

12 September 2011

Evotec

Year End	Revenue (€m)	PBT* (€m)	EPS* (c)	DPS (c)	P/E (x)	Yield (%)
12/09	42.7	(21.7)	(20.6)	0.0	N/A	N/A
12/10	55.3	4.5	3.8	0.0	62.6	N/A
12/11e	78.8	14.1	11.1	0.0	21.3	N/A
12/12e	86.0	13.8	11.0	0.0	21.5	N/A

Note: *PBT and EPS are normalised, excluding intangible amortisation and exceptional items.

Investment summary: Roche licensing deal

Evotec has out-licensed EVT 302 to Roche on very favourable terms in a deal worth \$830m. As a result we have raised our valuation by €126m to €500m. EVT 302 had been a dormant asset, but now Roche will develop it in Alzheimer's disease (AD). It will initiate a Phase IIb trial in 2012 and proceed directly into a Phase III programme if the first study is positive. EVT 302 could reach the market in 2019 and generate peak sales of \$3.2bn.

\$830m licensing deal with Roche

Evotec has received an upfront payment of \$10m and could be paid regulatory milestones up to \$170m, commercial milestones up to \$650m and tiered double-digit royalties on net sales following the out-licensing of EVT 302 to Roche for the treatment of AD. Roche will carry out and pay for all further development and marketing of EVT 302. A Phase IIb study will begin in 2012.

Phase IIb study to start in 2012

Roche will initiate a substantial Phase IIb study in 2012 so that if proof-of-concept is achieved, EVT 302 can advance immediately into a Phase III programme. No further details on the development programme have been disclosed, presumably for competitive reasons. However, we estimate that it could be launched in 2019.

Potential of EVT 302

EVT 302 is believed to be able to slow the development of AD. Aricept, the leading treatment, generated sales of \$4bn in FY10, although it only has a limited effect on cognition without altering the progression of the disease. We currently estimate that EVT 302 could achieve peak sales of \$3.2bn; however, it could be much higher depending on the drug's ability to slow the progression of AD.

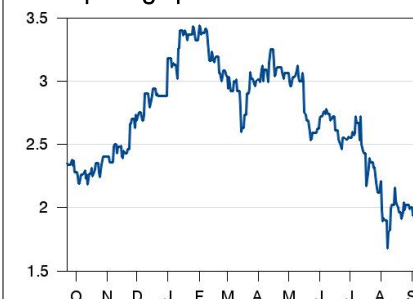
Valuation: DCF valuation increased to €500m

We have raised our DCF valuation by €126m to €500m following the deal; previously no value had been placed on EVT 302. We have also raised our revenue estimate for FY11 by €7m, as Evotec says that the upfront payment will be recognised in full this year, but our forecasts for later years are unchanged.

Price €2.28

Market Cap €270m

Share price graph



Share details

Code	EVT
Listing	Frankfurt, Prime Standard
Sector	Pharmaceuticals & Biotech
Shares in issue	118.2m

Price

52 week	High	Low
	€3.47	€1.58

Balance Sheet as at 30 June 2011

Debt/Equity (%)	N/A
NAV per share (€)	1.18
Net cash (€m)	44.7

Business

Evotec is a drug discovery business that provides outsourcing solutions to pharmaceutical companies, including Boehringer Ingelheim, Pfizer and Roche. It has operations in Germany, India, the UK and the US.

Valuation

	2010	2011e	2012e
P/E relative	596%	198%	227%
P/CF	141.3	12.8	12.6
EV/Sales	3.4	2.7	2.4
ROE	3.1%	8.8%	8.0%

Geography based on revenues

UK	Europe	US	Other
N/A	N/A	N/A	N/A

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Update: Roche licensing deal

The licensing deal with Roche provides Evotec with an additional late stage asset in active clinical development (Roche had returned the rights to EVT 101/103 to Evotec following the termination of a Phase II trial earlier in the year, Exhibit 1). Both DiaPep277 and EVT 302 are being developed for difficult to treat indications, but have considerable commercial potential should they prove to be effective treatments, especially the latter. Evotec is not dependent upon the success of any of its clinical pipeline – they are development programmes that are fully funded by its partners and its current valuation is fully supported by the value of its drug alliance business and cash position – however there is substantial upside associated with clinical progress.

Exhibit 1: Updated clinical R&D pipeline

Product	Development stage	Indication / Partner	Notes
DiaPep277	Phase III	Type I diabetes / Andromeda (Teva)	A synthetic peptide of 24 amino acids derived from human Hsp60. Phase II studies demonstrated that it can preserve β -cell function (assayed using c-peptide levels), and that more patients reached glyceric control of HbA1c<7%. Currently in two pivotal Phase III studies with 457 pts and 450 pts , due to report at the end of 2011 and in 2014 respectively. Teva is the exclusive distributor. Evotec could earn significant short- and mid-term milestones + single-digit royalties, 30% of which are payable to original shareholders of DeveloGen. Potential launch in 2015.
EVT 302	Phase II	Alzheimer's disease / Roche	Monoamine oxidase-B (MAO-B) inhibitor, initially licensed from Roche in 2006. Evotec has out-licensed EVT 302 back to Roche in September 2011 for development in Alzheimer's disease. Evotec was paid \$10m upfront and could receive \$170m in development milestones, \$650m in commercial milestones and tiered double-digit royalties on sales. Roche will pay for all of the development costs and expects to initiate a Phase IIb trial in 2012. EVT 302 had been developed for smoking cessation before it failed to demonstrate any benefit over nicotine replacement therapy alone in a PoC Phase II study. Potential launch 2019.
EVT 201	Completed Phase II	Insomnia / Jingxin Pharma	GABA _A receptor modulator, shown efficacy in two Phase II trials. In one trial, 75 adults, doses 1.5mg and 2.5mg, both primary endpoints met with increased total sleep time (TST, 33.1, 45.0 min; both p<0.0001) and reduced wake after sleep onset (-16.7, -25.7 min; p<0.0001) in a dose responsive manner. In second trial, 149 elderly pts, doses 1.5mg and 2.5mg, TST increased (30.9, 56.4min; p=0.0001, p<0.0001). No serious or unexpected adverse events. Jingxin Pharma in-licensed the exclusive rights to the drug in China and will initiate clinical trials in 2011; Evotec received a small upfront payment and could receive milestones and significant royalties. Further development in the rest of the world is on hold until the drug is partnered.
-	Phase I	Neuropathic pain / Boehringer Ingelheim	Boehringer Ingelheim initiated a Phase I trial in May 2011 with a back-up compound. The development of a different compound, which had started Phase I in May 2010, has been stopped.
EVT 101/103	Phase II (on hold)	Treatment resistant depression	NR2B-selective NMDA antagonists, originally discovered by Roche. EVT 103 is a back-up compound or for other CNS indications. Evotec terminated a Phase II PoC trial for EVT 101 in May 2011 because of difficulty recruiting patients. Successfully completed Phase I trial with EVT 103 (72 healthy males, with single and multiple dosing, safe and well tolerated). Roche will not exercise its option on this drug family so future development depends on a new partnership. They could be developed for pain and Alzheimer's disease.
EVT 401	Completed Phase I (on hold)	Rheumatoid arthritis, inflammatory diseases	Antagonist of P2X ₇ ; ATP-gated ion channel, thought to be involved in the inflammatory process. Phase I trial: 96 healthy males with ascending doses, no serious adverse events or withdrawals occurred. A pharmacodynamic assay demonstrated that EVT 401 blocked ATP-stimulated IL-1 β release in whole blood samples taken from the volunteers. A partner is needed to continue development.

Source: Edison Investment Research

Alzheimer's disease (AD) is already an indication of focus for Roche. It has two monoclonal antibodies in Phase II development, gantenerumab and crenezumab, both of which target β -amyloid, and has a collaboration with reMYND targeting the tau pathway. The in-licensing of EVT 302, a monoamine oxidase-B (MAO-B) inhibitor, provides the company with a third way of treating AD, which is possibly complementary to the other approaches.

It is believed that the inhibition of MAO-B by EVT 302 will lead to a decline in neuronal damage in the brain and the slowing of AD progression. MAO-B breaks down neurotransmitters such as dopamine and in doing so produces molecules that can cause oxidative stress and neuronal damage. Post-mortem studies indicate that patients with AD express higher levels MAO-B in the brain, thus it is thought that EVT 302 will slow down the rate at which AD progresses by decreasing the production of the molecules that cause oxidative stress.

There are other MAO-B inhibitors on the market (eg selegiline [Emsam] for major depressive disorder and rasagiline [Azilect] for Parkinson's disease), however their safety profiles mean that it is unlikely that they would ever be approved for the treatment of AD, which affects c 5.4m in the US. Patients taking these drugs need to be on a selective diet, which excludes dried or pickled meat/fish, aged cheese or beer, or they risk a hypertensive crisis (high blood pressure, headaches, vomiting, sweating and stiffness), also known as "the cheese effect", which can be fatal. This is because the current MAO-B inhibitors can also inhibit MAO-A and these foods contain the monoamine, tyramine, which is normally broken down by a different MAO-A. In contrast to these MAO-B inhibitors, EVT 302 is more selective (it does not inhibit MAO-A) so that patients taking it do not need a selective diet and it has an excellent safety profile (over 500 patients have received EVT 302 when it was being developed for smoking cessation). Another MAO-B inhibitor, safinamide, is in Phase III development for Parkinson's disease, and this also has a good safety profile. This might explain why Roche is cautious about disclosing its development programme beyond saying that it will start a Phase IIb study in 2012, which could be followed by a pivotal Phase III programme.

Financials and Valuation

We have increased our revenue forecasts for FY11 by €7m to €78.8m, because Evotec has indicated that the upfront payment will be recognised in full in FY11, and not spread over the term of the contract. This has led to our FY11 estimates for PBT increasing by €7.3m to €14.1m and EPS by 6.2c to 11.1c. No significant changes have been made to estimates in subsequent years.

We have also raised our valuation by €126m to €500m (Exhibit 2). This is primarily because of the inclusion of EVT 302 in the valuation; before the deal with Roche, no value had been placed on the product. Other changes include adjustments to the \$/€ exchange rate and discount factors because of the progression of time.

Exhibit 2: Summary of risk-adjusted DCF valuation

Note: For drug discovery business: WACC=10%; for product valuations: WACC=12.5%.

	Value (€m)	Value per share (€)	Notes
Drug alliance business	248	2.09	Three stage DCF valuation, terminal growth rate:2.5%
EVT 302	113	0.96	Expected launch: 2019; peak sales: \$3.2m; risk adjustment: 30%; royalties: 12.5% (excludes potential commercial milestones)
DiaPep277	48	0.41	Expected launch: 2015; peak sales: \$450m; risk adjustment: 50%; royalties: 5%
EVT 101/103	21	0.17	Probability of option being exercised: 50%; expected launch: 2018; peak sales: \$1.0bn; risk adjustment: 15%; royalties: 12.5%
EVT 070 milestones	11	0.09	Estimated milestones risk-adjusted by industry standards
EVT 770 milestones	10	0.08	Estimated milestones risk-adjusted by industry standards
EVT 401	6	0.05	Expected launch: 2015; peak sales: \$200m; risk adjustment: 40%; royalties: 10%
Cash	45	0.38	Net cash position at Q211
Total	500	4.23	

Source: Edison Investment Research

Exhibit 3: Financials

Note: The company is targeting liquidity of over €60m at FY11, comprised of cash and non-current cash equivalents; we forecast liquidity of €64.9m at FY11. Net debt includes non-current cash equivalents.

Year end 31 December	€'000s	2008	2009	2010	2011e	2012e	2013e
		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS							
Revenue		39,613	42,683	55,262	78,813	86,025	97,892
Cost of Sales		(21,977)	(24,262)	(30,916)	(40,242)	(46,784)	(52,398)
Gross Profit		17,636	18,421	24,346	38,571	39,241	45,494
EBITDA		(40,689)	(15,547)	6,480	21,089	18,314	23,667
Operating Profit (before GW and except.)		(44,942)	(19,157)	2,387	12,436	12,903	18,166
Intangible Amortisation		(553)	(455)	(672)	(1,087)	(1,060)	(1,048)
Exceptionals/Other		(27,715)	(22,687)	0	0	0	0
Operating Profit		(73,210)	(42,299)	1,715	11,350	11,843	17,119
Net Interest		(2,760)	(2,520)	2,152	1,686	863	1,043
Other		0	0	0	0	0	0
Profit Before Tax (norm)		(47,702)	(21,677)	4,539	14,123	13,767	19,209
Profit Before Tax (FRS 3)		(75,970)	(44,819)	3,867	13,036	12,706	18,161
Tax		(1,911)	(363)	(676)	(1,010)	(774)	(881)
Deferred tax		(406)	(315)	(206)	18	(0)	(0)
Profit After Tax (norm)		(49,613)	(22,040)	3,863	13,112	12,992	18,328
Profit After Tax (FRS 3)		(78,287)	(45,497)	2,985	12,044	11,932	17,280
Average Number of Shares Outstanding (m)		95.2	106.8	109.0	118.2	118.2	118.2
EPS - normalised (c)		(52.1)	(20.6)	3.8	11.1	11.0	15.5
EPS - FRS 3 (c)		(82.2)	(42.6)	3.0	10.2	10.1	14.6
Dividend per share (c)		0.0	0.0	0.0	0.0	0.0	0.0
Gross Margin (%)		44.5	43.2	44.1	48.9	45.6	46.5
EBITDA Margin (%)		N/A	N/A	11.7	26.8	21.3	24.2
Operating Margin (before GW and except.) (%)		N/A	N/A	4.3	15.8	15.0	18.6
BALANCE SHEET							
Fixed Assets		89,822	77,642	105,167	135,266	134,817	134,142
Intangible Assets		60,455	45,567	83,594	104,769	103,709	102,661
Tangible Assets		18,468	19,162	18,487	26,893	27,504	27,877
Other		10,899	12,913	3,086	3,604	3,604	3,604
Current Assets		93,078	68,957	86,692	78,507	89,155	109,986
Stocks		2,139	2,425	2,819	3,308	3,845	4,307
Debtors		2,531	4,510	11,841	6,478	7,071	8,046
Cash		84,098	58,358	67,394	61,882	71,399	90,793
Other		4,310	3,664	4,638	6,840	6,840	6,840
Current Liabilities		(21,826)	(26,445)	(32,802)	(37,746)	(35,381)	(38,574)
Creditors		(19,247)	(17,358)	(24,446)	(28,979)	(26,614)	(29,807)
Short term borrowings		(2,579)	(9,087)	(8,356)	(8,767)	(8,767)	(8,767)
Long Term Liabilities		(11,215)	(8,667)	(26,420)	(25,917)	(26,048)	(25,231)
Long term borrowings		(8,047)	(3,757)	(3,500)	(3,000)	(3,000)	(3,000)
Other long term liabilities		(3,168)	(4,910)	(22,920)	(22,917)	(23,048)	(22,231)
Net Assets		149,859	111,487	132,637	150,111	162,543	180,323
CASH FLOW							
Operating Cash Flow		(42,562)	(19,915)	1,759	21,071	21,378	26,799
Net Interest		2,116	(29)	(299)	(650)	(341)	(328)
Tax		(832)	(1,909)	(561)	(1,488)	(748)	(203)
Capex		(3,447)	(1,893)	(2,432)	(10,434)	(6,022)	(5,873)
Acquisitions/disposals		34,491	0	1,202	(13,250)	(4,750)	(1,000)
Financing		(1,951)	234	123	298	0	0
Dividends		0	0	0	0	0	0
Other		10,706	157	0	283	0	0
Net Cash Flow		(1,479)	(23,355)	(208)	(4,170)	9,517	19,394
Opening net debt/(cash)		(83,254)	(81,775)	(57,750)	(58,545)	(53,122)	(62,639)
HP finance leases initiated		0	0	0	0	0	0
Exchange rate movements		0	(272)	(510)	(775)	0	0
Other		0	(398)	1,513	(478)	0	0
Closing net debt/(cash)		(81,775)	(57,750)	(58,545)	(53,122)	(62,639)	(82,033)

Source: Edison Investment Research, company accounts

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