

Pharmaceuticals & Biotech



Source: Eikon Thomson Reuters

Market data

EPIC/TKR	AVCT
Price (p)	86.5
12m High (p)	154.0
12m Low (p)	83.0
Shares (m)	68.4
Mkt Cap (£m)	59.1
EV (£m)	39.2
Free Float*	44%
Market	AIM

*As defined by AIM Rule 26

Description

Avacta is a pre-clinical stage biotechnology company developing bio-therapeutics based on its proprietary Affimer protein technology that benefits from near-term revenues from research and diagnostic reagents

Company information

CEO	Alastair Smith
CFO	Tony Gardiner
Chairman	Trevor Nicholls
	01904 217 070
	www.avacta.com

Key shareholders

Directors	4.2%
IP Group	24.8%
Henderson	12.8%
Aviva	9.9%
Baillie Gifford	7.7%
Ruffer LLP	7.1%

Events

June 2016	Opened Cambridge
18 July 2016	Hardman research
August	New Wetherby facility
25 Oct	Finals
Jan 2017	AGM

Analysts

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Avacta

Change in R&D accounting policy

Avacta is a life science company providing high quality and highly specific tools to the biopharmaceutical industry to help in the diagnosis and treatment of humans and animals. The group's Affimer technology is a revolutionary alternative to the established antibody technology which dominates the drug industry despite its limitations. Following the Placing early in the current fiscal year to fund an in-house therapeutic Affimer programme, this has added a significant new element to the R&D spend which means that it is necessary for the company to change the method by which certain R&D investment is accounted for.

- **Strategy:** To commercialise its Affimer technology through a combination of bespoke research tools, collaborative deals and by identifying and developing its own proprietary therapeutic Affimer lead compounds. With about £20.0m on deposit, the company has the resource to deliver on its stated strategy.
- **Capitalised R&D:** Historically, Avacta has invested exclusively in Affimer R&D with a high probability of being embodied in commercial products, in the form of a reagent or diagnostic, in the near or medium term. Therefore, its policy has been to capitalise R&D and amortise this investment once commercialised.
- **Therapeutic R&D:** Following the £25m Placing earlier in fiscal 2016, Avacta has been able to execute on its strategy to develop a pipeline of therapeutic Affimers. This carries a much greater risk that a commercial product might not be achieved. Therefore, Avacta has taken the prudent view that therapeutic R&D should be written-off each year.
- **Financial impact:** This accounting change has no impact on cashflow. Our original forecast assumed that R&D investment of £3.8m would be capitalised. The accounting change means that £2.8m will continue to be capitalised and the £1.0m spent on therapeutic R&D will be written-off through the P&L account.
- **Investment summary:** Given that a putative drug in pre-clinical development has <1% probability of commercialisation, management is taking the prudent view that all its R&D investment in therapeutics should be written-off in the year in which the expenditure is incurred. This brings Avacta in-line with normal pharmaceutical industry practice and has no effect on cashflows.

Financial summary and valuation

Year end Dec (£m)	2013	2014	2015	2016E	2017E	2018E
Sales	2.70	3.18	1.81	2.15	3.02	4.17
EBITDA	-1.74	-1.33	-2.34	-4.36	-6.05	-6.99
Underlying EBIT	-1.83	-1.86	-2.91	-5.26	-7.35	-8.04
Reported EBIT	-1.87	-2.07	-5.57	-5.56	-7.68	-8.40
Underlying PTP	-1.80	-1.83	-2.89	-5.15	-7.18	-7.94
Statutory PTP	-1.85	-2.04	-5.54	-5.45	-7.51	-8.30
Underlying EPS (p)	-4.67	-3.07	-4.50	-6.98	-9.82	-10.89
Statutory EPS (p)	-4.82	-3.57	-9.84	-7.44	-10.30	-11.43
Net (debt)/cash	0.58	11.48	7.33	20.26	12.03	2.19
Shares issued	0.00	14.54	0.02	20.79	0.00	0.00
P/E (x)	nm	nm	nm	nm	nm	nm
EV/sales (x)	nm	nm	nm	nm	nm	nm

Source: Hardman & Co Life Sciences Research

Change in the accounting of R&D

Background

Until fiscal 2016, Avacta had been investing in R&D to identify and develop Affimer targets that could be used commercially. There is a reasonable probability that as a result of this investment the company would generate commercial products in the near to medium term for use in research, as a scientific reagent or as a diagnostic test. Consequently, the company's policy has been to capitalise its R&D investment, include it in 'intangibles' in the balance sheet and then to amortise it over a period of time when the product became commercial.

Revised corporate strategy

However, during fiscal 2016, management became able to execute on its strategy to also develop its own proprietary therapeutic Affimer lead compounds. Given that it takes on average about 10 years from identification of a putative drug through to regulatory approval, there is far more uncertainty about commercial success. Therefore, management has taken the prudent view that the accounting for its therapeutic R&D needs to be treated in a different way.

Given the probabilities associated with a putative drug failing at any stage of pre-clinical or clinical development, standard practise within the pharmaceutical industry is to write-off R&D against the P&L account in the year that such expenditure is incurred. Avacta has announced that it will be conforming to this industry standard from this financial year for the therapeutic R&D spend.

Probability of a putative drug reaching the market		
Phase completed	Small molecule	Biopharmaceutical
Pre-clinical	1%	2%
Phase I	5%	10%
Phase IIa	20%	35%
Phase IIb	40%	70%
Phase III	80%	85%
Submission to regulators	90%	96%

Source: Hardman & Co Life Sciences Research

Financial impact

- ▶ This accounting change has no impact on cashflow and the forecast net cash position at the end of the financial year
- ▶ Our original forecasts for R&D spend were £3.8m, £4.8m and £5.7m in fiscal 2016, 2017 and 2018 respectively, which was to be capitalised and included in intangible assets
- ▶ Of this forecast spend, that associated with therapeutic Affimers is forecast to be £1.0m, £2.5m and £3.0m. This will no longer be capitalised, but taken directly through the P&L account
- ▶ Forecast EBIT losses will rise by these amounts in the respective financial years, effectively writing off the therapeutic Affimer investment.
- ▶ In the event that this R&D investment results in a commercial success, there will not be any associated capitalised R&D that needs to be amortised, thereby boosting profitability in future years

- ▶ Amortisation of existing capitalised R&D has been accelerated which, together with slightly increased depreciation, has had a knock-on effect through the P&L account and the cashflow statement
- ▶ Basic underlying EPS has risen from -4.84p to -6.98p because of this accounting change
- ▶ Changed numbers are highlighted in red in the summary below

Changes to forecasts						
Year end July (£m)	---- 2016E ----		---- 2017E ----		---- 2018E ----	
	old	new	old	new	old	new
Profit & Loss						
Sales	2.15	2.15	3.02	3.02	4.17	4.17
COGS	-0.75	-0.75	-1.00	-1.00	-1.31	-1.31
Gross Profit	1.39	1.39	2.03	2.03	2.87	2.87
Gross margin	65%	65%	67%	67%	69%	69%
SG&A	-5.45	-5.65	-6.60	-6.88	-7.51	-7.90
R&D	-	-1.00	-	-2.50	-	-3.00
EBITDA	-3.30	-4.36	-3.81	-6.05	-3.89	-6.99
Depreciation & Amort.	-0.76	-0.90	-0.76	-1.30	-0.76	-1.05
Licensing/Royalties	0.00	0.00	0.00	0.00	0.00	0.00
Underlying EBIT	-4.06	-5.26	-4.57	-7.35	-4.65	-8.04
Share based costs	-0.30	-0.30	-0.33	-0.33	-0.36	-0.36
Exceptional items	0.00	0.00	0.00	0.00	0.00	0.00
Statutory EBIT	-4.36	-5.56	-4.90	-7.68	-5.01	-8.40
Net financial income	0.11	0.11	0.17	0.17	0.10	0.10
Underlying pre-tax profit	-3.95	-5.15	-4.40	-7.18	-4.55	-7.94
Underlying basic EPS (p)						
Statutory basic EPS (p)	-4.84	-6.98	-5.11	-9.82	-5.03	-10.89
Statutory basic EPS (p)	-5.29	-7.44	-5.59	-10.30	-5.57	-11.43
Balance sheet						
Fixed assets	1.85	1.85	1.91	1.61	1.78	1.48
Intangible assets	14.19	13.11	18.97	15.92	24.70	18.82
Inventories	0.39	0.39	0.56	0.56	0.77	0.77
Debtors less creditors	-21.88	-22.24	-22.26	-23.04	-22.65	-23.89
Invested capital	-5.45	-6.88	-0.83	-4.95	4.60	-2.83
Cashflow						
Trading profit	-4.06	-5.26	-4.57	-7.35	-4.65	-8.04
Depreciation	0.70	0.70	0.70	1.00	0.70	1.00
Amortisation	0.06	0.20	0.06	0.30	0.06	0.35
Inventories	-0.06	-0.06	-0.16	-0.16	-0.21	-0.21
Working capital	0.22	0.22	0.18	0.18	0.16	0.16
Other	0.00	0.00	0.00	0.00	0.00	0.00
Company op cashflow	-3.15	-4.20	-3.79	-6.03	-3.94	-7.04
Net interest	0.11	0.11	0.17	0.17	0.10	0.10
Tax	0.65	0.00	0.77	1.20	0.56	0.56
Operational cashflow	-2.39	-4.10	-2.86	-4.67	-2.89	-6.38
Capital expenditure	-1.01	-1.01	-0.76	-0.76	-0.57	-0.57
Capitalised R&D	-3.83	-2.75	-4.78	-2.81	-5.74	-2.89
Sale of fixed assets	0.00	0.00	0.00	0.00	0.00	0.00
Free cashflow	-7.22	-7.86	-8.39	-8.23	-9.19	-9.84
Change in net debt						
Opening net cash	13.57	10.90	-8.39	-8.90	-9.19	-9.80
Opening net cash	7.33	7.33	20.90	20.26	12.50	12.00
Closing net cash	20.90	20.26	12.50	12.00	3.31	2.20

Source: Hardman & Co Research Life Sciences Research

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