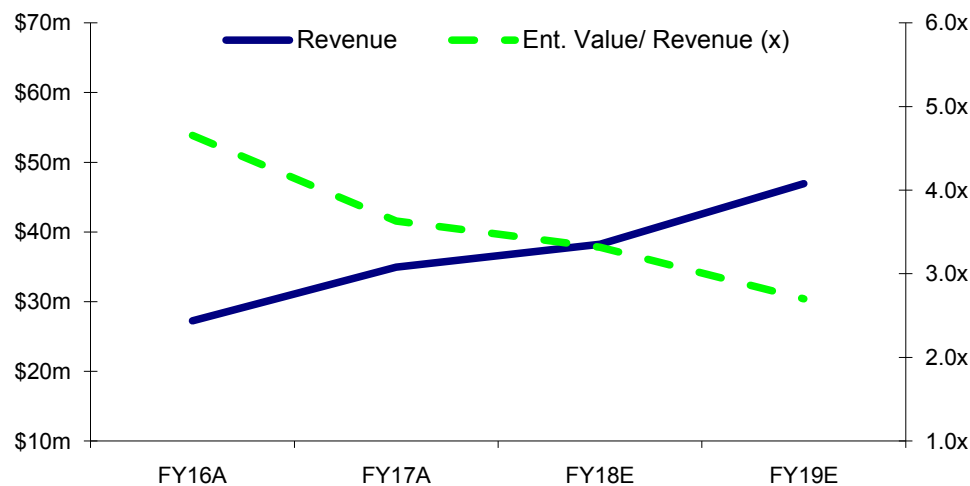
### KEY CUSTOMER PERFORMANCE - EBITDA GROWTH



Source: Capital IQ and Select Equities Research

- Cogstate's three biggest customers in FY17 were Eli Lilly (\$10.0m, 28.6% revenue), Johnson & Johnson Limited (\$6.9m, 19.7% of revenue) and Eisai Co (\$7.0m, 20.0% of revenue).
- All three customers substantially increased the amount they spent with Cogstate in FY17 when compared to the prior year.
- Consensus estimates show that these customers will all have positive EBITDA growth in FY19. The favourable outlook at the company level facilitates continued investment in risky and expensive clinical trials and is one factor that supports the continued demand for Cogstate's services

### VALUATION: EV / REVENUE



Source: Company Reports and Select Equities Research

- EV/Revenue in FY18 is 3.3x falling to 2.7x in FY19. Both represent record lows since the company listed.

**SER FORECAST REVISIONS**

Date	31-Mar-16	22-Jul-16	7-Sep-16	18-Oct-16	9-Mar-17	15-Aug-17	7-Sep-17
Event	Initiation	Update	Result	Update	Result	Update	Result
Price (\$)	\$0.60	\$0.60	\$0.80	\$1.03	\$1.05	\$1.07	\$1.09
<i>AUD/USD</i>	<i>0.766</i>	<i>0.750</i>	<i>0.768</i>	<i>0.763</i>	<i>0.753</i>	<i>0.796</i>	<i>0.799</i>
Revenue (\$m)	49.0	47.6	46.4	49.0	47.7	37.9	38.2
Gross Profit (\$m)	29.0	27.6	26.5	27.5	27.0	21.9	22.4
EBITDA (\$m)	11.1	9.1	6.4	6.7	3.8	0.9	2.2
EBIT (\$m)	10.5	8.5	5.8	6.1	3.3	0.5	1.0
NPAT (\$m)	7.5	6.1	4.1	4.3	2.4	0.4	0.8
EPS (¢)	6.0¢	4.8¢	3.2¢	3.6¢	1.9¢	0.3¢	0.7¢
<i>EV/Revenue (x)</i>	<i>1.4x</i>	<i>1.4x</i>	<i>1.9x</i>	<i>2.4x</i>	<i>2.5x</i>	<i>3.4x</i>	<i>3.3x</i>
Recommendation	BUY	BUY	LTB	LTB	LTB	HOLD	

Source: Select Equities Research

**BUSINESS DESCRIPTION**

- Cogstate Limited (CGS) is a niche CRO (contract research organisation) specialising in cognitive assessment that services global pharmaceutical and biotechnology companies. Key clients include Eli Lilly, Eisai and Johnson & Johnson.
- 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. 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.
- CGS is seeking to enter into the US Healthcare Market in 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.
- The company is headquartered in Melbourne and Connecticut, US and listed on the ASX in 2004. As at 30 June 2017, CGS had 160 full time equivalent employees (FY16: 130).

**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.
- The company has three customers in FY17 that contribute more than 10% of revenue and collectively represent 68.4% of FY17 revenue.
- 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.
- Academic recognition of CGS's competitors could eventuate and result in less demand for the company's services.
- Reduction in the size of the market for clinical trials that require an assessment of cognition.
- Difficulty in obtaining reimbursement for Cognigram.

**Cogstate Limited**

Select Equities Research

Financial Model

Code	CGS				June Year End	FY16A	FY17A	FY18E	FY19E
Last sale (\$)	07-Sep-17				\$1.09				
# Shares (m)	113.0				Financial Position (\$m)				
# Options (m)	12.4				Cash	7.5	9.3	10.0	11.6
Diluted Mkt Cap (\$m)	136.1				Accounts Receivable	6.2	6.3	6.8	8.1
Net Debt (\$m)	-9.3				PPE	1.7	2.1	2.3	2.8
Enterprise Value (\$m)	126.8				Deferred Tax Assets	3.8	3.8	3.5	3.0
June Year End	FY16A	FY17A	FY18E	FY19E	Intangibles	0.4	0.4	0.4	0.4
Financial Performance (\$m)					Total Assets	19.6	21.8	23.1	25.9
Revenue	27.3	34.9	38.2	47.0	Accounts Payable	3.1	3.4	3.2	3.4
Gross Profit	15.9	18.7	22.4	28.2	Borrowings	0.0	0.0	0.0	0.0
OpEx	-14.0	-18.6	-20.2	-24.7	Provisions	1.7	2.2	2.6	3.4
EBITDA	1.8	0.1	2.2	3.4	Unearned Revenue	0.3	1.2	1.3	1.6
D & A	-0.9	-1.0	-1.2	-1.4	Other Liabilities	0.7	0.6	0.0	0.0
EBIT	1.0	-0.9	1.0	2.0	Total Liabilities	5.8	7.4	7.2	8.5
PBT	1.0	-0.8	1.0	2.1	Net Assets	13.8	14.4	15.9	17.4
NPAT (pre-NCI & abs)	1.0	-0.8	0.8	1.5	Issued Capital	27.9	28.5	28.6	28.6
NCI	0.0	0.0	0.0	0.0	Reserves	0.6	1.4	2.0	2.0
Normalised NPAT	1.0	-0.8	0.8	1.5	Retained Earnings	-14.7	-15.5	-14.7	-13.2
Abnormals	1.6	0.0	0.0	0.0	NCI	0.0	0.0	0.0	0.0
Reported NPAT	2.6	-0.8	0.8	1.5	Total Equity	13.8	14.4	15.9	17.4
EPS (¢)	0.9	-0.7	0.7	1.2	Cash Flows (\$m)				
DPS (¢)	0.0	0.0	0.0	0.0	Net Receipts	2.0	2.6	2.0	3.5
NTA / Share (¢)	11.0	11.2	12.3	13.5	Net Interest	0.1	0.1	0.1	0.1
Book Value / Share (¢)	11.3	11.5	12.6	13.8	Tax Received/(Paid)	0.5	0.0	0.0	0.0
Valuation/Performance Ratios					Operating Cash Flow	2.6	2.7	2.1	3.5
PER (x)	126.5	n/a	165.1	91.1	Acquisitions & Investments	0.0	0.0	0.0	0.0
Ent. Value/ Revenue (x)	4.7	3.6	3.3	2.7	Net Purchase of PPE	-1.6	-1.3	-1.4	-1.9
Ent. Value/ EBITDA (x)	69.4	n/a	58.7	36.9	Net Purchase of Intangibles	0.0	0.0	0.0	0.0
Revenue Growth (%)	69.5%	28.2%	9.4%	22.8%	Investing Cash Flow	-1.6	-1.3	-1.4	-1.9
Gross Profit Growth (%)	100.6%	17.9%	19.7%	25.9%	Net Change in Equity	0.9	0.5	0.1	0.0
OpEx Growth (%)	32.1%	32.3%	8.9%	22.4%	Net Change in Debt	0.0	0.0	0.0	0.0
EBITDA Growth (%)	n/a	n/a	n/a	59%	Dividends	0.0	0.0	0.0	0.0
NPAT Growth (%)	n/a	n/a	n/a	82%	Financing Cash Flow	0.9	0.5	0.1	0.0
EPS Growth (%)	n/a	n/a	n/a	81%	Net Inc/Dec Cash	1.9	1.9	0.7	1.6
P/NTA (x)	9.9	9.7	8.8	8.0	Cash at Beginning of Year	5.5	7.5	9.3	10.0
P/BV (x)	9.6	9.4	8.6	7.8	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	10.0	11.6
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	2.1	3.5
Gross Margin (%)	58.2%	53.5%	58.5%	60.0%	Δ Working Capital	0.0	-1.2	0.6	0.8
EBITDA Margin (%)	6.7%	0.4%	5.6%	7.3%	Normalised OCF	2.6	1.5	2.7	4.3
EBIT Margin (%)	3.5%	-2.6%	2.5%	4.2%	Less Maintenance CapEX	-0.9	-1.1	-1.3	-1.9
NPAT Margin (%)	3.8%	-2.3%	2.2%	3.2%	Free Cash Flow	1.8	0.4	1.3	2.4
Current Ratio (x)	2.7	2.3	2.4	2.3	FCF/NPAT Conversion (%)	172%	-50%	162%	159%
Interest Cover (x)	-12.0	12.0	-14.6	-29.9	P/FCF (x)	76.3	333.5	101.6	56.9
Net Debt/Equity (%)	-54.2%	-64.6%	-63.0%	-66.6%	Revenue Breakdown (\$m)				
ROE (%)	8.7%	-5.8%	5.4%	9.0%	Clinical Trials (incl. prec rec.)	27.2	34.7	37.2	44.7
ROIC (%)	18.0%	-15.2%	14.2%	12.5%	Growth (%)	73.0%	27.6%	7.5%	20.1%
Interim Results (\$m)					US Healthcare	n/a	n/a	0.7	1.9
Revenue	13.0	14.3	18.5	16.4	Growth (%)	n/a	n/a	n/a	171.4%
Gross Profit	7.4	8.4	10.5	8.2	Other	0.1	0.3	0.3	0.3
EBITDA	1.2	0.6	1.7	-1.5	Contracted Revenue (30 June 2017)				
D & A	-0.1	-0.7	-0.2	-0.8				18.9	8.7
EBIT	1.1	-0.1	1.5	-2.4	Substantial Shareholders				
PBT	1.1	-0.1	1.5	-2.3			No. (m)	%	
Normalised NPAT	1.0	0.0	1.0	-1.8	Dagmar Dolby (Director)			19.8	17.5%
Reported NPAT	2.6	0.1	1.0	-1.8	Martyn Myer (Chairman)			19.5	17.3%
					Alan Finkel			9.0	8.0%
					Fidelity		↑	9.3	8.3%

Source: Company Reports and Select Equities Research

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