

4 April 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	N/A	N/A
12/11e	64.8	3.9	2.8	0.0	N/A	N/A
12/12e	74.5	7.4	5.6	0.0	54.5	N/A

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

Investment summary: A profitable biotech

Evotec has reported its first profit in its 17 year history and is on track to become sustainably profitable by 2012. Recent acquisitions have significantly enhanced its capabilities and should enable the company to form new alliances and maintain its strong revenue growth. Its focus on drug discovery collaborations removes much of the risk normally associated with biotech companies. We value Evotec at €389m.

Profitable ahead of schedule

Evotec is implementing a strategy to become a sustainably profitable company by 2012. It has already achieved profitability in FY10 by expanding its drug alliance business and tight cost control, and is on track to maintain its profitability going forward. Revenues grew by 29% in FY10, leading to Evotec's first ever profit .

Expanding capabilities for future growth

Evotec has enhanced its capabilities with the acquisition of DeveloGen and proposed purchase of Kinaxo. The former extended Evotec's expertise into metabolic disorders; the latter will enhance its knowledge of oncology and its ability to profile the effects of drugs. Both acquisitions should enable Evotec to form new alliances as pharmaceutical companies are focused on metabolic and oncology indications.

Increasing capacity to meet demand

Evotec is increasing its operational capacity during 2011, so that it can meet the demand for its services. Its order book at the beginning of March 2011 was 43% higher than it was last year. It will be increasing its capital expenditure to €8m this year to expand all of its facilities, including moving into new premises in Hamburg.

Valuation: €389m based on DCF

We have reduced our valuation by €11m to €389m after making several minor adjustments to our model. Its cash position and discovery alliance business accounts for 57% of the valuation. The company is well capitalised with net cash of €59m at FY10 and its operations generate cash, so it could make further bolt-on acquisitions.

Price **€2.96**
Market Cap **€341m**

Share price graph



Share details

Code **EVT**
Listing **Frankfurt, Prime Standard**
Sector **Pharmaceuticals & Biotech**
Shares in issue **115.6m**

Price

52 week **High** **Low**
€3.48 **€1.80**

Balance Sheet as at 31 December 2010

Debt/Equity (%) **N/A**
NAV per share (€) **1.15**
Net cash (€m) **58.5**

Business

Evotec is a leading drug discovery business that provides integrated outsourcing solutions to the pharmaceutical industry. It has particular expertise in pain, CNS, metabolic and oncology indications.

Valuation

	2010	2011e	2012e
P/E relative	N/A	N/A	574%
P/CF	183.4	22.6	22.6
EV/Sales	4.8	4.5	4.5
ROE	3%	2%	2%

Revenues by geography

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

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Investment summary: A sustainable biotech

Company description: A leading drug discovery company

Evotec is a German biotechnology company that provides drug discovery services to the pharmaceutical industry and develops its own drugs. It was founded in 1993 by a group of eminent German scientists, including the Nobel Laureate Professor Manfred Eigen and employs c 175 people in Germany, c 225 in UK and c 140 in India. It can undertake all parts of the drug discovery process and has particular expertise in pain, CNS, metabolic and oncology indications, and regenerative medicine. The company has undergone a major restructuring programme over the last two years to reduce costs and focus more on the services it offers pharmaceutical companies. It has a broad range of long-term collaborations with pharmaceutical companies, including Genentech and Boehringer Ingelheim.

Valuation: €389m based on DCF

We have reduced our risk-adjusted DCF valuation of Evotec by €11m to €389m, after making a number of small amendments to our valuation; the company's market cap is currently €341m. Its drug discovery business and cash is valued at €220m, with EVT101/103 being the other main value driver.

Its shares have risen by c 40% since the beginning of 2010 because of the progress the company has made to becoming sustainably profitable. It is also trading at a higher EV/sales multiple than its peers; however, we believe this is justified because of the strength of its revenue growth, its gross margins relative to its competitors and the potential of its pipeline.

Sensitivities

Evotec is not heavily exposed to the outcome of clinical trials unlike most biotechnology companies, because of the breadth and depth of its drug discovery alliances, in which its partners bear most of the risk. Thus, it is more sensitive to factors that affect its drug alliance business, which include:

- the outsourcing strategy of the pharmaceutical companies,
- Evotec's rate of innovation so that it can maintain its competitive advantage, and
- its ability to sustain its reputation as a leading provider of drug discovery solutions.

However, it is still sensitive to the outcome of the Phase II trial with EVT101 in treatment resistant depression in H211 and the subsequent decision of Roche on whether to exercise its option to in-license the drug and related products.

Financials

We have raised our revenue estimates by 4% for the next two years, because of Evotec's performance in FY10. We forecast that it will generate sales of €64.8m in FY11 and will remain profitable, in line with the company's guidance.

The company remains in a strong financial position with net cash of €58.5m (including €3.0m of non-current cash equivalents) at FY10. It will increase its capital expenditure to c €8m in FY11 to expand its operational capacity, but still has the financial flexibility to pursue a bolt-on acquisition strategy.

Company description: A leader in drug discovery

Evotec's strong revenue growth (+29% in FY10) and restructuring programme has converted it into a profitable biotechnology company. It has expanded its expertise into metabolic diseases and oncology, which should enable it to maintain its growth and increase its profitability. Unlike most biotechnology companies, its business model is not dependant on the outcome of clinical trials because of breadth and structure of its long-term alliances with many major pharmaceutical companies. We value the company at €389m, with 57% of its value supported by its strong balance sheet and drug discovery business.

Evotec is a leading provider of drug discovery services to the pharmaceutical industry. It was founded in 1993 and gradually expanded its capabilities through internal development (eg the high-throughput screening system, the EVOscreen, launched in 2000) and by acquisition (eg Oxford Asymmetry International in 2000) so that it can provide the full range of services from target discovery to clinical development. This has led to it entering many collaborations with companies such as Boehringer Ingelheim and Roche.

Evotec 2012 – Action Plan to Focus and Grow

The company is currently implementing a strategy called "Evotec 2012 – Action Plan to Focus and Grow" to make it sustainably profitable, through the reduction of its cost base the expansion of its drug discovery alliances. The initial target was to achieve profitability by 2012, but this has already been achieved in FY10. The company is now focused on maintaining its profitability, by forming new collaborations while continuing to develop its drug discovery capabilities (through investments in R&D, acquisitions and the formation of academic collaborations).

Evotec has undergone many cost cutting measures and limited spending on its proprietary drugs. It closed the facility that it acquired with Renovis in San Francisco, which contributed to it reducing its R&D expense by 51% in FY09. The level of R&D spending fell a further 71% to €6.1m in FY10 as it limited its un-partnered research essentially to developing its discovery platforms and focused the rest of its research resources on meeting the demands of its clients. Evotec also reduced its SG&A expense by 16% in FY09 and a further 4% in FY10.

Over the last two years, the expansion of Evotec's drug discovery alliances has driven strong sales growth. In FY10 it entered eight new collaborations, including the major partnership with Genentech, and extended two others; this contributed to the increase in revenues of 29% in FY10, after growing by 8% in FY09. This has been achieved without the erosion of the gross margin at c 44%, which could improve as milestone payments from performance-related contracts make up a greater proportion of total revenues (milestones increased by 157%, 20% of total sales in FY10).

This performance contrasts with that of some of its competitors and highlights the competitiveness of Evotec's drug discovery services. Between 2008 and 2010, revenues generated by Pharmaceutical Product Development from discovery services fell by 57% to \$8m; similarly sales from Charles River Laboratories' preclinical services rose by only 5% to \$667m over the same period; and the latter's gross margin also fell by 3.1% to 41.7% at the same time. This indicates that Evotec is a preferred partner for many pharmaceutical companies and that it is able to resist pricing pressure at a time when they are increasingly cost conscious.

Discovery Alliance Business

Evotec has a proven track record in discovering new chemical entities that target novel proteins, having identified over 100 lead compounds, 20 preclinical drugs and 15 clinical compounds, and has drug development alliances with 19 companies (detailed in Exhibit 1).

It has particular expertise in the following areas of drug discovery:

- assay development and screening,
- fragment-based drug discovery,
- medicinal chemistry, and
- ADMET (absorption, distribution, metabolism, excretion and toxicology assays) including its proprietary zebrafish screening.

It is also continually developing its core technical capabilities. The proposed acquisition of Kinaxo will enhance Evotec's proteomics capabilities because of the former's expertise in high-end mass spectrometry. This will improve Evotec's ability to profile the effects of a drug on a cell (especially kinase inhibitors), and identify biomarkers and new drug targets. Evotec has also recently formed a collaboration with San Diego-based ChemBridge to increase the effective size of its library of drug-like and lead-like compounds for screening from 250,000 to 360,000. These advances are vital to the success of Evotec because they allow it to offer a more advanced service despite many of the processes in drug discovery becoming commoditised.

Evotec also differentiates itself from its competitors by the quality of its decision making. Major pharmaceutical companies have sufficient confidence in its processes that it is able to form long-term alliances, providing an integrated drug discovery service. Thus, the drug development process is accelerated, effectively extending a product's life span, and it is less onerous for its partner.

The therapeutic areas in which Evotec has specific expertise are CNS, pain, metabolic and oncology (Exhibit 2). Its main focus used to be in the first two fields, with some knowledge in oncology from working with some partners, but the acquisition of DeveloGen gives it significant expertise in metabolic diseases, especially diabetes, and the proposed purchase of Kinaxo enhances its knowledge and capabilities in oncology drug discovery. This expansion into the two new disease areas should help Evotec maintain the growth of drug alliance business, because the major pharmaceutical companies are particularly interested in both of these fields.

The acquisition of DeveloGen has also given Evotec a strong position in regenerative medicine. This knowledge is currently being used for the development of treatments for diabetes, but it has the potential to be used in chronic kidney disease, neurodegenerative disorders and congestive heart failure. An indication of its potential of its regenerative medicine capability is that AstraZeneca has entered a collaboration with Evotec to co-develop EVT770 and associated products (biological drugs developed to increase the number of insulin-producing β -cells in the pancreas), in a deal which could generate milestone payments of over €250m and royalties for Evotec.

Evotec has also signalled that it will increase the depth of its knowledge in therapeutic areas by forming relationships with academic institutions. This has been initiated with the collaboration with Harvard University and the Howard Hughes Medical Institute in diabetes research in March 2011. This will allow Evotec to benefit from the work of Dr Doug Melton, a leading researcher in diabetes. The company will probably enter similar collaborations in the fields of neurology and oncology.

Exhibit 1: Evotec's main collaboration partners

Partner	Value	Indications	Notes
Active Biotech	N/A	Immune disorders and oncology	Collaboration initiated in March 2010, Evotec will identify small molecule modulators against a target selected by Active Biotech
Almirall	N/A	Respiratory diseases	In September 2010, Evotec started identifying small modulators of an ion channel, selected by Almirall, that is involved in respiratory diseases.
Apeiron Biologics	N/A	Pain	In October 2010, Evotec formed a collaboration with responsibility initially to identify targets against DREAM (Downstream Regulatory Element Antagonistic Modulator) to treat pain.
Biogen Idec	N/A	N/A	Partnership started in September 2009 to identify compounds against a specified target, with the option of further targets being added at a later date.
Boehringer Ingelheim	Excl. diabetes: €15m over four years + milestones + royalties; Diabetes: €7m upfront + > €230m milestones + royalties	CNS, inflammation, cardiometabolic, respiratory and oncology	Collaboration commenced in September 2004 with a three-year contract to identify GPCR modulators to treat CNS diseases. The initial agreement has been extended on three occasions, with the latest extension in November 2009. Seven milestone payments have been received to date with the first one nine months after the collaboration started. First Phase I trial with one product has been stopped, and a back-up is in preparation in an unnamed programme. A diabetes alliance was acquired with the purchase of DeveloGen and involves the development of EVT070 which improves insulin sensitivity without causing weight gain in Type 2 diabetes; 30% of milestones and royalties payable to original owners of DeveloGen.
CHDI	Up to \$37.5m over three years	Huntingdon's disease	CHDI is a not-for-profit organisation that is attempting to develop new therapies using an outsourcing approach. It also has collaborations with Galapagos, AMRI and Vertex. The partnership was initiated in March 2006 and was extended in February 2008 in a deal worth up to \$37m; this was extended further in January 2008 and again in January 2010.
Cubist	N/A	Anti-bacterial	Collaboration initiated in July 2009 to support two of Cubist's projects, and was extended in February 2010 for it to continue until the end of 2010.
Genentech (Roche)	N/A	CNS	The multi-year alliance started in May 2010, one of Evotec's largest alliances.
InterMune	N/A	N/A	Collaboration began in early 2007 with Evotec using a broad range of its drug discovery capabilities.
MedImmune (AstraZeneca)	€5m upfront + >€254m milestones + royalties	Diabetes	In December 2010, Evotec formed an alliance to develop EVT-770 and associated biological products to treat both Type 1 and Type 2 diabetes, by increasing the number of insulin-producing β cells in the pancreas. The programmes are currently in preclinical development. 30% of milestones and royalties are payable to original owners of DeveloGen.
Merck KGaA	N/A	CNS	Alliance initiated in October 2010; Evotec will develop pre-clinical drugs for an undisclosed neurological disease as part of the NEU 2 consortium (partially funded by the German Government).
Ono	N/A	CNS	The partnership began in March 2008 with protease targets and was extended in October 2009 for ion channel targets. In December 2009, a milestone was achieved for progression into lead optimisation.
Novartis	Milestones >\$28m + royalties	N/A	Evotec is responsible for identifying drugs against a nominated target until they are ready for pre-clinical testing, after which Novartis will continue the development. The deal was initiated in December 2008 and is due to be completed in three years. The agreement could be expanded to include a second target.
Pfizer	Milestones \$170m + double-digit royalties	Analgia	The initial agreement was signed in May 2005 with Renovis, which Evotec bought in 2007. There are combined research teams working on developing treatments to relieve pain by targeting the ion channel, VR1 (vanilloid receptor 1). First Phase I trial has been stopped, and a back-up is in preparation.
Roche	>€200m in milestones + royalties	CNS and other indications	In June 2006, a global alliance was formed to discover novel drugs; this is the continuation of the long-running relationship between the two companies that began in June 2001. Roche also has an option on the EVT 100 family of products for treatment-resistant depression. Phase II data expected in H112, after which Roche might exercise the option.
Shionogi	N/A	Inflammation and infectious diseases	In October 2010, Evotec began identifying small molecule modulators of protein-protein interactions of targets selected by Shionogi.
Spermatech	N/A	Contraception	Partnership began in March 2008. High throughput screening with Evotec's 250,000 drug-like compounds to identify compounds that inhibit a sperm-specific target protein, for non-hormonal reversible contraception.
Takeda	N/A	CNS and metabolic diseases	Alliance signed in January 2011 with Evotec small molecule modulators against GPCR and protease targets associated with CNS and metabolic diseases.
Vifor	>€5.5m	Anaemia	In February 2010, Evotec agreed to identify a preclinical candidate for the treatment of anaemia within an agreed budget.

Source: Edison Investment Research

Exhibit 2: Therapeutic areas of expertise

Note: Evotec has alliances in contraception (Spermatech), anaemia (Vifor), respiratory diseases (Almirall), infectious diseases (Cubist, Shinogi). It also has significant expertise in regenerative medicine, which could be used to develop treatments across many indications.

Therapeutic area	Alliances	Notes
CNS	Roche, Ono, Genentech, CHDI, Takeda	Evotec has proprietary products for Alzheimer's disease, insomnia, depression
Metabolic	Boehringer Ingelheim, Andromeda (Teva), AstraZeneca, Takeda	Evotec acquired the alliances with Boehringer Ingelheim and Andromeda with the purchase of DeveloGen, and formed the collaboration with AstraZeneca to develop EVT 770, which had been created by DeveloGen. Takeda alliance formed in 2011.
Oncology	Boehringer Ingelheim	Alliance in oncology formed in 2009. Expertise has been enhanced in this field with the proposed acquisition of Kinaxo Biotechnologies GmbH.
Pain	Novartis, Pfizer, Boehringer Ingelheim, Apeiron Biologics	Two proprietary programmes in preclinical development

Source: Edison Investment Research

Evotec is focused on entering more collaborations with clients rather than fee-for-service relationships, and has been successful because of its reputation for quality. Most of its alliances last a minimum of three years and cover at least three drug targets. Its leading clients in 2010 were Boehringer Ingelheim and Genentech which generated c 30% of total revenues. It is aiming to have c six core clients with a maximum of 15-20% of total revenues generated by any company.

An important aspect of the collaborations is that they remove the financial risk associated with drug discovery for Evotec, while leaving it with considerable upside (potential milestone payments of >€1bn). Its partners cover all of Evotec's research costs; it makes a gross margin of c 30% on all of its drug development activities (including fee-for-service work), which is then increased through the payment of milestones. The alliance strategy reduces Evotec's risk profile further because it allows the company to spread the risk of a programme across a much larger number of projects that would be possible if all of them were proprietary. Evotec retains the most upside potential in the following alliances:

- Boehringer Ingelheim (diabetes)
- MedImmune (diabetes)
- Roche (treatment-resistant depression)
- Pfizer (inflammation)

Pipeline

Evotec currently has five products in clinical development, as detailed in Exhibit 3. It also has six other products in preclinical development, which include an H3 receptor antagonist for the treatment of cognition and narcolepsy, EVT070 (insulin sensitiser, being developed with Boehringer Ingelheim) and EVT770 (β cell regeneration factors, partnered with MedImmune).

The company follows a pragmatic approach to its proprietary drug development, which is fully integrated with its drug alliance business. Much of its own drug discovery is undertaken to initiate new collaborations. Also it will not fund the development of unpartnered products into Phase II development because of the cost of such trials and the risk associated with them, especially as these compounds will not have received commercial validation from a third party. For example, the further clinical development of EVT 201 for insomnia is only occurring in China, where Jingxin Pharma has in-licensed the rights to the drug, despite promising Phase II data.

This approach also gives Evotec a lower risk profile than most biotechnology companies, as the return on invested capital is not dependent on the outcome of a few clinical trials.

Exhibit 3: Updated Clinical R&D pipeline

Product	Development stage	Indication / Partner	Notes
DiaPep277	Phase III	Type I diabetes / Andromeda	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 glycemic control of HbA1c<7%. Currently in two pivotal Phase III studies with 457 pts and 450 pts , due to report end of 2011 and 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 101/103	Phase II	Treatment resistant depression / Roche	NR2B-selective NMDA antagonists, originally discovered by Roche. EVT 103 is a back-up compound or for other CNS indications. Roche bought an option for \$10m to buy-back the rights to EVT 100 family at end of Phase II (expected in H112) for \$65m, and is funding the current development programme. Milestones worth over \$235m, escalating double-digit royalties. Evotec is conducting a Phase II PoC trial for EVT 101, completion expected September 2011 (n=100, trial began in July 2010). Successfully completed Phase I trial with EVT 103 (72 healthy males, with single and multiple dosing, safe and well tolerated).
EVT 401	Completed Phase I	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. Drug being reformulated for Phase II study at start of 2011.
EVT 302	Phase II	Alzheimer's disease	Monoamine oxidase-B (MAO-B) inhibitor, discovered by Renovis, initially developed for smoking cessation, but in April 2009 it failed to demonstrate any benefit over nicotine replacement therapy alone in a PoC Phase II study. It is now being developed for Alzheimer's disease, but a partner is needed to continue development.
EVT 201	Completed Phase II	Insomnia	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 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.

Source: Edison Investment Research

Its most valuable products are EVT 101/103 for treatment-resistant depression (TRD). It is estimated that there are c 15m people in the US with major depressive disorder (MDD) and that c 30% do not respond to at least two antidepressants. Drugs currently in development for this indication are detailed in Exhibit 4.

Roche will decide at the end of the Phase II PoC trial whether or not to exercise the option on the drug family. If the option is exercised, Evotec will receive \$65m, and Roche might decide to do so even with unconvincing Phase II data because both EVT 101 and EVT 103 have demonstrated favourable safety profiles in Phase I and they can be developed for indications other than TRD, such as schizophrenia or Alzheimer's disease.

We forecast that EVT 101 could generate peak sales of \$2.7bn in TRD.

Drug discovery industry

Pharmaceutical companies are outsourcing their drug discovery activities as they look to improve the efficiency and productivity of the process. This is driving the growth of the drug discovery industry, however not all companies are benefiting so far because of the competition nature of the market, as indicated in Exhibit 5.

Exhibit 4: Products being development for the treatment resistant depression

Product	Company	Development stage	Notes
Olanzapine/ fluoxetine	Eli Lilly	Phase III	1,230 pts in Phase III trial, expected to be completed in 2014. Primary endpoint is time to relapse by any criteria. Treatment is a combination of a atypical antipsychotic (olanzapine/Zyprexa) and a SSRI (fluoxetine/Prozac).
BMS-820836	Bristol-Myers Squibb	Phase II	900 pts in Phase II trial that is due to start imminently, expected to be completed in February 2013. Primary endpoint is efficacy Montgomery Asberg Depression Rating Scale (MADRS) at various time points over a 14 week period.
CX157	CeNeRex BioPharma	Phase II	360 pts in Phase II trial, expected to be completed in July 2011. Primary endpoint is efficacy based on (MADRS) over 6 week period.
EVT100	Evotec	Phase II	100 pts in Phase II trial, expected to be completed in July 2011. Primary endpoint is safety and tolerability. An NMDA antagonist.
GLYX-130	Naurex	Phase II	80 pts Phase II study to be started imminently, expected to be completed in December 2011. Primary endpoint is efficacy based on depression score. An NMDA receptor modulator.
RO4917523	Roche	Phase II	48 pts in Phase II trial, expected to be completed in June 2011. Primary endpoint is safety and tolerability. Drug also being developed for fragile X syndrome.
AZD6765	AstraZeneca	Phase II	24 pts in Phase II trial, expected to be completed in June 2011. Primary endpoint is efficacy MADRS at various time points over the first three days after intravenous infusion. An NMDA antagonist.

Source: Edison Investment Research

The drug discovery process takes on average six years to get a product into clinical development from the start of the process. Companies such as Evotec enable pharmaceutical companies to outsource the process, so that they can convert some of their R&D spending into a variable cost, and have a more flexible approach to drug discovery. The pharmaceutical industry is also increasing the outsourcing of drug discovery in an attempt to increase the efficiency and productivity of the process.

The outsourced drug discovery market is worth c \$5bn and is fragmented, with no dominant companies. However, only a limited number of them can offer an integrated drug discovery service comparable to Evotec's (most drug discovery companies only carry out fee-for-service work); these companies are able to charge premium prices and enter multi-year alliances with pharmaceutical companies. The main companies in this niche of the market are listed in Exhibit 5.

Exhibit 5: Competitor analysis

Companies	Location	Revenues in 2010 (€m)	Revenue growth in 2010	Gross margin	Notes
Evotec	Germany, UK, India	55.3	29%	44%	
BioFocus and Argenta	UK, The Netherlands, Switzerland, the US	65.8	17%	32%	Part of Galapagos NV
WuXi Pharmatech	US, China	245.7	24%	38%	Sales of US services division increased 18% to €55.5m.
AMRI	US, UK, Hungary, Singapore, India	145.6	1%	23%	
Cerep	France, US, Japan, China	26.0	(1%)	N/A	

Source: Edison Investment Research

Growth prospects

Evotec's strong revenue growth is set to continue because its order book at the beginning of March 2011 was 43% higher at €40m than it was at the same time in 2010. This has led the company to guide towards revenue growth of over 15%.

Another goal for Evotec is to establish at least two significant discovery alliances in 2011. This also looks very achievable given that it formed eight alliances in 2010, including the major ones with

Genentech and MedImmune, especially as it has developed its new expertise in metabolic diseases and oncology (major pharmaceutical companies are focusing on both indications). This should build the foundations for sustained double-digit revenue growth for the coming years.

Evotec should also benefit from the products developed in alliances generating more significant milestones as the drugs progress through the drug discovery process. This could lead to an enhanced gross margin.

Some of its alliances are due to lapse in the next few years; however, Evotec is confident that they will all be extended. It has had no indication that its partners want to terminate their relationships and many are already discussing extending the collaborations.

Evotec's rapid growth and continued demand for its services is leading to capacity issues. To resolve this issue, it is embarking on a significant upgrading programme which will include the company moving into a new campus in Hamburg, and expanding all of its sites. It will also invest in its platforms to improve their capacities. This will lead to a significant increase in capital expenditure to c €8m, but is vital for Evotec's continued growth.

Evotec increased its number of employees by over 10% to 540 during 2010. It will probably have to maintain this rate of hiring to meet the demand for its services. This could be problematic for the company because it will need to hire scientists with very particular fields of expertise and it cannot afford to reduce the quality of its researchers. However, the transformation of Evotec into a profitable company and its leading position in the field of drug discovery should enable it to attract suitable people.

Sensitivities

Evotec's risk profile is considerably lower than that of most companies in the biotechnology sector because of its drug discovery alliance strategy. It is undertaking a large number of discovery projects at once, so that the inevitable failure of some programmes is not going to undermine the business. Evotec also spreads the risk associated with the majority of its projects with a partner. Instead the main issues that affect the investment case are regarding Evotec's ability to grow revenues and to keep control of its cost structure, including:

- **Strategy of the major pharmaceutical companies:** The current vogue among the large pharmaceutical companies is to enter into more collaborations to diversify their drug discovery attempts and to reduce fixed costs. However, the rate at which the industry will increase its use of outsourcing and the level at which it will stabilise is uncertain.
- **Innovation:** Evotec's competitive advantage is largely derived from its innovations that enable it to develop potentially better drugs, faster than other drug discovery companies. If it is unable to maintain this advantage, its rate of revenue growth and gross margin will decline; conversely, they could grow if the rate of innovation increases.
- **Reputation:** Evotec has established a strong reputation for being a leading drug discovery company, which it has maintained throughout the recent challenging period.

Evotec will be affected by the outcomes of the Phase III study with DiaPep277 and the Phase II trial with EVT101. However, there is more upside than downside risk associated with these results because Evotec is mostly a drug discovery company and is not dependant on their outcomes.

Valuation

We have made a number of small adjustments to our DCF valuation of Evotec which has led to us reducing our valuation by €11m to €389m. A summary of the risk adjusted DCF valuation is shown in Exhibit 6. It indicates that although Evotec's EV is largely supported by the value of the relatively low-risk drug discovery business, EVT101/103 is a significant value driver for the company.

Exhibit 6: 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	155	1.41	Three stage DCF valuation, terminal growth rate:2.5%
EVT101/103	116	1.06	Probability of option being exercised: 50%; expected launch: 2015; peak sales: \$2.7bn; risk adjustment: 15%; royalties: 12%
DiaPep277	30	0.28	Expected launch: 2015; peak sales: \$450m; risk adjustment: 50%; royalties: 5%
EVT070 milestones	13	0.12	Estimated milestones risk-adjusted by industry standards
EVT770 milestones	11	0.10	Estimated milestones risk-adjusted by industry standards
Cash	65	0.59	Estimated cash position at Q111
Total	389	3.55	

Source: Edison Investment Research

EV/sales multiples analysis shows that Evotec continues to trade at a significant premium to its peers (Exhibit 7). We believe this is justified because of Evotec's strong revenue growth, its high gross margin (Exhibit 5) and the value of its drug pipeline. Other relative valuation techniques are of limited value because Evotec has recently become profitable.

Exhibit 7: Peer analysis

	Market cap (€)	Enterprise value (€)	EV/sales 2010	EV/sales 2011
Evotec	323	264	4.8	4.1
Albany Molecular Research Inc	102	80	0.5	0.5
Cerep	14	9	0.3	0.3
Galapagos	307	268	2.0	1.7
WuXi Pharmatech	823	732	2.8	2.4
Average			2.1	1.8

Source: Edison Investment Research

Evotec's shares have risen by c 40% since the beginning of 2010, driven largely by the rapid progress it has made to becoming sustainably profitable.

Financials

We have raised our revenue estimates for the next two years by 4% following Evotec's better than expected FY10 results. We forecast that sales will now grow by 17% to €64.8m in FY11 and 15% to €74.5m in FY12; we have also increased our adjusted EPS estimates from 0.6c to 2.8c in FY11 and from 2.8c to 5.6c in FY12, and estimate its liquidity will be €73m (net cash of €61m, including €3m of non-current cash equivalents) at FY11. Evotec is guiding towards revenues of €64-66m, that it will remain profitable (before impairments), and will finish the year with liquidity of >€65m in FY11.

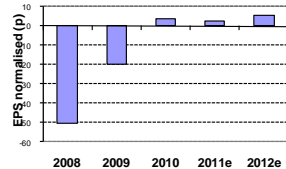
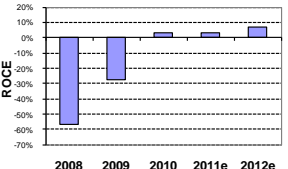
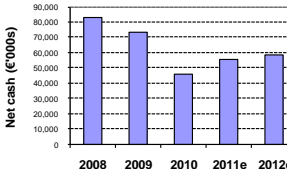
Evotec will increase its capital expenditure in FY11 to c €8m to expand its operational capacity, as discussed above. Thereafter, we are expected maintenance capital expenditure to match depreciation approximately; it had fallen below the latter in recent years.

Exhibit 8: Summary of financials

Note: Net cash includes €3m of non-current cash equivalents

	€'000s	2008	2009	2010	2011e	2012e
Year end 31 December		IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Revenue		39,613	42,683	55,262	64,799	74,519
Cost of Sales		(21,977)	(24,262)	(30,916)	(36,288)	(41,731)
Gross Profit		17,636	18,421	24,346	28,512	32,788
EBITDA		(40,689)	(15,547)	6,480	7,440	11,522
Operating Profit (before GW and except.)		(44,942)	(19,157)	2,387	3,100	6,435
Intangible Amortisation		(553)	(455)	(672)	(688)	(680)
Exceptionals/Other		(27,715)	(22,687)	0	0	0
Operating Profit		(73,210)	(42,299)	1,715	2,412	5,755
Net Interest		(2,760)	(2,520)	2,152	779	933
Other		0	0	0	0	0
Profit Before Tax (norm)		(47,702)	(21,677)	4,539	3,878	7,368
Profit Before Tax (FRS 3)		(75,970)	(44,819)	3,867	3,190	6,688
Tax		(1,911)	(363)	(676)	(583)	(671)
Deferred tax		(406)	(315)	(206)	(0)	(0)
Profit After Tax (norm)		(49,613)	(22,040)	3,863	3,295	6,697
Profit After Tax (FRS 3)		(78,287)	(45,497)	2,985	2,607	6,017
Average Number of Shares Outstanding (m)		95.2	106.8	109.0	118.4	118.9
EPS - normalised (c)		(52.1)	(20.6)	3.8	2.8	5.6
EPS - FRS 3 (c)		(82.2)	(42.6)	3.0	2.2	5.1
Dividend per share (c)		0.0	0.0	0.0	0.0	0.0
Gross Margin (%)		44.5	43.2	44.1	44.0	44.0
EBITDA Margin (%)		N/A	N/A	11.7	11.5	15.5
Operating Margin (before GW and except.) (%)		N/A	N/A	4.3	4.8	8.6
BALANCE SHEET						
Fixed Assets		89,822	77,642	105,167	120,301	119,749
Intangible Assets		60,455	45,567	83,594	91,706	91,026
Tangible Assets		18,468	19,162	18,487	25,509	25,638
Other		10,899	12,913	3,086	3,086	3,086
Current Assets		93,078	68,957	86,692	85,934	96,212
Stocks		2,139	2,425	2,819	3,977	4,573
Debtors		2,531	4,510	11,841	7,101	8,166
Cash		84,098	58,358	67,394	70,218	78,835
Other		4,310	3,664	4,638	4,638	4,638
Current Liabilities		(21,826)	(26,445)	(32,802)	(34,609)	(37,195)
Creditors		(19,247)	(17,358)	(24,446)	(26,253)	(28,839)
Short term borrowings		(2,579)	(9,087)	(8,356)	(8,356)	(8,356)
Long Term Liabilities		(11,215)	(8,667)	(26,420)	(27,081)	(27,706)
Long term borrowings		(8,047)	(3,757)	(3,500)	(3,500)	(3,500)
Other long term liabilities		(3,168)	(4,910)	(22,920)	(23,581)	(24,206)
Net Assets		149,859	111,487	132,637	144,544	151,061
CASH FLOW						
Operating Cash Flow		(42,562)	(19,915)	1,759	15,511	14,590
Net Interest		2,116	(29)	(299)	(129)	(110)
Tax		(832)	(1,909)	(561)	(1,197)	(647)
Capex		(3,447)	(1,893)	(2,432)	(8,362)	(5,216)
Acquisitions/disposals		34,491	0	1,202	(3,000)	0
Financing		(1,951)	234	123	0	0
Dividends		0	0	0	0	0
Other		10,706	157	0	0	0
Net Cash Flow		(1,479)	(23,355)	(208)	2,824	8,617
Opening net debt/(cash)		(83,254)	(81,775)	(57,750)	(58,545)	(61,369)
HP finance leases initiated		0	0	0	0	0
Exchange rate movements		0	(272)	(510)	0	0
Other		0	(398)	1,513	0	0
Closing net debt/(cash)		(81,775)	(57,750)	(58,545)	(61,369)	(69,986)

Source: Evotec, Edison Investment Research

Growth	Profitability	Balance sheet strength	Sensitivities evaluation	
			Litigation/regulatory	■
			Pensions	○
			Currency	■
			Stock overhang	○
			Interest rates	○
			Oil/commodity prices	○

Growth metrics	%	Profitability metrics	%	Balance sheet metrics	Company details
EPS CAGR 08-12e	N/A	ROCE 11e	3.3	Gearing 11e	N/A
EPS CAGR 10-12e	22.0	Avg ROCE 08-12e	N/A	Interest cover 11e	N/A
EBITDA CAGR 08-12e	N/A	ROE 11e	2.3	CA/CL 11e	2.5
EBITDA CAGR 10-12e	33.3	Gross margin 11e	44.0	Stock turn 11e	22.4
Sales CAGR 08-12e	17.1	Operating margin 11e	4.8	Debtor days 11e	40.0
Sales CAGR 10-12e	16.1	Gr mgn / Op mgn 11e	9.2	Creditor days 11e	44.8
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				22525 Hamburg	
				Germany	
				Phone	+49(0)40 560 810
				Fax	+49(0)40 560 812
				www.evotec.com	

Principal shareholders	%	Management team
Roland Oetker	13.5	CEO: Dr Werner Lanthaler
TVM Capital	6.0	Dr Werner Lanthaler became CEO in March 2009, having been CFO of Intercell for the previous eight years. Between 1995 and 1998 he was a senior consultant at McKinsey & Co. He holds a doctorate in economics from Vienna University.
LBBW Asset Management	3.0	
Dimensional Fund Advisors	1.6	
Adamant Biomedical Inv.	0.5	
		CFO: Colin Bond
		Colin Bond became CFO in August 2010. Previously he was CFO at Novartis Europe in Switzerland; he was also CFO EMEA for Ecolab and CFO for Jet Aviation Group. He is a qualified chartered accountant and pharmacist.
Forthcoming announcements/catalysts	Date	Chairman: Dr Flemming Ornskov
Q111 results	12 May 2011	Dr Flemming Ornskov became chairman of the supervisory board in August 2008. He was global president of Pharmaceuticals at Bausch & Lomb, CEO and president at LifeCycle Pharma and at Ikaria. He has also worked at Novartis and Merck & Co.
AGM	16 June 2011	
Q211 results	11 August 2011	
Q311 results	10 November 2011	
Companies named in this report		
AstraZeneca, Boehringer Ingelheim, Eli Lilly, Cubist, Galapagos, Novartis, Pfizer, Roche, Takeda, Teva, Wuxi Pharmatech		

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