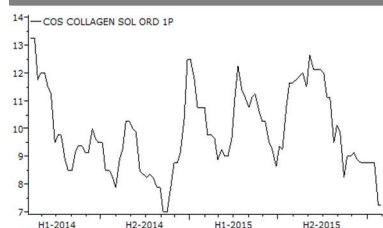


Healthcare Equipment & Services



Source: Fidessa

Market data

EPIC	COS
Price (p)	6.75
12m High (p)	14.75
12 Low (p)	6.75
Shares (m)	171.0
Mkt Cap (£m)	11.5
EV (£m)	8.5
Free Float*	78%
Market	AIM

*As defined by AIM Rule 26

Description

COS is a biomedical company developing & manufacturing medical grade collagen for use in medical devices, regenerative medicine products and in-vitro diagnostics. It supplies bio-functional collagen and provides R&D and contract services to a broad range of multi-national clients.

Company information

CEO	Stewart White
CFO	Gill Black
Chairman	David Evans

0141 648 9100

www.collagen.solutions.com

Key shareholders

Directors	22.0%
L&G	9.0%
NVM PE	7.4%
Helium	6.4%

Next event

FY results	July 2016
AGM	Aug 2016

Analysts

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	mh@hardmanandco.com

Collagen Solutions

Secure base, and opportunities intact

COS is a biomaterials company developing and manufacturing medical grade collagen components for use in medical devices, regenerative medicine, and in vitro diagnostic products. It aims to grow organically and through acquisition to take the business closer to the end-product margin. While the majority of sales are secure, visibility and timing of new business is less certain. Therefore, our forecasts are based on a more conservative approach for coming years. Recently added commercial and operational firepower provides greater support and reassurance that new opportunities will convert, allowing revised forecasts to be exceeded.

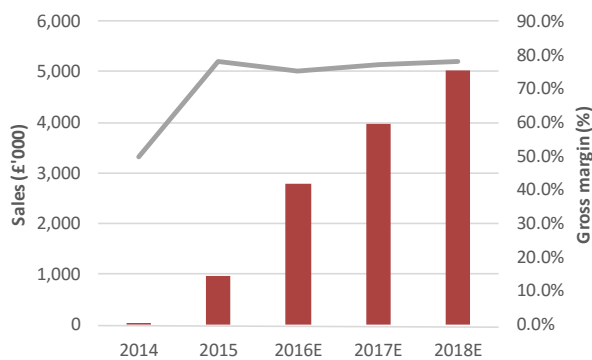
- **Strategy:** COS supplies value-added bio-functional collagen and provides R&D and contract manufacturing services to a broad range of international clients. Its growth strategy is to expand the client base organically and through acquisitions to take the company further up the value added chain.
- **Changes to forecasts:** For new opportunities, COS has limited control over the decisions, buying patterns and regulatory position of clients, making forecasting difficult. A more conservative view on conversion of new business over the next 3 years reduces forecasts markedly (24-52%), although EBITDA is less affected.
- **Valuation:** The cut in medium-term forecasts has a significant effect on our DCF valuation, as near-term changes have a disproportionate influence. Our NPV of the enterprise has fallen from £73m to £46m, or from 39p to 26p per share. 97% of this value is derived from the terminal value, given the short-term cash burn.
- **Risks:** Recurring revenues are secure, but the exact timing of new development, manufacturing, and supply agreements is less certain. Changes to customer project timelines and regulatory delays remains a source of risk. Route to Chondromimetic commercialisation is currently in early stage planning.
- **Investment summary:** Management is developing a value added company which will ultimately be reflected in the valuation. COS is reviewing new opportunities, which include a China JV and cartilage repair product Chondromimetic – however, the company remains sensitive to the short-term buying activities of its new customers.

Financial summary and valuation

Year end March (£'000)	2014	2015	2016E	2017E	2018E
Sales	24	973	2,795	3,982	5,034
Underlying EBITDA	-364	-726	-755	-259	176
Reported EBIT	-381	-793	-1,135	-714	-359
Underlying PBT	-381	-920	-1,345	-855	-455
Statutory PBT	-480	-1,102	-1,395	-905	-505
Underlying EPS (p)	-0.87	-0.98	-0.87	-0.59	-0.34
Statutory EPS (p)	-1.10	-1.17	-0.90	-0.62	-0.37
Net (debt)/cash	1,492	3,282	1,756	884	335
Shares issued	3,374	5,422	100	1,409	1,000
P/E (x)	-7.7	-6.9	-7.7	-11.4	-19.6
EV/sales (x)	429.7	10.6	3.7	2.6	2.1
EV/EBITDA (x)	-28.4	-14.2	-13.7	-39.9	58.6

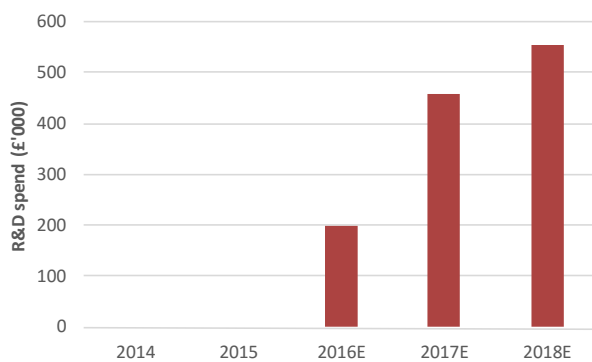
Source: Hardman & Co Life Sciences Research

Sales & Gross margin



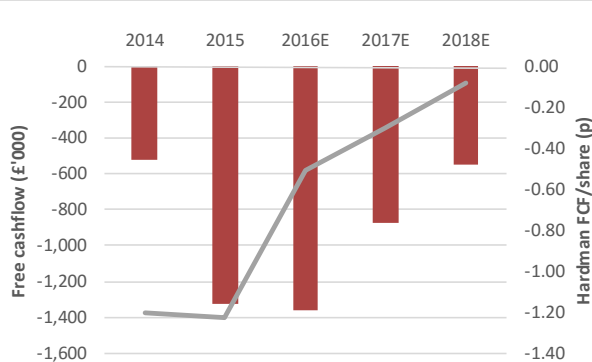
- ▶ Sales are expected to grow substantially as customers receive regulatory approvals, albeit slower than previously thought
- ▶ Numerous new opportunities but timing of their contribution is complex and, therefore, not included in our conservative forecasts
- ▶ Gross margin is stable in the range 74-80% – longer-term this could go higher as COS moves up the value added chain

R&D investment



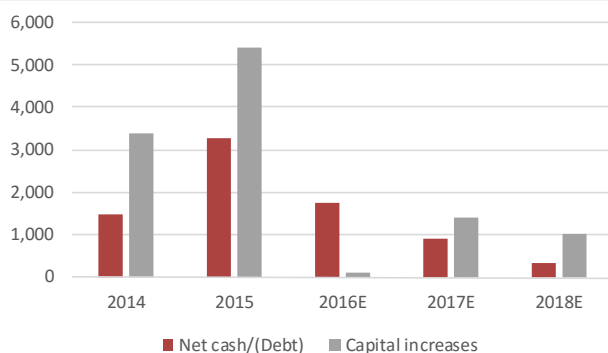
- ▶ COS makes a modest investment in R&D each year
- ▶ Investment will rise as COS acquires more assets to move it up the value chain
- ▶ COS adds value through development of customer formulations
- ▶ Internal development is capable of supporting ongoing R&D

Cashflow and FCF/share



- ▶ The reduction in forecasts has put more pressure on the cashflow and delayed the time to reach profitability
- ▶ Uncommitted capex investment could be delayed to preserve cash
- ▶ Forecasts are much more conservative and any future change is more likely to be in an upward direction with improved cashflows

Net cash/capital increases



- ▶ Reduced forecasts, and hence cashflow, has put more pressure on the balance sheet
- ▶ COS has sufficient cash to cover its operational and investment requirements over the forecast period
- ▶ Capital increases in 2017 & 2018 currently reflect deferred consideration for acquisition in shares
- ▶ Management could defer R&D and capital expenditure to preserve cash

Source: Company data; Hardman & Co Research

Trading update

More prudent view of sales

Solid recurring revenue base...

...but timing of new opportunities more difficult to predict

New customer contracts in place...

...but less clarity about when they will contribute

Although two months still to go...

...sales look set to be about £800k below previous expectations

At the interim results (to 30th September 2015) issued last December there was clear progress towards the Board's objective of creating a strong business with multiple revenue streams by 2020 that would ultimately drive value. Underlying sales growth of 97% was driven by new contract wins and pipeline progress from existing customers and there was a clear expectation that growth would continue and accelerate as more contracts are won, customers' products receive regulatory approvals for full commercialisation, potentially boosted by acquisitions. The difficulty, however, is predicting the timing of such growth.

In fiscal 2016, COS has won a number of customer contracts and made some asset acquisitions, which would be a key driver of future growth. However, the timing of when these agreements begin to contribute remains difficult to assess. Although momentum has clearly been building over the last year, the market has often questioned the probability of meeting what were quite demanding expectations. Even though there were still two months until the year end, management decided that it would be prudent to alert the market that there remained considerable uncertainty about the likely recognition of revenues in fiscal 2016.

In a statement to the market, the company indicated that there would be a likely shortfall of £800k compared to consensus market forecasts and, taking a more prudent view, indicated that a more conservative approach should be considered for following years to factor in revenue slippages which are out of the company's direct control. There were a number of reasons suggested for this shortfall.

Customer impact on sales forecasts

Issue	Impact
Customer delays – Development, Ordering, Testing, Regulatory	-£359k
Customer acquired	-£156k
Lower than predicted order volumes	-£236k
Cancelled customer project	-£49k
Total effect	-£800k

Source: Collagen Solutions

It has always been the case that, with several customer projects at the development and regulatory stages, delays can be expected. Even when a product receives full marketing approval, companies often do not launch products immediately, which has a knock-on effect onto their suppliers, such as COS. What is less foreseeable is when a customer is taken over, leading to potential order delays, and when customers simply drop projects.

Lower impact on profitability

Flexibility in the cost base means impact at EBITDA level is lower...

...which also applies to R&D and capex spend, thereby preserving cash

Fortunately, COS has some flexibility in its cost base and the impact of some decisions listed above means that associated costs will also not now be borne, such that the effect of this sales shortfall is less at the EBITDA level, where the impact is likely to be only ca.-£100k.

In addition, some flexibility in the timing of capital expenditure suggests that the impact of this on the net cash position can also be controlled. However, taking a more conservative approach to future forecasts, suggests that net cash does get quite low in fiscal 2018.

Changes to forecasts

- ▶ Taking a more conservative view of contracts and allowing for possible delays, we have cut back sales expectations by 39% for fiscal 2017 and 52% for fiscal 2018
- ▶ The biggest reductions are in Contract Services, which are more sensitive to customer delays
- ▶ On the cost side of the equation, forecasts for both Selling & Marketing and Administration are little changed, as the company continues to invest in developing sales opportunities
- ▶ There is a natural saving in Cost of Goods which is intimately linked to sales, therefore the fall is directly proportionate to the fall in sales
- ▶ Management has close control over the timing of R&D investment and 15-20% of savings are likely in this area until the actual sales outcome for future years is better understood
- ▶ Capital expenditure has been reduced in each of fiscal 2016-2018. Again, following the committed investment in manufacturing in New Zealand in the current year, management has reasonable scope to control the timing of future spend

Changes to forecasts

Year to March (£'000)	----- Old forecasts -----			----- New forecasts -----		
	2016E	2017E	2018E	2016E	2017E	2018E
Raw materials	1,000	1,600	2,500	790	1,185	1,600
Development services	300	400	500	205	277	360
Contract services	2,400	4,500	7,500	1,800	2,520	3,074
Total sales	3,700	6,500	10,500	2,795	3,982	5,034
COGS	-798	-1,469	-2,415	-700	-916	-1,107
Gross profit	2,902	5,031	8,085	2,095	3,066	3,926
Gross margin	78.4%	77.4%	77.0%	75.0%	77.0%	78.0%
Selling & marketing	-1,150	-1,275	-1,550	-1,150	-1,374	-1,561
% sales	31.1%	19.6%	14.8%	41.1%	34.5%	31.0%
Administration	-1,575	-1,500	-1,800	-1,500	-1,493	-1,636
% sales	42.6%	23.1%	17.1%	53.7%	37.5%	32.5%
R&D	-450	-550	-650	-200	-458	-554
% sales	12.2%	8.5%	6.2%	7.2%	11.5%	11.0%
EBITDA	-273	1,706	4,085	-755	-259	176
EBIT	-718	1,196	3,505	-1,135	-714	-359
Cap-ex	-725	-825	-950	-500	-350	-400
Net cash/(debt)	1,941	952	2,347	1,757	884	335

Source: Hardman & Co Life Sciences Research

- ▶ On the basis of these revisions, we believe that COS will end fiscal 2017 with net cash of around £0.9m and remain cash positive through fiscal 2018
- ▶ Although, the net cash position is low during fiscal 2018, the conservative nature of the revised forecasts allows scope for upward revision when the sales outlook becomes clearer over the next two years.

Financial summary

Profit & Loss Account					
Year end March (£'000)	2014	2015	2016E	2017E	2018E
Sales	24	973	2,795	3,982	5,034
Cost of goods sold	-12	-214	-700	-916	-1,107
Gross Profit	12	759	2,095	3,066	3,926
Administrative expenses	-304	-1,266	-1,500	-1,493	-1,636
Selling and marketing costs	-72	-219	-1,150	-1,374	-1,561
R&D	0	0	-200	-458	-554
Underlying EBITDA	-364	-726	-755	-259	176
Depreciation	-13	-75	-200	-255	-315
Amortisation	-4	-55	-180	-200	-220
Other income	0	63	0	0	0
Underlying EBIT	-381	-793	-1,135	-714	-359
Share based costs	-25	-27	-50	-50	-50
Exceptional items	-75	-155	0	0	0
Statutory Operating profit	-480	-975	-1,185	-764	-409
Net financial income	0	-128	-210	-142	-96
Underlying Pre-tax profit	-381	-920	-1,345	-855	-455
Exceptional items	0	0	0	0	0
Reported pre-tax	-480	-1,102	-1,395	-905	-505
Reported taxation	0	-21	-150	-169	-188
Underlying net income	-381	-942	-1,495	-1,024	-642
Statutory net income	-480	-1,123	-1,545	-1,074	-692
Period-end shares (m)	63.8	171.0	179.0	187.0	187.0
Weighted average shares (m)	43.7	96.4	171.0	172.3	187.0
Fully diluted shares (m)	47.7	102.3	177.0	178.3	192.9
Underlying Basic EPS (p)	-0.87	-0.98	-0.87	-0.59	-0.34
U/I fully-diluted EPS (p)	-0.87	-0.98	-0.87	-0.59	-0.34
Statutory basic EPS (p)	-1.10	-1.17	-0.90	-0.62	-0.37
Statutory fully-diluted EPS (p)	-1.10	-1.17	-0.90	-0.62	-0.37
DPS (p)	0.00	0.00	0.00	0.00	0.00

Source: Hardman & Co Life Sciences Research

Key metrics					
Year end March (£'000)	2014	2015	2016E	2017E	2018E
Growth					
Sales		3950%	187%	42%	26%
Gross profit		6258%	176%	46%	28%
Operating profit		n/a	n/a	n/a	-49%
EPS		n/a	n/a	n/a	6%
DPS		n/a	n/a	n/a	n/a
Operating ratios					
Cost of goods	50.3%	22.0%	25.0%	23.0%	22.0%
Gross margin	49.7%	78.0%	75.0%	77.0%	78.0%
Admin	nm	130.1%	53.7%	37.5%	32.5%
Sales & Marketing	299.4%	22.5%	41.1%	34.5%	31.0%
EBITDA	nm	-74.6%	-27.0%	-6.5%	3.5%
Operating profit	nm	-81.5%	-43.1%	-19.3%	-7.8%
Reported tax rate	0.0%	-1.9%	-9.3%	-18.6%	-37.1%

Source: Hardman & Co Life Sciences Research

Balance Sheet					
@31st March (£'000)	2014	2015	2016E	2017E	2018E
Shareholders' funds	6,256	12,853	11,220	11,045	11,303
Cumulated goodwill	0	0	0	0	0
Total equity	6,256	12,853	11,220	11,045	11,303
Share capital	683	1,755	1,935	2,015	3,015
Reserves	5,573	11,099	9,285	9,031	8,288
Deferred tax	0	285	272	272	272
Long-term loans	0	88	65	65	65
Bank overdrafts	0	22	18	18	18
less: Cash	1,492	3,391	1,757	884	336
less: Marketable securities	0	0	0	0	0
less: Non-current investments	0	0	0	0	0
Invested capital	4,764	9,856	9,817	10,515	11,321
Fixed assets	232	794	1,094	1,189	1,274
Intangible assets	6,894	12,919	12,739	12,539	12,319
Stocks	39	219	294	400	535
Trade debtors	0	419	394	509	654
Trade creditors	0	-215	-310	-410	-530
Tax liability	0	-40	-78	-150	-169
Debtors less creditors	-2,402	-4,075	-4,310	-3,613	-2,807
Invested capital	4,764	9,856	9,817	10,515	11,321
Net cash/(debt)	1,492	3,282	1,756	884	335

Source: Hardman & Co Life Sciences Research

Cashflow					
Year end March (£'000)	2014	2015	2016E	2017E	2018E
Operating profit	-381	-793	-1,135	-714	-359
Depreciation	13	75	200	255	315
Amortisation	4	55	180	200	220
Stocks	-13	-123	-75	-107	-135
Working capital	-72	-105	120	-15	-25
Exceptionals/provisions	-75	-155	0	0	0
Other (Fx)	-1	-106	0	0	0
Net cash used in operations	-525	-1,152	-710	-381	16
Net interest	0	-2	2	8	4
Tax	0	-26	-157	-150	-169
Operational cashflow	-525	-1,180	-865	-522	-149
Capital Expenditure	0	-159	-500	-350	-400
Free cashflow	-525	-1,326	-1,365	-872	-549
Dividends	0	0	0	0	0
Acquisitions	-1,357	-2,192	-100	-1,409	-1,000
Other investments	0	-127	-93	0	0
Cashflow after investments	-1,882	-3,645	-1,557	-2,281	-1,549
Share issues	3,374	5,422	100	1,409	1,000
Currency effect	0	12	-82	0	0
Change in net debt	1,492	1,790	-1,525	-872	-549
Opening net cash	0	1,492	3,282	1,756	884
Closing net cash	1,492	3,282	1,756	884	335
Hardman FCF/share (p)	-1.20	-1.27	-0.51	-0.30	-0.08

Source: Hardman & Co Life Sciences Research

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(Disclaimer Version 2 effective: August 2015)

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