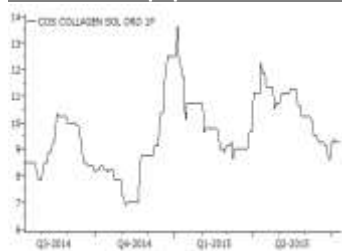


15th July 2015

Healthcare Equipment & Services



Source: Fidessa

Market data

Price (p)	10.00
12m High (p)	14.75
12 Low (p)	6.75
Shares (m)	171.0
Mkt Cap (£m)	17.1
EV (£m)	15.2
EPIC	COS
Free Float* (%)	78%
Market	AIM

*As defined by AIM Rule 26

Description

Collagen Solutions develops and manufactures medical grade collagen components for use in regenerative medicine, medical devices and in-vitro diagnostics.

Company information

CEO	Stewart White
CFO	Gill Black
Chairman	David Evans
www.collagen-solutions.com	
Tel	0141 558 9838

Next event

AGM	24-Aug
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Collagen Solutions (COS.L) FY update

Embedding technology: gross margins will drive value

Collagen Solutions reports on a year of change with significant progress being made towards its short term goals of cash flow breakeven. The acquisition of SLB is delivering on its strategic intent. Evidence of cross selling products and services exists with sales approaching £1m. With clear evidence of meaningful gross margins (78%) and new customer wins, the anticipated higher sales volumes should begin to offset the c. £1.5m central overhead with cash flow breakeven anticipated in H2 2015/16. These margins, in turn, are expected to drive long term shareholder value.

Full year results: Included 3½ months contribution from SLB acquisition. Sales were £0.98m, up from £24k. Group revenue, including grant income of £60k, was £1.035m. A LBITDA of £0.726m was recorded (£0.689m if include grant income). Exceptional costs of £0.155m, relating to the acquisition and integration of SLB are excluded. Net cash at year end was £3.3m, comprising free cash outflow of £1.37m, acquisition costs (net of acquired cash) of £2.226m and £5.4m from the share placing in December 2014.

Strategic outlook: The combination of three businesses over the past 18 months has created the bedrock from which to build out the business. There is a customer base generating recurring revenues, a surety of supply of high grade collagen and the evidence that global medical device manufacturers want to work with COS, evidenced by the four disclosed supply agreements announced over the past 12 months.

Valuation: With no change to forecasts but rolling on one year, our DCF valuation rises to £73m or 39p per share (32p) – forecast cashflows to 2018, projected cashflows thereafter to 2021 and a 2% terminal growth rate. As visibility to contracts improves so too are forecasts likely to be underpinned/rise, with the full value of the technology platforms increasingly being reflected in the share price.

Risks: The integration of SLB appears to be well in hand. The single biggest risk remains the exact timing of development and manufacturing contracts and supply agreements, although recurring revenues do exist. Regulatory delays for client products and potential competition from alternate biomaterials remain risks.

Investment summary: The Board's stated objective is to create a business worth c.£100m by 2020. To achieve this, the Company will have to win further developmental contracts. Equally management are expected to source additional technologies and businesses to build critical mass and exploit the opportunities in the field of biomaterials.

Financial Summary and Valuation

Year end Mar (£,000s)	FY 14A	FY 15A	FY 16E	FY 17E	FY 18E
Sales	24	973	3,700	6,500	10,500
Underlying EBITDA	(364)	(726)	(273)	1,707	4,086
Reported EBIT	(480)	(975)	(768)	1,147	3,456
Underlying PTP	(381)	(921)	(701)	1,211	3,530
Statutory PTP	(480)	(1,102)	(971)	1,011	3,380
Underlying EPS (p)	(0.87)	(0.98)	(0.42)	0.52	1.43
Statutory EPS (p)	(1.10)	(1.17)	(0.58)	0.40	1.35
Net (debt)/cash	1,492	3,282	1,951	2,504	3,510
Shares issued	3,374	5,422	1,000	1,409	-
P/E (x)	-11.2	-10.0	-23.2	18.9	6.8
EV/sales (x)	645.2	15.9	4.2	2.4	1.5
EV/EBITDA (x)	-42.6	-21.4	-56.9	9.1	3.8

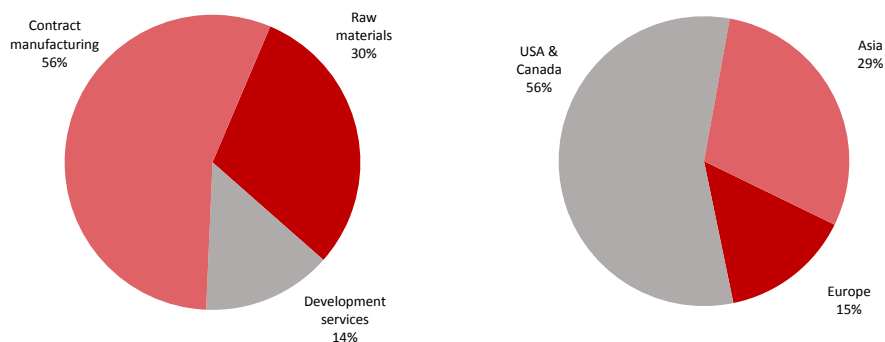
FY 2014/15 summary

Revenues up 40x to
c.£1m

Group revenues, including grant income, were reported as £1.035m compared with £24,000 in the previous year. Excluding grant income, revenues were £0.97m in line with our forecast of £1.0m. Key variables:

- Recurring revenue from clients of £972,846
- Grant income of £62,654, which is reported below gross profit
- A contribution from Southern Lights Biomaterials' (SLB) acquisition (consolidated from 10th December 2014) of £562,624
- Two customers, located in Korea and the USA, accounted for 28.8% (£280,000) and 16% (£156,000) of revenues, respectively. These revenues represented 98% of Asian and 28.5% of US/Canada revenues, respectively

Revenues by category and geography



Source: Collagen Solutions

Gross margins up to
78% from 50%

Cost of goods £214,000 against our forecast of £228,000, representing 22% of sales. This compares with 50.3% in the comparable period and reflects the high margins attained from both SLB's customer contracts as well as the supply of higher added-value collagen supplies to key customers. Gross margins were 78%. We expect this level to be sustained in the future. Together with additional customer volume growth and new customer wins, this is expected to cover the central overhead of c.£1.5m within the next 12 months.

LBITDA of £726,000
compared with
forecast of £763,000

A loss before interest, tax, depreciation and amortization (LBITDA) of £689,816 was reported. Stripping out the grant income, our underlying LBITDA was £726,000, which compares with our forecast of £763,000. This can be attributed largely to:

- lower than expected selling & marketing costs (£219,000 vs £440,000)
- slightly higher administrative expenses (£1,266,000 versus £970,000)
- whereas we had forecast a separate R&D line item of £125,000 the Company has incorporated c.£161k into administrative expenses

An exceptional charge of £155,000 was incurred which related to the acquisition and integration costs pertaining to the SLB acquisition. A reported pre-tax loss of £1.1m compared to our forecast of a loss of £0.939m. The key difference is in the financial expenses line of the Profit & Loss account, which amounted to £0.128m. This related to a non-cash item of £125,300, which reflects the unwinding of the discount of the contingent consideration for acquisitions made to date.

Variance with forecasts				
Year end Mar (£,000s)	FY 14	FY 15E	FY15A	delta
Sales	24	1,000	973	(27)
Cost of goods	(12)	(228)	(214)	14
Gross Profit	12	772	759	(13)
Administrative expenses	(304)	(970)	(1,266)	(296)
Selling and marketing cost	(72)	(440)	(219)	221
R&D	-	(125)	-	125
Underlying EBITDA	(364)	(763)	(726)	37
Depreciation	(13)	(71)	(75)	(4)
Amortisation	(4)	(107)	(55)	52
Other income	-	-	63	63
Underlying EBIT	(381)	(941)	(793)	148
Share based costs	(25)	(50)	(27)	23
Exceptional items	(75)	-	(155)	(155)
Statutory Operating profit	(480)	(991)	(975)	16
Net financial income	-	2	(128)	(130)
Underlying Pre-tax profit	(381)	(939)	(921)	18
Exceptional items	-	-	-	-
Reported pre-tax	(480)	(989)	(1,102)	(113)
Reported taxation	-	-	(21)	(21)
Underlying net income	(381)	(939)	(942)	(3)
Statutory net income	(480)	(989)	(1,124)	(135)
Period-end shares in issue	63.8	171.0	171	-
Weighted average shares (m)	43.7	96.4	96	-
Fully diluted shares (m)	47.7	102.3	102	-
Underlying Basic EPS (p)	(0.87)	(0.97)	(0.98)	(0.00)
Underlying fully-diluted EP	(0.87)	(0.97)	(0.98)	(0.00)
Statutory basic EPS (p)	(1.10)	(1.03)	(1.17)	(0.14)
Statutory fully-diluted EPS	(1.10)	(1.03)	(1.17)	(0.14)

Source: Hardman & Co Life Sciences Research

The underlying net loss of £942,000 was in line with our forecast of £939,000. A statutory net loss of £1.124m compared with our forecast of £0.939m.

Year end net cash of
c.£3.3m

At the 31st March 2015 the Company had net cash of £3.282m, comprising £3.391m cash offset by modest borrowings.

Operating cash outflows of £1.227m and capital expenditure of £0.159m in the year resulted in free cash outflow of £1.373m. The acquisition of SLB, completed on 10th December 2014, was for a maximum consideration of £6m to be satisfied by an initial consideration of £4m (£2.5m cash and £1.5m in shares at 7p per share) and a deferred payment of £2m (NZD4m). In FY 2014/15 the cash consideration of £2.462m was offset by £0.27m cash acquired with SLB.

Outlook

A full year contribution
from SLB.....

In 2015/16 there will be a full year's contribution from SLB which not only includes the recurring revenues from its current key customers in Korea and North America but additional customer wins that have been notified over the past 12 months, which were both pre- and post-SLB:

- KYERON (Holland) – December 2014 agreement to develop fibrous collagen powder for the manufacture of a wound management device with the future potential for other collagen-based products such as bone grafts
- Desu Medical (Turkey) – December 2014 supply agreement for soluble collagen used in the production of its brain and spinal implants DECOLL and DEBONE

- Globus Medical (USA) – January 2015 supply agreement to provide fibrous collagen powder for use in the manufacture of its bone grafting products
- NovaBone (USA) – March 2015 supply of medical grade collagen for use in the manufacture of FDA-approved bone grafts and wound dressings. Although only announced on 10th March, the FDA website indicates that these products were approved in the period August 2014 and January 2015, and include:

NovaBone product approvals

Name	Product type	FDA clearance /date
NovaBone Bioactive Strip	Bone graft	Orthopaedics Division – 31/10/14
NovaBone MacroForm Bioactive	Bone graft	Orthopaedics Division – 22/8/14
NovaTape/NovaPlug	Wound dressings	Dental Division – 8/1/15

Source: Collagen Solutions; FDA website; Hardman & Co Life Sciences Research

From an investors' perspective, these are the only visible contracts that have been announced with the agreement of its customers. There are other contracts, which have been won, but the Company has been unable to disclose for reasons of secrecy and to maintain competitive advantage for the customer.

The Company is yet to reach a critical mass of manufactured products, which is anticipated to occur during the current financial year. Additional investment into plant and equipment is forecast to amount to c.£2.5m over the next three years and reflects the anticipated demand from both disclosed and undisclosed customer contracts as well as those expected to be signed over the next year or so.

*Revenues rising to
£3.7m.....*

We are forecasting revenues of £3.7m (excluding any grant income), which we assume to be zero. Underlying LBITDA is expected to be c.£0.27m, with the Company becoming EBITDA positive in the second half.

*.... with year end net
cash of £2.06m*

Net cash at 31st March 2016 is expected to be £1.95m, driven by a free cash outflow of £1.2m. The company is expected to have sufficient cash reserves to be able to fund from operations the investments in plant and machinery, R&D and sales and marketing. Net cash is forecast to rise to c.£2.5m in 2016/17 and to c.£3.5m in 2017/18 despite some of the contingent deferred acquisition payments being made in cash.

Managing risk

Whilst the Company is still in its early phases of development and growth, management have adopted a growth plan that mitigates many of the risk associated with proprietary development programmes.

- Building a broad customer base
- Embedding its technology (functional collagen and other biomaterials) into its customers' development programmes and ultimately their manufacturing processes, which in turn should lead to increased revenues as these products are commercialised
- Customers operating in a range of industries that should drive revenues both in the short term (in-vitro diagnostics), short to medium term (medical devices) and medium to longer term (regenerative medical products)

Valuation

There are few direct comparator companies to consider when looking at Collagen Solutions. However, Innocoll, which underwent an IPO on NASDAQ in July 2014, raising net \$51.5m, and a further placing in 2015 raising \$16.1m, provides a good example, in our opinion, of the potential value that can be achieved by moving from a company supplying collagen to one developing proprietary end products. The other comparator companies' current valuations in no way reflect the potential value that Collagen Solutions might generate in the next few years.

Comparator company valuations									
Company	Ticker	Curr.	Share price	Shares (m)	Mkt Cap (lc. m)	Mcap (£m)	EV (£m)	EV/Sales (x)	EV/Sales FY1
Holista Coltech	HCT.AX	AUD	0.13	141.3	18.4	8.8	8.2	2.7	
Innocoll	INN.L	USD	14.7	19.9	292.7	188.8	149.0	46.0	
CollPlant	CLPT.TA	ILA	38.0	241.4	91.7	15.7	11.6	n/a	
Collagen Solutions	COS.L	GBP (p)	9.25	171.0	15.8	15.8	12.5	12.9	12.9

Based on closing prices on 12th July 2015
Source: Hardman & Co Life Sciences Research

We have not adjusted our forecasts for 2016-2018 financial years. It remains the case that the exact timing of revenues is not easy to forecast either for the equity markets or the Company. However, it is increasingly clear that the long term revenue generation of the Company should become more secure and tangible as the supply of high quality collagen and other biomaterials to its customer base becomes embedded into the customer's product supply chain.

On a DCF basis and cognisant of the obvious variable inputs, we have taken forecast FCF from our model, extrapolated until 2021 and discounted cashflows using a WACC of 11.1% and a terminal growth rate of 2%. The DCF model, on this basis, suggests a value of c.£73m or 39p per fully diluted share. This compares with 32p in our previous June publication and reflects the fact that we have rolled on cashflows by a year.

DCF valuation						
Year end March	2016	2017	2018	2019	2020	2021
£,000s						
Year	1	2	3	4	5	6.0
Free Cash Flow	(1,222)	553	2,397	3,596	4,675	5,610
		-145%	334%	50%	30%	20%
Discounted Cashflow	(1,100)	448	1,748	2,360	2,762	2,983
Discounted Cash Flow for Forecast Period (£,000)				9,202	13%	
Terminal Value (£,000)				61,650	87%	
Total Enterprise Value (£,000)				70,852	100%	
Net cash/(debt) in year 1 (£,000)				1,951		
Implied market value (£,000)				72,803		
Fully diluted shares (m)				187.0		
Implied value per share (p)				39		
WACC	11.1%		Risk-free Rate	2.5%		
% of debt	0%		Market return	8.0%		
% of Equity	100%		Market Risk	5.6%		
Equity Beta	1.00					
Average Interest Rate	0.5%		Terminal Growth	2%		
CAPM	11.1%					

Source: Hardman & Co Life Sciences Research

Profit & Loss account					
Year end Mar (£,000s)	FY 14A	FY 15A	FY 16E	FY 17E	FY 18E
Sales	24	973	3,700	6,500	10,500
Cost of goods	(12)	(214)	(798)	(1,469)	(2,415)
Gross Profit	12	759	2,903	5,032	8,086
Administrative expenses	(304)	(1,266)	(1,575)	(1,500)	(1,800)
Selling and marketing costs	(72)	(219)	(1,150)	(1,275)	(1,550)
R&D	-	-	(450)	(550)	(650)
Underlying EBITDA	(364)	(726)	(273)	1,707	4,086
Depreciation	(13)	(75)	(200)	(265)	(335)
Amortisation	(4)	(55)	(245)	(245)	(245)
Other income	-	63	-	-	-
Underlying EBIT	(381)	(793)	(718)	1,197	3,506
Share based costs	(25)	(27)	(50)	(50)	(50)
Exceptional items	(75)	(155)	-	-	-
Statutory Operating profit	(480)	(975)	(768)	1,147	3,456
Net financial income	-	(128)	(203)	(135)	(76)
Underlying Pre-tax profit	(381)	(921)	(701)	1,211	3,530
Exceptional items	-	-	-	-	-
Reported pre-tax	(480)	(1,102)	(971)	1,011	3,380
Reported taxation	-	(21)	(18)	(323)	(856)
Underlying net income	(381)	(942)	(719)	888	2,674
Statutory net income	(480)	(1,124)	(989)	688	2,524
Period-end shares in issue (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	176.9	178.2	192.9
Underlying Basic EPS (p)	(0.87)	(0.98)	(0.42)	0.52	1.43
Underlying fully-diluted EPS (p)	(0.87)	(0.98)	(0.42)	0.50	1.39
Statutory basic EPS (p)	(1.10)	(1.17)	(0.58)	0.40	1.35
Statutory fully-diluted EPS (p)	(1.10)	(1.17)	(0.58)	0.39	1.31
DPS (p)	-	-	-	-	-
Key metrics	FY 14A	FY 15A	FY 16E	FY 17E	FY 18E
Growth					
Sales		3950%	280%	76%	62%
Gross profit		6257%	282%	73%	61%
Operating profit		n/a	n/a	n/a	193%
EPS		n/a	n/a	n/a	177%
DPS		n/a	n/a	n/a	n/a
Operating ratios					
Cost of goods	50.3%	22.0%	21.6%	22.6%	23.0%
Gross margin	49.7%	78.0%	78.4%	77.4%	77.0%
Admin	1264.0%	130.1%	42.6%	23.1%	17.1%
Sales & Marketing	299.4%	22.5%	31.1%	19.6%	14.8%
EBITDA	-1513.6%	-74.6%	-7.4%	26.3%	38.9%
Operating profit	-1584.2%	-81.5%	-19.4%	18.4%	33.4%
Reported tax rate	0.0%	-1.9%	-1.9%	32.0%	25.3%

Source: Hardman & Co Life Sciences Research

Balance Sheet					
At 31 March (£,000s)	FY 14A	FY 15A	FY 16E	FY 17E	FY 18E
Shareholders funds	6,256	12,853	13,074	14,812	17,386
Cumulated goodwill	-	-	-	-	-
Total equity	6,256	12,853	13,074	14,812	17,386
Share capital	683	1,755	2,835	2,915	2,915
Reserves	5,573	11,099	10,240	11,898	14,471
Deferred tax	-	285	285	285	285
Long-term loans	-	88	88	88	88
Short-term loans	-	22	22	22	22
less: Cash	1,492	3,391	2,060	2,613	3,620
less: Marketable securities	-	-	-	-	-
less: Non-current investments	(2,409)	(4,320)	(3,540)	(2,281)	(981)
Invested capital	7,174	14,176	14,948	14,875	15,142
Fixed assets	232	794	1,319	1,879	2,494
Intangible assets	6,894	12,919	12,674	12,429	12,184
Stocks	39	219	369	569	819
Trade debtors	-	419	569	794	1,094
Other debtors	167	226	647	535	840
Trade creditors	-	(215)	(295)	(395)	(515)
Tax liability	-	(40)	(40)	(342)	(1,179)
Other creditors	(160)	(144)	(294)	(594)	(594)
Debtors less creditors	7	245	587	(2)	(354)
Invested capital	7,174	14,176	14,948	14,875	15,142
Key metrics	FY 14A	FY 15A	FY 16E	FY 17E	FY 18E
Net cash/(debt)	1,492	3,282	1,951	2,504	3,510
Net debt/equity (%)	24%	26%	15%	17%	20%
Net debt/EBITDA (x)	4.1	4.5	7.2	-1.5	-0.9
After-tax ROIC	-5.3%	-5.7%	-4.8%	6.0%	17.7%
Interest cover (x)	n/a	6	(42)	81	145
Dividend cover (x)	n/a	n/a	n/a	n/a	n/a
Cap-ex/depreciation (x)	0.0	2.1	3.6	3.1	2.8
Cap-ex/sales (%)	1.8%	16.3%	19.6%	12.7%	9.0%
Net asset value/share (p)	14.3	13.3	7.6	8.6	9.3
Stock days	593	220	134	116	105
Debtor days	-	79	49	38	33
Creditor days	-	183	117	86	69

Source: Hardman & Co Life Sciences Research

Cashflow statement					
Year end Mar (£,000s)	FY 14A	FY 15A	FY 16E	FY 17E	FY 18E
Operating profit	(381)	(793)	(718)	1,197	3,506
Depreciation	13	75	200	265	335
Amortisation	4	55	245	245	245
Stocks	(13)	(123)	(150)	(200)	(250)
Working capital	(72)	(105)	(70)	(125)	(180)
Exceptionals/provisions	(75)	(155)	-	-	-
Other (Fx)	(1)	(106)	-	-	-
Net cash used in operations	(525)	(1,152)	(493)	1,382	3,656
Net interest	-	(2)	17	15	24
Tax	-	(26)	(21)	(18)	(323)
Operational cashflow	(525)	(1,180)	(497)	1,378	3,356
Capital Expenditure	(0)	(159)	(725)	(825)	(950)
Free cashflow	(525)	(1,326)	(1,222)	553	2,406
Dividends	-	-	-	-	-
Acquisitions	(1,357)	(2,192)	(1,000)	(1,409)	(1,400)
Other investments	-	(127)	-	-	-
Cashflow after investments	(1,882)	(3,645)	(2,222)	(856)	1,006
Share issues	3,374	5,422	1,000	1,409	-
Currency effect	-	12	-	-	-
Change in net debt	1,492	1,790	(1,222)	553	1,006
Opening net cash	-	1,492	3,282	1,951	2,504
Closing net cash	1,492	3,282	1,951	2,504	3,510
Hardman cashflow/share (p)	-1.2	-1.2	-0.3	0.8	1.8

Source: Hardman & Co Life Sciences Research

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