PROGRESSIVE
EQUITY RESEARCH

26 March 2014

INSTEM

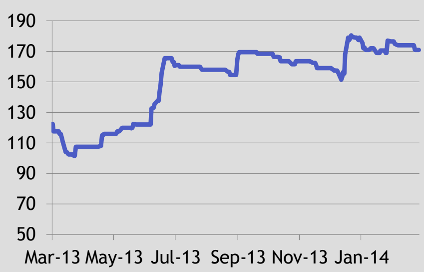
SOFTWARE & COMPUTER SERVICES

INS.L

171p

Market Cap: £20.1m

SHARE PRICE (p)



12m high/low	180.5p/101.5p

Source: LSE Data

KEY INFORMATION

Enterprise value	£18.1m
Index/market	FTSE AIM
Next news	H114 results Sep '14
Gearing	N/A
Interest cover	N/A

INSTEM IS A RESEARCH CLIENT OF PROGRESSIVE

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Foundations looking solid; extensions under way

Instem has reported FY13 results that were modestly ahead of our expectations with revenues around £0.4m (3%) better than we anticipated, and a beat of c£0.1m at the Adjusted PBT level. The Group reports strong customer retention rates and notes a number of significant deals and client wins, with the increase in new SaaS deals a notable plus. Instem has increased its share of the preclinical market, and the entry into the early phase clinical market (via the Logos Technologies acquisition) is now fully integrated and 'performing strongly'. The outlook statement suggests that end markets are showing some improvement, and takes a confident tone towards the prospects for FY14. We nudge our Adjusted EBITDA estimates up by a conservative 2% for both FY14 and FY15.

- Revenues of £11.4 million for FY13 were 3% ahead of our expectations with growth driven mainly by the UK businesses. Approximately 72% of revenue was recurring, and high-value SaaS revenues grew by around a third to £1.5m. Adjusted PBT was some £0.1m ahead of our expectations, and net cash at the period end was roughly in line with the prior year at £2.1m, despite a net £1.6m spend on acquisitions during the year.
- The performance has been solid across the board, with the flagship Provantis product selling into some major US government clients, and winning add-on business elsewhere, while Centrus (the information exchange platform) is beginning to see the benefit of FDA-driven SEND standards. In the clinical market, the ALPHADAS product secured its first major post-acquisition contract, and the smaller businesses of Instem Scientific and recently-acquired Perceptive Instruments appear to be trading well.
- The Outlook statement notes the 'nascent signs of a recovery in end markets' and we believe that this should combine well with Instem's moves into clinical (as opposed to pre-clinical) markets, and the FDA's focus on SEND standard. Today's announcement of the $1.3m extension to the US government NIEHS contract is an early example.

Instem had hoped for a better end to 2013, but today's announcement demonstrates both that the cautious January statement contained a good degree of prudence, and also that 2014 appears to be off to a strong start. We anticipate further growth, both organically and via acquisitions (or partnerships) as the group moves to capitalise on its solid position.

FYE	2011	2012	2013	2014E	2015E
Revenue	10.8	10.7	11.4	13.9	14.8
Adjusted EBITDA	**2.0**	**1.7**	**1.9**	**2.3**	**2.6**
Adjusted PBT	1.6	1.4	1.4	2.0	2.3
Adjusted EPS (p)	**8.9**	**10.4**	**8.1**	**11.5**	**13.2**
EV/Sales	1.7x	1.7x	1.6x	1.3x	1.2x
EV/ Adj. EBITDA	9.0x	10.9x	9.7x	7.7x	6.8x
P/E	**19.1x**	**16.4x**	**21.1x**	**14.8x**	**12.9x**

Source: Company Information and Progressive Equity Research estimates

The FY13 numbers

Revenue

Instem reported total revenues of £11.4 million for FY13 (FY12: £10.7 million) – some 3% ahead of our expectations, with growth driven mainly by the UK businesses (£2.5 million, up from £1.3 million in FY12). Approximately 72% of revenue was recurring (FY12: 70%).

Expenses

Operating expenses increased to £9.69 million (FY12: £9.16 million) mainly reflecting the two acquisitions made during FY13.

Operating profit

In January, Instem had noted the delay in one particularly significant perpetual licence in a trading update. Despite that, the Group has produced an operating performance ahead of the prior year (and our expectations). Profit before amortisation, share based payments and non-recurring costs was £1.5 million (FY12: £1.3 million).

Other points of note

- Customer retention rate of 95%.
- Development costs incurred in FY13 were £1.8 million (FY12: £1.7 million), of which £0.3 million was capitalised (FY12: £0.3 million).
- Non-recurring costs of £0.2 million include legal and professional fees associated with the two completed acquisitions during the year.
- There was an increase in the funding deficit on the Company's defined benefit pension scheme of £0.6 million (FY12: £1.4 million). There is an agreed schedule of payments designed to eliminate the funding deficit over an eight year period.
- Cash generated from operations was £2.0 million (FY12: £0.4 million) and Instem ended FY13 with net cash of £2.1million (FY12: £2.2 million).

Outlook

It is worth noting the positive comments on the 'nascent signs of a recovery in end markets' follow a year in which market conditions were best described (and often were by Instem and others) as 'challenging'. There is a confident tone in addressing the outlook for FY14 with the prospect of further organic and acquisitive growth (aided by full year contributions from last year's acquisitions).

The statement notes that, during FY13, Instem further increased its share of the preclinical market and made 'important strategic progress including expansion of its product sets and entry into the early phase clinical market'. It also states that regulatory and fiscal pressures continue to drive demand for its product portfolio. We believe that 2014 could see material growth from the Centrus suite, driven by uptake across the industry of the FDA-promoted SEND standards.

Market backdrop and expanded opportunity

Instem highlights signs that the global pharmaceutical market is returning to early stage development work to refill the pipeline of preclinical candidates after several years of focus on drugs in late stage development. This is particularly relevant to Instem's positioning, which is primarily in early stage (preclinical) data management. In addition, it notes an increased preference for regulatory authorities to receive data for new drug submissions electronically (Centrus/SEND) and greater demand for analysis of historic data to extract further value from previous development work.

The relevance of these points was seen in FY13 and should produce further benefit in FY14. Instem's preclinical business benefitted from increased demand from governmental customers (witness the Provantis / NIEHS deal in the USA). In addition, "government funding is indirectly supporting investment in Instem technologies through funding a wide variety of commercial organisations and research institutes".

Overall, it seems that Instem's positioning continues to improve, through a combination of organic evolution and acquisitive extension, in a marketplace which is itself exhibiting something of a recovery. We see recent M&A into the clinical trials software market as a major strategic move, and the addition of Perceptive Instruments added another strand (genetic toxicology) to the pre-clinical product suite.

US government contract renewal & extension

In addition to today's results release, Instem has announced a $1.3m extension to the Provantis licence contract with the US government body NIEHS. This contract is for the delivery of pre-clinical trial management software Provantis under a SaaS (Software as a Service) model, and today's announcement represents an important validation through both the renewal and a useful extension to the deal size.

Estimates

With Instem's FY13 results coming in ahead of our numbers by around 13% at the adjusted EBITDA level, we are making hopefully-conservative 2% increases to our Adjusted EBITDA estimates for both FY14 and FY15. Our estimates changes are summarised in the table below:

Estimate changes

	FY14E			FY15E		
£m unless stated	**Old**	**New**	**Change (%)**	**Old**	**New**	**Change (%)**
Revenue	13.7	13.9	1.4%	14.5	14.8	2.1%
Adj EBITDA	2.3	2.3	1.5%	2.6	2.6	1.6%
Reported PBT	2.0	2.0	1.5%	2.3	2.3	1.9%
Fully adj PBT	2.0	2.0	1.5%	2.3	2.3	1.9%
Reported EPS (p)	11.2	11.5	3.1%	12.8	13.2	3.4%
Fully adj EPS (p)	11.2	11.5	3.1%	12.8	13.2	3.4%

Source: Progressive Equity Research estimates

INSTEM FINANCIAL SUMMARY

Year ended December	**FY-11A**	**FY-12A**	**FY-13A**	**FY-14E**	**FY-15E**
£m unless stated					
Profit & Loss					
Revenue	**10.8**	**10.7**	**11.4**	**13.9**	**14.8**
Adj EBITDA	2.0	1.7	1.9	2.3	2.6
Adj EBIT	**1.6**	**1.3**	**1.4**	**1.9**	**2.2**
Reported PBT	1.5	1.3	0.7	2.0	2.3
PBT before exceptionals and AAG	1.8	1.4	0.9	2.3	2.6
Fully adj PBT	**1.6**	**1.4**	**1.4**	**2.0**	**2.3**
NOPAT	1.1	1.1	1.0	1.3	1.6
Reported EPS (p)	8.5	8.9	4.5	11.5	13.2
EPS before exceptionals and AAG (p)	10.3	10.3	5.6	12.9	14.5
Fully adj EPS (p)	**8.9**	**10.4**	**8.1**	**11.5**	**13.2**
Dividend per share (p)	0.0	0.0	0.0	0.0	0.0
Cash flow & Balance sheet					
Operating cash flow	1.3	0.5	2.8	1.7	2.2
Free Cash flow £m	0.4	(0.4)	2.2	0.5	1.0
FCF per share p	3.0	(3.7)	18.9	4.1	8.1
Acquisitions	(0.1)	(0.1)	(1.6)	(0.5)	(0.7)
Disposals	0.0	0.0	0.0	0.0	0.0
Shares issued	0.0	0.0	0.0	0.3	0.2
Net cash flow	**0.4**	**(0.6)**	**0.6**	**0.3**	**0.5**
Overdrafts / borrowings / other	(0.5)	(0.3)	0.0	0.0	0.0
Cash & equivalents	**3.4**	**2.5**	**2.1**	**2.3**	**2.8**
Net (Debt)/Cash	**2.9**	**2.2**	**2.1**	**2.3**	**2.8**
NAV and returns					
Net asset value	5.4	5.0	5.0	6.6	8.5
NAV/share (p)	**0.5**	**0.4**	**0.4**	**0.6**	**0.7**
Net Tangible Asset Value	(2.7)	(3.0)	(7.9)	(6.0)	(4.3)
NTAV/share (p)	**(0.2)**	**(0.3)**	**(0.7)**	**(0.5)**	**(0.4)**
Average equity		5.2	5.0	5.8	7.6
Post-tax ROE (%)		**20.1%**	**10.6%**	**24.4%**	**21.7%**
Metrics	**FY-11A**	**FY-12A**	**FY-13A**	**FY-14E**	**FY-15E**
Adj EBIT growth		*-16.5%*	*6.7%*	*33.9%*	*16.1%*
Adj PBT growth		*-8.7%*	*-4.6%*	*48.8%*	*15.5%*
Adj EPS growth		*16.2%*	*-22.0%*	*42.5%*	*14.6%*
Dividend growth		*n/a*	*n/a*	*n/a*	*n/a*
Adj EBIT margins		*12.5%*	*12.6%*	*13.8%*	*15.0%*
Valuation	**FY-11A**	**FY-12A**	**FY-13A**	**FY-14E**	**FY-15E**
EV/Sales	1.7	1.7	1.6	1.3	1.2
EV/EBITDA	9.0	10.9	9.7	7.7	6.8
EV/NOPAT	16.7	15.8	18.1	13.5	11.6
PER	19.1	16.4	21.1	14.8	12.9
Dividend yield	0.0%	0.0%	0.0%	0.0%	0.0%
FCF yield	1.8%	-2.2%	11.0%	2.4%	4.7%

Source: Instem information, Progressive Equity Research estimates

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