23 October, 2017

Cogstate Ltd. (CGS)

Outperform

Recent Weakness in Stock Presents Good Buying Opportunity

Price Target: $1.27

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Summary (AUD)

Market Capitalisation	**$116M**
Share Price	**$1.01**
52 week low	$0.60
52 week high	$1.39
Ave Monthly Vol (year rolling)	47.99K

Key Financials (A$ million)

Year End	FY16 Act.	FY17 Act.	FY18 Est.
Revenue ($m)	**27.3**	**34.9**	**45.4**
EBITDA ($m)	1.4	1.7	4.0
NPAT ($m)	**2.6**	**1**	**4.4**
EPS (c)	2.4	0.6	3.9
EPS Growth (%)	150%	-131%	287%
Diluted EPS	2.3	0.5	3.6
PE (x)	**21**	**116**	**26**
EV ($M)	113	133	134
EV/EBITDA (x)	**81**	**78**	**34**

Share Price Graph (AUD)

The Taylor Collison Insight

Since we have initiated on CGS, there have been numerous clinical trial readouts in the Alzheimer's Disease (AD) space. Unfortunately, every recent major Alzheimer's trial readout has been negative, and this has had a negative effect on the CGS share price. A combination of a weak 2H17 and poor Alzheimer's clinical readouts have generated headwinds for the stock, and we see current weakness as a buying opportunity. Management alludes to a stronger first half, and we think an improvement in revenues could re-establish investor confidence in CGS. We look forward to the company's quarterly earnings report in late October.

Recent headwinds for the stock present a good buying opportunity. The stock has shown continued weakness over the past month following weaker than expected earnings over the last half's results (partially attributable to timing issues). We see the recent continued weakness as a buying opportunity. Management has indicated guidance of growth over this half, and we anticipate a meaningful recovery for revenues and in the share price ahead of earnings.

2018 will be a quiet year for pivotal Alzheimer's readouts. Three key Alzheimer's programs will read-out in 2019. There are currently 28 agents in Phase 3 for Alzheimer's, and we look forward to the next major trial readouts in 2019, (aside from a possible interim readout of Biogen's aducanumab in the 2018 timeframe). We like that less noise in the Alzheimer's space will shift investors' attention from the trial data itself and potentially towards CGS's growth potential, as well as to the imminent launch and future profit potential of the Healthcare offering.

…but there is still room for growth in the Alzheimer's market and beyond
We think Alzheimer's will always be CGS's main source of revenues, given the size of the market. There are more numerous early stage Alzheimer's trials that may progress in the clinical trial pathway, and CGS is becoming highly reputable, especially since Eli Lily named CGS as a preferred partner for rater training. We think CGS may be able to differentiate its rater training offering, especially since competitors have recently undergone an M&A period, which could sway future clients to a more stable service provider such as CGS. We also like the potential for CGS to establish itself in the non-Alzheimer's neuropsychiatric market, as well as in the orphan disease space (discussed in the body of this report).

We maintain our $1.27 price target. We maintain our price target and think the stock has been oversold on previous earnings.

CGS At a Glance

Price Target: $1.27 (30% Implied Upside)

Investment thesis

CGS offers a variety of clinical trials solutions in the cognition space. It has capabilities in rater training, precision recruitment, computerized assessment, scales management, and rater training, giving the company a broad offering into the $800M and growing cognition trials market. The clinical trials market in the cognition space is growing, attributable to the ageing population, increased awareness of cognition as an endpoint in CNS and non-CNS disorders, and Alzheimer's disease trial tailwinds. We see the platform as de-risked, because the success of CGS is not dependent on trial outcomes, and think We think they key upside component for CGS is the healthcare offering, which we do not think is priced into the stock. The stock is currently trading at a level which supports current sales, and we see substantial room for upside for broader cognition healthcare offering, especially when a Phase 3 Alzheimer's trial hits statistical significance, because at that point, testing outcomes would be able to have an impact on how a patient is

Upcoming Catalysts

- Quarterly growth and contract sales following the recent announcement that CGS will be the preferred source for Eli Lilly's rater training in Alzheimers.
- Announcement of commercialization strategy for Cognigram offering
-Potential first-sales for healthcare product offering (mid/late 2018)

Base Case Assumptions

- Base Case Valuation: $1.00 supports current sales revenue and only assumes modest revenue growth, assumes modest revenues from healthcare offering.
- Cost of sales remains at ~40-45%
- Does not assume large contract wins for CGS

Upside Options

- Upside Valuation: $1.79, assumes revenue growth and contract-wins, as well as synergies associated with cost of sales, potentially generating superior margins.
- Healthcare offering commercial plan and meaningful first-revenues, as well as early indications of growth, and could trigger a re-rating of the stock.
- Positive Phase 3 of Alzheimer's therapy and subsequent approval would generate momentum for CGS

Downside/Risks

$0.72, assumes continued costs with lower investment in healthcare offering with significantly reduced levels of revenue growth vs historic revenue growth.

- Competive threat from additional companies in the cognition trials space make it harder for CGS to gain market share

Company Description

Cogstate focuses on cognitive science measurement, and on streamlining and simplifying the measurement of cognition in clinical trials, academic research, and research. The company has created highly sensitive, computerized cognitive tests which are currently used in clinical trials, and also has broader offerings for the clinical trials market, offering consulting, rater training, and precision recruitment tools to drive higher quality outcome measures in trials. Cogstate's services are available in over 100 languages and dialects, have been administered in over 56 countries and more than 12,600 assessment site, and

Key P&L Data

(A$M)	2015A	2016A	2017E	2018E	2019E	2020E
Revenue						
Total	16.1	27.3	34.9	45.4	59.1	73.8
Finance income	0.1	0.1	0.1	0.0	0.0	0.0
Total revenue	16.2	27.3	34.9	45.4	59.1	73.8
Revenue Growth	*26%*	*69%*	*28%*	*30%*	*30%*	*25%*
Cost of sales	-8	-12	-17	-20	-25	-31
Cost of sales as % of revenue	*-51%*	*-44%*	*-48%*	*-43%*	*-42%*	*-41%*
Gross profit	**8.02**	**15.40**	**18.19**	**24.98**	**33.66**	**42.34**
OpEx	-11.08	-14.36	-19.00	-23.42	-26.08	-29.22
Profit before tax	**-16.30**	**1.04**	**-0.81**	**1.57**	**7.58**	**13.12**
Profit for year (NPAT)	**-16.14**	**2.64**	**-0.82**	**1.57**	**7.58**	**13.12**
EPS (cents)	**-4.80**	**2.40**	**-0.74**	**1.38**	**6.54**	**11.10**
Growth	*60%*	*150%*	*-131%*	*-287%*	*374%*	*70%*
Diluted EPS (cents)	**-4.80**	**2.30**	**-0.70**	**1.30**	**6.16**	**10.47**

Valuation Metrics

We use an EV/EBITDA ratio of 11.8X, the average EV/EBITDA
The calculation of EBITDA for the valuation excluded costs
As soon as management provides additional information around the specifics of the healthcare offering, as well as how they plan we will be encouraged to reevaluate our price target.

Our base case DCF valuation yields a price target of $1.26, leading to a blended price target of $1.27.

	FY18E	FY19E	FY20E
Trials EBITDA (X)	11.8	11.8	11.8
Implied EV ($M) (assuming 11.8X)	100.2	156.3	231.6
+Cash ($M)	111.0	173.2	257.0
Implied price/share (A$)	0.98	1.49	2.17

2017 was riddled with late stage Alzheimer's trial failures.

The CGS share price historically suffers on the back of Alzheimer's therapies trial failures. While there should be no read-through (the number of Alzheimer's trials in the clinic has not decreased), investors can be concerned that poor Alzheimer's data will impact big pharma's interest in the disease target. We do not think this is the case, given the number of Phase 1 and 2 trials in the Alzheimer's pipeline that could progress. We like that an upcoming relatively quiet period for Alzheimer's pivotal readouts will allow investors to shift their focus on CGS fundamentals, rather than on trial readouts that do not reflect on the value of CGS's service offering. Potentially improved future revenues, without the noise of Alzheimer's trial read-outs, could generate some upward pressure for the stock.

We note more late-stage readouts in the schizophrenia, depression, and bipolar spaces than in the Alzheimer's space in 2017-2018. We think that increased news flow in non-Alzheimer's CNS areas should help bolster confidence in the potential applicability of CGS's offering across a broader range of indications. We look forward to increased revenues from non-Alzheimer's trials for CGS in the 2018 timeframe.

We think the market underappreciates the non-Alzheimer's market for CGS

While the Alzheimer's market will always be a key component of CGS's clinical trials and rater training business, we anticipate incremental growth in additional indications, based on relatively recent key hires to head and grow the clinical trials business. Below, we list key Phase 3 non-Alzheimer's trial readouts in the CNS space. This highlights the real opportunity for growth in the non-Alzheimer's neuropsychiatric (and broader neurology) space. We also note significant opportunity for growth in the orphan drug market, upon which we will elaborate in this report.

Phase 3 Key Neuropsychiatric Trial Readouts

Indication	Therapy	Company	Readout date
Depression	Esketamine	JnJ	October 2017
	Rapastinel	Allergan	
	ALKS-5461	Alkermes	November 2019
	Lu AA21004	Lundbeck	April 2018
	Vilazodone	Allergan	January 2018
Pediatric depression	Levomolnacipran ER	Allergan	March 2018
	Fluoxetine	Lundbeck	October 2018
Schizophrenia	ALKS-3831	Allergan	September 2018
Treatment-resistant schizophrenia	Lu AF35700	Lundbeck	January 2019
	Pimavanserin	Acadia	January 2019
	Respirodine microparticles	Rovi Pharma	August 2018
Bipolar depression	ITI-007	Intracellular therapies	August 2018
	Cariprazine	Allergan	July 2018

Rare disease trials are also a robust opportunity for CGS.

We previously have not discussed the value for CGS in the rare disease space. Upon further investigation, we determined that there is a significant revenue-generating potential in this therapeutic area. The orphan disease space is a significant business development opportunity for CGS going forward, given the volume of trials. There are over 8,000 known rare diseases, half of which are in children, and many of which are neurodevelopmental. There were just over 60 orphan drug approvals in the 2013-2014 timeframe, and 450 orphan drug designations delivered for the same period (meaning that many trials will begin in the near term). About one third of drugs approved are for rare diseases.[1]

[1] https://www.fda.gov/downloads/Drugs/NewsEvents/UCM440797.pd

These trials have fast track to FDA, so the trials tend to run relatively quickly, which is beneficial for CGS from a revenue perspective. The trial would run faster, and CGS would record revenues over a shorter period of time. We think the orphan opportunity is low hanging fruit for the company, since there is very little competition for these groups of patients, and there is a growing number of trials in these diseases.

Once CGS gets experience in orphan, we think the company could have the opportunity to repackage their experience as a brand, and formulate a rapid and aggressive expansion strategy. This could prove profitable, especially since there are biotechnology companies with exclusive focuses on rare diseases including:

- Abeona
- Acceleron
- Adverum
- Agios
- Akari
- Alexion
- Amicus
- aTyr Pharma
- Avexis
- Biomarin
- Bluebird
- Catabasis
- Catalyst
- Chiasma
- Corbus
- Dimension therapeutics
- Fate therapeutics
- Genzyme
- GSK
- Horizon Pharma
- Idera
- Insmed
- Intercept Pharma
- Ionis
- MyoKardia
- Novelion
- ONCE
- Pfizer
- PTCT
- Sarepta
- Shire
- Strongbridge biopharma
- Summit therapeutics
- Ultragenyx
- Uniqure
- Xenon

While competitors may copy CGS in pursuing the rare disease space, we think if CGS develops a quieter, more guerrilla approach to achieving this business, that the company could begin establishing its first-to-market presence in the field before competitors have a chance to develop and brand a similar offering. We look forward to CGS having an increased presence in the rare disease space, and anticipate increased clinical trials business in the rare disease space over the next 12 months.

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Date Prepared: October 2017
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ESTABLISHED 1928

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