

Healthcare Equipment & Services



Source: Fidelity

Market data

Price (p)	10.25
12m High (p)	15.9
12m Low (p)	7.5
Shares (m)	171.0
Mkt Cap (£m)	17.5
EV (£m)	16.0
EPIC	COS
Free Float* (%)	78%
Market	AIM

*As defined by AIM Rule 26

Description

www.collagen-solutions.com

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

Company information

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Next event

Finals Jul -15

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Collagen Solutions plc (COS.L) Update

Strategically relevant acquisition – greater than SOP

The acquisition of Southern Lights Biomaterials (SLB) in New Zealand is a significant step on the way to achieving the strategic goal of creating a £100m business by 2020. SLB is both additive and complementary in terms of its products and services but also its geographic footprint. In addition, it secures raw material supply, thereby strengthening its supply chain, and de-risking the investment proposition further.

SLB acquisition: Completed on 10th December for a maximum consideration of £6m, comprising an initial consideration of £4m (£2.5m cash and £1.5m in shares) together with a £2m deferred cash consideration that is self-funded by performance-related revenue milestones. It was funded by way of a £6m Placing and £1.5m in consideration shares, leaving the company with ample working capital to fund and grow the business.

Opportunities are enhanced: The acquisition is highly complementary and strategically significant. It not only brings revenues (£1.26m), EBITDA (£0.27m), an expanded client list (28 customers over past 3 years) and a presence in new geographies/territories but it provides other intangible, but not insignificant, benefits such as an additional of supply of high grade collagen from a negligible risk source (New Zealand), additional premium biomaterials (pericardium) as well as new intellectual property (IP) and know how.

Valuation: Based on the forecast cashflows to 2018, projected cashflows thereafter to 2020 and a 2% terminal growth rate, a DCF value of £62m (33p per share) is indicated. 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: Integration of SLB, timing of development and manufacturing contracts, supply agreements, regulatory delays, and potential competition from alternate biomaterials.

Investment summary: Underlying biomaterial market growth, the embedded nature of processes in its customers' products, expected new client wins – exemplified by KYERON agreement on 15 December – as well as the benefits that its exclusive access to novel collagen processing technology should bring, management has made a substantial step on the way to achieving its stated objective of creating a business worth c.£100m by 2020.

Financial summary and valuation

Year end Mar (£,000s)	FY 14	FY 15E	FY 16E	FY 17E	FY 18E
Sales	24	1,415	4,325	6,760	11,000
Underlying EBITDA	(364)	(582)	498	1,943	4,580
Reported EBIT	(480)	(810)	3	1,383	3,950
Underlying PTP	(381)	(758)	73	1,455	4,024
Statutory PTP	(480)	(808)	23	1,405	3,974
Underlying EPS (p)	(0.87)	(0.79)	0.02	1.06	1.65
Statutory EPS (p)	(1.10)	(0.84)	(0.03)	1.01	1.62
Net (debt)/cash	1,492	3,429	3,116	2,390	4,212
Shares issued	3,374	5,230	-	-	-
P/E (x)	-11.8	-13.0	574.0	9.7	6.2
EV/sales (x)	600.9	10.2	3.3	2.1	1.3
EV/EBITDA (x)	-39.7	-24.8	29.0	7.4	3.2

Source: Hardman & Co Life Sciences Research

Company overview

Collagen Solutions is a biomaterials company developing and manufacturing medical grade collagen components for use in medical devices, regenerative medicine, and *in vitro* diagnostic products. It supplies value-added bio-functional collagen, provides R&D and contract manufacturing services to a broad range of clients, ranging from research organisations to multi-national corporates. The markets in which it operates are substantial; the end markets in which biomaterials such as collagen are utilised are valued as much as \$16bn.

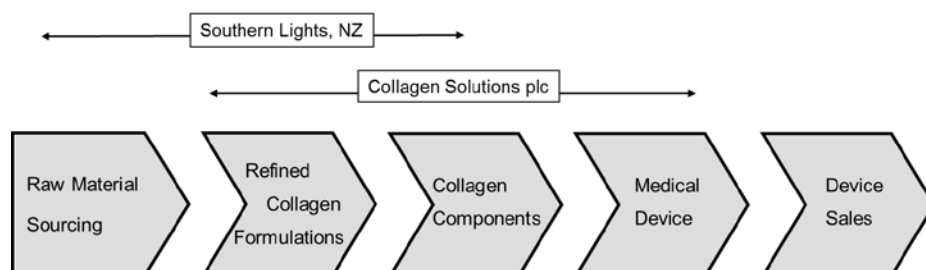
Collagen Solutions was formed by the acquisition of Collbio Ltd and Collagen Solutions LLC, via the reverse takeover of a cash shell, Healthcare Investment Opportunities plc, in January 2014, Collagen Solutions benefits from all the sunk development costs, manufacturing know-how and customer work undertaken over the past six years within these businesses. During this time the precursor companies developed its collagen product range and built its client base, working with the likes of Taxus Cardium to develop an FDA-approved topically formulated collagen gel for the treatment of diabetic ulcers, which clearly demonstrates to the outside world the competencies that reside within the company as well as the potential for future revenues.

Acquisition of Southern Lights Biomaterials

The acquisition of Southern Lights Biomaterials (SLB), completed on 10th December 2014, is considered a strategically significant deal that not only buys revenues (£1.26m), EBITDA (£0.27m), an expanded client list (28 customers over past 3 years) and a presence in new geographies/territories but it provides other intangible, but not insignificant, benefits such as an additional supply of high grade collagen from a negligible risk source (New Zealand), additional premium biomaterials (pericardium) as well as new intellectual property (IP) and know how. The key benefits of the acquisition can be summarised as follows:

- Surety of supply of high grade Collagen from negligible BSE risk source
- Expansion of customer base to cover Asia, Europe & The Americas
- Additional IP and know-how
- Strengthened management - Geoff Bennett as Chief Business Officer
- A turn-key value offering to its customers, providing a wide range of services from the supply of raw materials to the production of a finished device

Collagen Solutions – additive and complementary



Source: Collagen Solutions

SLB's key customer is a Korean medical device manufacturer with a meaningfully significant contract to supply insoluble Type 1 collagen which is used in approved medical devices (resorbable dental membrane and bone graft) and regulated by the Korean FDA. Although SLB's financials are skewed by the dominance of this large single customer (c.63% of revenues in the year ending 31st March 2014), the contract has been extended

until 31st March 2018 with minimum annual orders for 36kg/year, which generated c.US\$1.54m in the year ending 31st March 2014. SLB has the production capacity to produce up to 20kg per month of processed insoluble collagen powder which represents potential annual sales of c.£5.25m (US\$8.4m at \$35 per gram). Not only does this provide access for Collagen Solutions to the key Asian markets but it provides a visibility to cashflows which the enlarged Company can reinvest in new growth opportunities.

Complementary businesses		
	Collagen Solutions	Southern Lights Biomaterials
Key products	Collagen (soluble)	Collagen (insoluble) Pericardium
Key Geographies	N. America	Asia
	Europe	N. America
	ROW	ROW
Key clients	Raw material supply – FDA approved bone graft	Supply contract - Korean FDA approved dental membrane & bone graft Development services
	Contract manufacturing – FDA approved diabetic ulcer treatment	
	Development and manufacturing – cell therapy product approved by FDA to enter clinical trials	
Key focus	Embedding added value functional collagen into customers products	Converting sourced collagen into higher value formulations , embedding into clients’ regulatory approved products and supply of other processed biomaterials

Source: Hardman & Co Life Sciences Research

Combined business streams mitigate risk

The business model supports a strategy for growth that provides the prospect of maximal revenue growth and new product opportunities whilst minimising financial risk. The company aims to embed its products and services into its customers’ approved devices by virtue of the biomaterials’ functionality. By doing so, these contracts are expected to generate long term revenues. SLB provides Collagen Solutions with its own/additional new source of high grade collagen which is of strategic relevance, given that it has up until now relied on a sole supplier of bulk medical grade collagen. In addition it has embedded its insoluble collagen into a key Korean customer’s medical device. The Company’s activities are now focused on four business streams, namely:

Collagen Solutions – business streams		
Business stream	Activity	Location
Raw material sourcing	Sourcing/supply of high grade collagen	New Zealand
Material supply	Bulk collagen supply	Glasgow
	Added value collagen supply	Glasgow/San Jose, USA New Zealand
Development services	Development service for collagen formulations	San Jose, USA
	Development of medical devices	San Jose, USA/Glasgow New Zealand
Contract manufacturing	Contract manufacturing of medical devices	Glasgow
	Contract manufacturing of regenerative medicine products	Glasgow New Zealand
Manufacturing	Proprietary collagen products	Potential Future Opportunity

Source: Hardman & Co Life Sciences Research

Southern Lights Biomaterials

Southern Lights Biomaterials (SLB) was co-founded in 2003 by Geoffrey Bennett who has joined the Board of Collagen Solutions as Chief Business Officer. Following the discovery of BSE in US and Canadian herds and the potential for supply chain disruptions to and concerns amongst medical device manufactures using bovine-based biomaterials, SLB was set up in New Zealand as a supplier of such biomaterials given that New Zealand was and remains ranked by the World Organisation for Animal Health as a negligible BSE risk country. SLB provides its services to an international client base, having acted for or supplied products to 28 customers over the three years to 31st March 2014.

SLB's production and engineering facility, which is ISO 13485-certified with Class 7 clean rooms and segregated processing areas (4,300 sq ft), is situated in Marton (North Island), New Zealand. Its administrative office is in Napier. It has 9 full time employees. From its production facility it supplies the following products:

- Processed biomaterials, mainly insoluble Type 1 Collagen, for use in medical devices and an ideal candidate for implantable tissue scaffolds
- Preserved pericardium (membrane protecting the heart) for use in the manufacturing of implantable heart valves
- Semi-processed biomaterials, mainly pericardium and tendon, but also including hide, bone, tendon, glands and blood vessels

In addition, SLB provides a range of services:

- Consultancy services, supporting established and emerging medical device companies working to develop new or improved products for market. In the year ending 31st March 2014, consultancy revenues were c. £250,000
- Collagen related services, delivering engineered biomaterials with specified properties to companies focussed on medical device product design, testing and approval
- Supply chain logistics for its customers in relation to delivery of product including transport logistics from Australasia to customer production facilities and export documentation and country-specific import documentation
- Regulatory support to assist its customers to meet the requirements for the use of animal products

The key strategic benefits of this acquisition can be summarised as follows:

- De-risks the business by broadening the customer base, bringing additional biomaterials and vertically integrating raw material sources in its supply chain
- Complementary products, customers and geographic territories in which it operates. Our understanding is that there are no customer conflicts and cannibalisation of existing business. It is totally complementary
- Security of supply of high grade collagen from a negligible risk BSE country. It directly sources and undertakes primary processing of its biomaterials (primarily collagen and pericardium)
- Diversifying product offering. In addition to collagen, pericardium biomaterials provides scope to enter another medical device segment that previously was not available to Collagen Solutions, namely cardiology (heart valves)
- Extends supply chain management, from raw material sourcing to production
- Increases its overall production capacity by over 100% but also brings its processing capabilities closer to the sources of raw material

- Wider geographical customer base with access to Asia which accounted for c.64% of SLB's revenues to 31st March 2014
- Additional intellectual property and know how associated with biomaterials processing technology

Acquisition cost

The acquisition of Southern Lights Biomaterials was for a maximum of £6m (NZ\$12m), comprising an upfront consideration of £4m (NZ\$8m);

- a cash consideration of £2.5m (NZ\$5m) payable on completion
- a share consideration of £1.5m (NZ\$3m) by way of the issue of 21,428,572 shares to the Vendors, based on the Placing price of 7p per share

and a maximum deferred payment of up to £2m (NZ\$4m), payable in cash in two tranches, based on achieving revenue targets of £3.25m (NZ\$6.5m) in any year to 31 March 2017:

- "First Earn-Out Payment" of £1m (NZ\$2m) will be payable in cash if, in the first 3 financial years ending 31st March 2017, revenues of £3.25m (NZ\$6.5m) are achieved or exceeded in any one year. If revenues fall below £3.25m but above the base level of £1.25m the First Earn-Out Payment will be prorated accordingly. For example if revenues of £2.5m are achieved, £1.25m above the base level, a cash payment of £0.5m will be payable
- "Second Earn-Out Payment" of £1m (NZ\$2m) will be payable in cash provided that target revenues of £3.25m are met in any of the first 3 financial years and another year up to 31st March 2017. If this condition is not met but revenues exceed the base level in the year to end 31st March 2018 an earn-out will be payable but prorated. For example if revenues of £2.5m are achieved in 2018, £1.25m above the base level, a cash payment of £0.5m will be payable

These deferred payments will be self-funded from the cashflows generated from the revenues above the revenue target level of £1.25m. Given the strategic benefits that increased scale brings to Collagen Solutions we consider the acquisition multiples to be reasonable, having paid an EV/Sales multiple of 3x historic sales and 2.3x prospective current year sales and EV/EBITDA multiples of 13.8x and 7.8x, respectively. This compares very favourably with the 4.0x EV/sales and 10x EV/EBITDA paid by DSM for Kensey Nash in 2012; the only recent and relevant comparable that we have data on.

Acquisition multiples		
	2014	2015est
Upfront acquisition cost (£m)	4.0	4.0
Net cash	0.23	0.50
EV (£m)	3.77	3.50
EV/Sales	3.0x	2.3x
EV/EBITDA	13.8x	7.8x

Source: Hardman & Co Life Sciences Research

Financial performance

SLB's supply agreement with a Korean medical device manufacturer since 2011 was renewed in 2014 for a further two years until 31st March 2018. This supply agreement has provided the bedrock of the company's financial performance over the past 4 years, having contributed c. 63% of 2014 revenues. We estimate that SLB will generate revenues and EBITDA of c.£1.5m and £0.45m, respectively, in the year to end 31st March 2015. Of note is the gross margin which is around 90%. This demonstrates the potential margins achievable by embedding a functional biomaterial into a customer's medical device. For comparison purposes, we have provided summary financials for Collagen Solutions (pre-

acquisition) in which a lower gross margin can be attributed to a high component of lower margin raw materials supply contracts. The higher costs compared with SLB can largely be attributed to the PLC and ancillary AIM listing expenses.

Summary financials – Southern Lights Biomaterials

Year to end March	Southern Lights Biomaterials				COS
	2012	2013	2014	2015est	2015est
£,000					
Revenue	750	912	1,267	1,500	1,040
Cost of goods	(181)	(135)	(122)	(180)	(281)
Gross Profit	569	777	1,144	1,320	759
Gross margin %	75.9%	85.2%	90.3%	88.0%	73.0%
Costs	(670)	(740)	(870)	(870)	(1,475)
EBITDA	(101)	38	274	450	(716)
EBITDA margin	-13.4%	4.2%	21.6%	30.0%	-68.8%
Net cash	43	68	234	504	572

Source: Hardman & Co Life Sciences Research

Sensitivity/risks

Revenue forecasts will still be sensitive in the short term to existing customers retaining Collagen Solutions' services, variable sales cycle and signing with new customers. These in turn are dependent, albeit it to a lesser extent, on the success or failure of its customers' product clinical trials, changes to reimbursement for collagen-based therapies and the possibility that existing customers might use other collagen supplies or other biomaterials. We consider the latter to be less likely for existing products in which Collagen Solutions' bio-functional collagen is embedded into the manufacturing process and regulatory certification. With the spread of clients, exposure to different segments of the value chain we consider Collagen Solutions to have mitigated many of the near term revenue risks.

Financial and corporate history

Healthcare Investment Opportunities plc was established in April 2013, raising £3.6m net of expenses by issuing 40m shares at 10p per share to specifically exploit acquisition opportunities in the healthcare sector.

Collagen Solutions plc was formed via the reverse takeover of Healthcare Investment Opportunities by Collbio Limited and the simultaneous acquisition of Collagen Solutions (US) and subsequent name change in January 2014. A maximum acquisition price of £7.09m (£7.19m fair value) for the purchase of Collbio Limited and Collagen Solutions LLC was agreed, consisting of £1.4m in cash on completion, £3.06m (£3.38m fair value) in Healthcare Investment Opportunities shares and up to £2.63m (£2.41m fair value) in ordinary shares (£2m; £1.78m fair value) and cash dependent on performance criteria over three accounting periods ending 28th February 2017.

Collagen Solutions acquired Southern Lights Biomaterials in December 2014 for a maximum consideration of £6m, comprising £2.5m cash on completion, £1.5m in Collagen Solutions Ordinary shares (21.4m at 7p per share) and up to £2m in cash, contingent on revenue performance criteria in the years to 31st March 2018.

Recent funding

By way of a share Placing, £6m gross was raised (c.£5.23m net) through the issue of 85.714m Ordinary shares at 7p per share. These proceeds will be used to fund the initial cash consideration for the purchase of SLB (£2.5m) as well as providing additional working capital resources.

Use of proceeds

	£m
Cash component of acquisition	2.50
Equity issue fees	0.77
Working capital	2.73
Total	6.00

Source: Collagen Solutions

Share capital

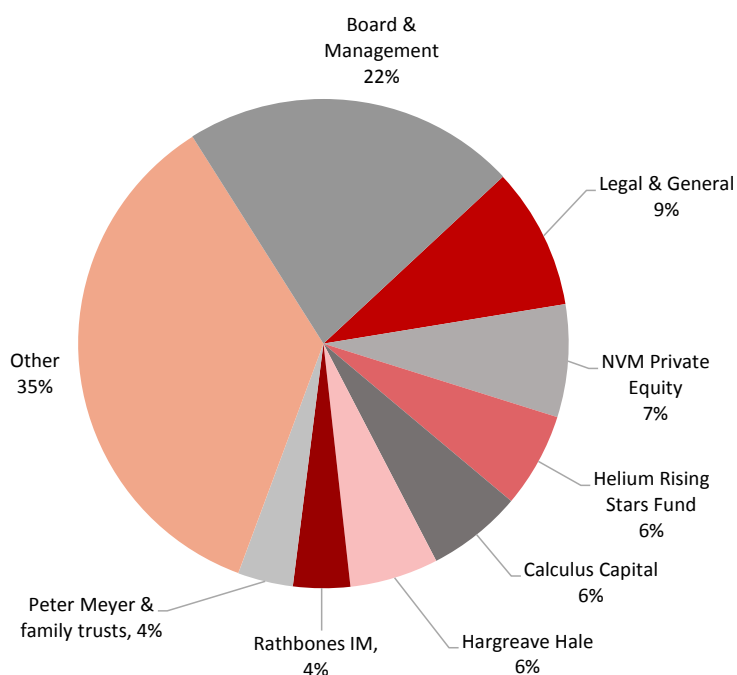
Following the acquisition of Southern Lights Biomaterials there are 170.9m Ordinary shares in issue. An additional 16m Ordinary shares is expected to be issued to the vendors of Collbio and Collagen Solutions LLC in 2017, contingent on revenue targets and the addition of three new manufacturing contracts to 28th February 2017.

Shares in issue - evolution

	Ordinary shares	Price per share (p)	Consideration (£)	% of enlarged share capital
Founder shares	500,000			0.3%
Healthcare Investment Opportunities	40,000,000	10	4,000,000	23.4%
Collbio acquisition	16,000,000	12.5	2,000,000	9.4%
Collagen Solutions LLC	7,326,007	12.5	915,751	4.3%
Existing shares	63,826,012			37.3%
Consideration shares issued	21,428,572	7	1,500,000	12.5%
Placing shares issued	85,714,286	7	6,000,000	50.1%
Total shares in issue	170,968,870			100.0%
Deferred shares	16,000,000			
Total shares (incl potential deferred)	186,968,870			
Share options	5,938,349			
Fully diluted shares (incl potential deferred)	192,907,219			

Source: Hardman & Co Life Sciences Research

Share capital – December 2014



Source: Collagen Solutions

Financial discussion

Collagen Solutions reported its maiden interim results to 30th September 2014 with sales of £0.14m, LBITDA of £0.52m and a pre-tax loss of £0.56m. Revenues were primarily related to raw materials supply and development services. During the period, the company embarked upon the technology transfer of a major client's production process from San Jose to Glasgow. Although this process has taken a couple of months longer than expected to complete, fulfilment of initial production volumes is expected in the current financial year, contributing to the 2H bias.

SLB will be consolidated from 10th December 2014 into Collagen Solutions (ie. c. 3½ months). The following table illustrates the impact of the acquisition to Collagen Solutions' financials. The combined group becomes profitable and generating positive operating cashflows in FY 2016, a year earlier than previously forecast.

Summary financials – impact from SLB acquisition

Forecasts - pre-SLB acquisition					
Year end Mar (£,000s)	FY 14	FY 15E	FY 16E	FY 17E	FY 18E
Sales	24	1,040	2,525	4,360	7,000
Underlying EBITDA	(364)	(716)	68	1,155	2,780
Underlying EBIT	(381)	(802)	(23)	1,034	2,644
Underlying Pre-tax profit	(381)	(799)	(21)	1,037	2,654
Underlying net income	(381)	(799)	(21)	1,070	2,123
Underlying Basic EPS (p)	(0.87)	(1.25)	(0.03)	1.64	2.66
Underlying fully-diluted EPS (p)	(0.87)	(1.25)	(0.03)	1.55	2.53
Net Cash	1,492	572	252	529	2,739
Forecasts - post-SLB acquisition					
Year end Mar (£,000s)	FY 14	FY 15E	FY 16E	FY 17E	FY 18E
Sales	24	1,415	4,325	6,760	11,000
Underlying EBITDA	(364)	(582)	498	1,943	4,580
Underlying EBIT	(381)	(760)	53	1,433	4,000
Underlying Pre-tax profit	(381)	(758)	73	1,455	4,024
Underlying net income	(381)	(758)	17	1,102	3,086
Underlying Basic EPS (p)	(0.87)	(0.79)	0.02	1.06	1.65
Net Cash	1,492	3,429	3,116	2,390	4,212
% change					
Year end Mar (£,000s)	FY 14	FY 15E	FY 16E	FY 17E	FY 18E
Sales		36%	71%	55%	57%
Underlying EBITDA		-19%	630%	68%	65%
Underlying EBIT		-5%	-334%	39%	51%
Underlying Pre-tax profit		-5%	-454%	40%	52%
Underlying net income		-5%	-183%	3%	45%
Underlying Basic EPS (p)		-37%	-155%	-35%	-38%

Source: Hardman & Co Life Sciences Research

Revenues

As a consequence of the acquisition, revenues of £1.415m are expected in FY 2015, c.£0.375m of which is expected from the consolidation of SLB. These are expected to rise to c.£11m in 2018 – driven by existing supply agreements and a strong pipeline of opportunities that are expected to convert into supply contracts, contract manufacturing agreements and development agreements. Whilst revenues are clearly sensitive in the near term to the ramp up of product sales by client companies which is not under Collagen Solutions' control, the longer term trajectory is expected to be strongly positive given the contracts currently visible and those that we understand the company to be in discussions over.

Costs

Of particular note and significance are the high forecast gross margins which, ultimately, are expected to give rise to strong free cashflow generation. Gross margin is enhanced from an expected 72-73% for Collagen Solutions to c.78% for the combined group in FY 2018. SLB's gross margins of 90% in FY 2014 are forecast to be c.88% over the period to FY 2018, illustrative of the incremental value achieved by embedding added-value functional biomaterials into regulated and approved medical devices.

Administrative expenses are expected to be around £0.97m in FY 2015, rising to £1.8m in 2018 of which SLB constitutes c.£0.6m. Of this PLC costs are expected to be c.£0.5m.

Sales & Marketing expenses are expected to be c.£0.44m in FY 2015, £0.15m of which is as a result of SLB's consolidation. This is expected to rise to £1.55m in FY 2018 of which £0.8m is from SLB. As a percentage of sales these expenses are expected to fall to c.17½% of group revenues largely due to the expectation of customers' increased volume demands for their products but also due to the consultancy revenues which have less associated selling costs.

Research & Development is expected to amount to c.£0.25m in FY 2015, rising to £0.55m in 2018 as the company focuses on the development of next generation collagen biomaterials. R&D costs are lower than previously forecast for FY 2015 given that collaboration with UCL on next generation collagens is expected to start in H2 2015.

Cashflow

Underlying EBITDA is expected to be around -£0.6m in the current financial year, becoming positive in FY 2016 (c.£0.5m) and rising to around £4.6m in 2018. As a consequence free cash outflow of c.£0.8m in FY 2015 is expected to build to c.£2.8m in 2018. The incremental cashflows from SLB of c.£1.5m in FY 2017 and 2018 will fund the expected deferred £2m cash consideration for SLB, payable as £1m tranches in FY 2017 and 2018 – earlier if the targeted revenues of £3.25m are met. As a consequence of the £6m gross placing (£5.23m net), net cash is expected to fall to £3.4m in FY 2015, which takes into account the initial cash consideration for SLB and the losses of Collagen Solutions. We expect Collagen Solutions to build additional capacity in both Glasgow and New Zealand over the coming years with capital expenditures increasing by c.£0.35m in 2016 and £0.5m in 2017 and 2018 above previous forecasts. Taking into consideration also the anticipated deferred £2m cash consideration for SLB, net cash is expected to be c.£2.4m in FY 2017 and £4.2m in FY 2018. This should provide the company ample working capital headroom as well as the opportunity to pursue bolt-on acquisitions.

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, 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 (m)	Mcap (£m)	EV (£m)	EV/Sales (x)
Holista Coltech	HCT.AX	AUD	0.05	141.3	7.1	3.9	3.2	1.1
Innocoll	INN.L	USD	7.5	19.8	148.6	88.4	57.8	19.9
CollPlant	CLPT.TA	ILA	17.8	241.4	43.0	7.5	3.3	n/a
Collagen Solutions	COS.L	GBP (p)	8.75	171.0	15.0	15.0	13.5	561.2

Source: Hardman & Co Life Sciences Research

We have simplistically looked at the potential value of the company by taking 2018 forecasts and assuming an prospective EV/EBITDA multiples of 8-15x, typical of medical device companies. Under this basis the business could be worth around £40-73m in 2017 implying a fully diluted value of c.22-39p per share.

Potential valuation based on 2018 multiples

EV/EBITDA (x)	EV £,000	Mcap £,000	Shares (m)	Price (p)
8	36,640	40,852	187.0	22
10	45,800	50,012	187.0	27
12	54,960	59,172	187.0	32
15	68,700	72,912	187.0	39

Source: Hardman & Co Life Sciences Research

We have also looked at the value of Collagen Solutions based on a DCF model. Whilst there are the obvious variable inputs, we have taken forecast FCF from our model, extrapolated until 2020 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.£62m or 33p per fully diluted share.

DCF valuation

Year end March £,000s	2015	2016	2017	2018	2019	2020
Year	1	2	3	4	5	6
Free Cash Flow	-793	-313	683	2,821	3,950	4,740
Discounted Cashflow	-713	-254	498	1,852	2,333	2,520
Discounted Cash Flow for Forecast Period (£,000)				6,237	11%	
Terminal Value (£,000)				52,083	89%	
Total Enterprise Value (£,000)				58,320	100%	
Net cash/(debt) in year 1 (£,000)				3,429		
Implied market value (£,000)				61,749		
Fully diluted shares (m)				187.0		
Implied value per share (p)				33		
WACC		11.1%				
% of debt		0%				
% of Equity		100%				
Equity Beta		1.00				
Average Interest Rate		0.5%				
CAPM		11.1%				
Risk-free Rate		2.5%	10 year UK bond yield			
Market return		8.0%				
Market Risk		5.6%	UK equity risk premium			
Terminal Growth		2%				

Source: Hardman & Co Life Sciences Research

Based on the sensitivity to WACC and terminal growth rates, the following valuation matrix is derived.

DCF sensitivity to WACC and terminal growth – pence per share

		WACC					
		8.0%	9.0%	10.0%	11.1%	13.0%	15.0%
Terminal growth rate	0%	37	34	31	28	24	21
	1%	42	37	34	30	26	23
	2%	48	42	37	33	28	24
	3%	56	48	42	36	30	26
	4%	69	56	48	41	33	28
	5%	90	69	56	47	30	30

Source: Hardman & Co Life Sciences Research

KYERON supply agreement

Collagen Solutions announced on 15th December that it had entered an agreement with KYERON, a private Dutch biomaterials company, to develop and supply fibrous collagen powder for the manufacture of a wound management device. KYERON considers Collagen Solutions as a preferred supplier for these raw materials for the woundcare device as well as other collagen-based biomaterials such as bone graft substitutes, which it has already commercialised.

Investment conclusion

We consider Collagen Solutions to offer investors a much more de-risked investment proposition than prior to the acquisition of SLB. It is now forecast to become strongly EBITDA and EPS positive in FY 2016. The acquisition of SLB demonstrates also the opportunity that exists for the management team to generate substantial incremental value from the technologies that Collagen Solutions possesses and the high potential gross margins and free cashflows that these products can generate. Its investment attractions lie in the fact that business model is based upon:

- a broad range of customers ranging from small research organisations through to large, blue chip multinationals
- collagen formulations with utility in multiple market segments; medical devices, regenerative medicine and in vitro diagnostics
- ISO certified GMP manufacturing facilities in Glasgow, UK and New Zealand which can produce products that can be sold in all major geographic territories
- a range of value-added collagen processing technologies that are expected to create additional customer demand

Management has set an ambitious target of creating a business with a value of £100m by 2020, derived through organic growth, exploitation of its intellectual property (IP) as well as selective acquisitions. In our opinion, the leadership team has experience of generating substantial value in the life science industry. The acquisition of SLB is a significant step on the way to achieving these goals.

Given the underlying growth of the biomaterials market, expected new client contract wins, coupled with the added benefits that its exclusive access to UCL's novel processing technology is expected to bring, this is not considered an over-ambitious goal although investors should clearly be aware of the highlighted risks.

Financials

Profit & Loss statement

Year end Mar (£,000s)	FY 14	FY 15E	FY 16E	FY 17E	FY 18E
Sales	24	1,415	4,325	6,760	11,000
Cost of goods	(12)	(337)	(952)	(1,492)	(2,420)
Gross Profit	12	1,078	3,373	5,268	8,580
Administrative expenses	(304)	(970)	(1,375)	(1,500)	(1,800)
Selling and marketing costs	(72)	(440)	(1,050)	(1,275)	(1,550)
R&D	-	(250)	(450)	(550)	(650)
Underlying EBITDA	(364)	(582)	498	1,943	4,580
Depreciation	(13)	(71)	(150)	(215)	(285)
Amortisation	(4)	(107)	(295)	(295)	(295)
Underlying EBIT	(381)	(760)	53	1,433	4,000
Share based costs	(25)	(50)	(50)	(50)	(50)
Exceptional items	(75)	-	-	-	-
Statutory Operating profit	(480)	(810)	3	1,383	3,950
Net financial income	-	3	20	22	24
Underlying Pre-tax profit	(381)	(758)	73	1,455	4,024
Exceptional items	-	-	-	-	-
Reported pre-tax	(480)	(808)	23	1,405	3,974
Reported taxation	-	-	(56)	(353)	(938)
Underlying net income	(381)	(758)	17	1,102	3,086
Statutory net income	(480)	(808)	(33)	1,052	3,036
Period-end shares in issue (m)	63.8	171.0	171.0	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)	(0.79)	0.01	0.64	1.65
Underlying fully-diluted EPS (p)	(0.87)	(0.79)	0.01	0.62	1.60
Statutory basic EPS (p)	(1.10)	(0.84)	(0.02)	0.61	1.62
Statutory fully-diluted EPS (p)	(1.10)	(0.84)	(0.02)	0.59	1.57
DPS (p)	-	-	-	-	-
Key metrics	FY 14	FY 15E	FY 16E	FY 17E	FY 18E
Growth					
Sales		5790%	206%	56%	63%
Gross profit		8929%	213%	56%	63%
Operating profit		n/a	n/a	n/a	179%
EPS		n/a	n/a	n/a	158%
DPS		n/a	n/a	n/a	n/a
Operating ratios					
Cost of goods	50.3%	23.8%	22.0%	22.1%	22.0%
Gross margin	49.7%	76.2%	78.0%	77.9%	78.0%
Admin	1264.0%	68.6%	31.8%	22.2%	16.4%
Sales & Marketing	299.4%	31.1%	24.3%	18.9%	14.1%
EBITDA	-1513.6%	-41.1%	11.5%	28.7%	41.6%
Operating profit	-1584.2%	-53.7%	1.2%	21.2%	36.4%
Reported tax rate	0.0%	0.0%	239.5%	25.1%	23.6%

Source: Collagen Solutions; Hardman & Co Life Sciences forecasts

Balance sheet

At 31 March (£,000s)	FY 14	FY 15E	FY 16E	FY 17E	FY 18E
Shareholders funds	6,256	13,066	13,083	16,185	19,271
Cumulated goodwill	-	-	-	-	-
Total equity	6,256	13,066	13,083	16,185	19,271
Share capital	683	1,755	1,755	1,915	1,915
Reserves	5,573	11,311	11,328	14,270	17,356
less: Cash	1,492	3,429	3,116	2,390	4,212
less: Marketable securities	-	-	-	-	-
less: Non-current investments	(2,409)	(4,427)	(4,427)	(1,017)	(17)
Invested capital	7,174	14,063	14,394	14,812	15,077
Fixed assets	232	695	1,145	1,830	2,545
Intangible assets	6,894	12,326	12,031	11,736	11,441
Stocks	39	149	299	499	749
Trade debtors	-	300	450	675	975
Other debtors	167	1,003	1,015	1,071	1,367
Trade creditors	-	(220)	(300)	(400)	(520)
Tax liability	-	-	(56)	(409)	(1,291)
Other creditors	(160)	(190)	(190)	(190)	(190)
Debtors less creditors	7	893	918	746	342
Invested capital	7,174	14,063	14,394	14,812	15,077
Key metrics	FY 14	FY 15E	FY 16E	FY 17E	FY 18E
Net cash/(debt)	1,492	3,429	3,116	2,390	4,212
Net debt/equity (%)	24%	26%	24%	15%	22%
Net debt/EBITDA (x)	4.1	5.9	-6.3	-1.2	-0.9
After-tax ROIC	-5.3%	-5.4%	0.1%	7.4%	20.5%
Interest cover (x)	n/a	(303)	3	65	166
Dividend cover (x)	n/a	n/a	n/a	n/a	n/a
Cap-ex/depreciation (x)	0.0	1.6	4.0	4.2	3.5
Cap-ex/sales (%)	1.8%	8.1%	13.9%	13.3%	9.1%
Net asset value/share (p)	14.3	13.6	7.7	9.4	10.3
Stock days	593	102	86	98	94
Debtor days	-	39	32	30	27
Creditor days	-	119	100	86	69

Source: Collagen Solutions; Hardman & Co Life Sciences forecasts

Cashflow statement

Year end Mar (£,000s)	FY 14	FY 15E	FY 16E	FY 17E	FY 18E
Operating profit	(381)	(760)	53	1,433	4,000
Depreciation	13	71	150	215	285
Amortisation	4	107	295	295	295
Stocks	(13)	(50)	(150)	(200)	(250)
Working capital	(72)	(60)	(70)	(125)	(180)
Exceptionals/provisions	(75)	-	-	-	-
Other (Fx)	(1)	-	-	-	-
Net cash used in operations	(525)	(692)	278	1,618	4,150
Net interest	-	3	20	22	24
Tax	-	-	(11)	(56)	(353)
Operational cashflow	(525)	(690)	287	1,583	3,821
Capital Expenditure	(0)	(115)	(600)	(900)	(1,000)
Free cashflow	(525)	(793)	(313)	683	2,821
Dividends	-	-	-	-	-
Acquisitions	(1,357)	(2,500)	-	(1,409)	(1,000)
Other investments	-	-	-	-	-
Cashflow after investments	(1,882)	(3,293)	(313)	(726)	1,821
Share issues	3,374	5,230	-	-	-
Currency effect	-	-	-	-	-
Change in net debt	1,492	1,937	(313)	(726)	1,821
Opening net cash	-	1,492	3,429	3,116	2,390
Closing net cash	1,492	3,429	3,116	2,390	4,212
Hardman cashflow/share (p)	-1.2	-0.7	0.2	0.9	2.0

Source: Collagen Solutions; Hardman & Co Life Sciences forecasts

Notes

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