Evotec AG
Transcript of the Conference Call
First half-year 2018 results, 09 August 2018 – 2.00 p.m. CEST

Speakers: Dr Werner Lanthaler (CEO), Dr Cord Dohrmann (CSO), Dr Mario Polywka (COO), Enno Spillner (CFO)

Operator

Hello and welcome to this Evotec AG 2018 half-year report. Throughout this, all participants will be in listen-only mode, and afterwards there will be a Q&A session and, just to remind you, this is being recorded. So now I am very pleased to pass you over to Dr Werner Lanthaler, CEO.

Werner Lanthaler

Good afternoon. This is Werner speaking from Evotec. We are here to report on our first half of 2018. I welcome, here together with me my management team – Enno Spillner, Mario Polywka and Cord Dohrmann – who are executing an excellent first half together with me, as the collective management team. We have uploaded a presentation for this event and we would like to invite you to follow this presentation at the beginning of this call, and then of course we will go into Questions and Answers later. When you go to page 4 of this presentation you should see that the business performance across all areas is strong. Our growth is not happening by chance; it is the result of all forces working together as one within ONE Company. Mario will tell you more about the excellent progress within EVT Execute; Cord will tell you more about the excellent progress with EVT Innovate; and Enno and I will then update you on corporate events that have been happening.

So I will go to page 5 and highlight a few numbers first. You should see that we are fully on track for increased growth, increased profits, and this with even higher value generation through higher investments into our R&D, which we are guiding as of today. We are very happy that by increasing our R&D expenses, we will also translate this into higher value going forward. The numbers should speak for themselves – and Enno will guide you through that, but you see a strong financial performance through all business lines at this stage. When you go to page 6 of this presentation, you should be reminded of our hybrid business model. Both segments are performing nicely at this stage. And, as an overall picture, you should see that in the last five years we have come to critical size, which also allows us, as a hybrid business model, to approach larger initiatives and translate these initiatives into larger collaborations with our partners. Every segment alone can do little; two segments together can do so much more. And that's why we are so convinced about this hybrid business model, as we are running it and as we are building it.

Page 7 should remind you of our current footprint. And we are very happy to report back to you that the closing of our alliance with Sanofi in the field of infectious diseases has happened, effective 01 July 2018. Our day one, together with our new team in Lyon has happened. And we are integrating our infectious disease unit and team as we speak. And with this, you should see that the Company now has approx. 2,400 people coming together with experience and excellence within Evotec.

When you go to the next page of this presentation, you should see that we are following our Action Plan 2022 as we have laid it out to you in the year 2009, as we have updated it in the year 2012, as we have accelerated it in the year 2018 and as we are now building it into the year 2022, on a consistent path, where everyone is moving together towards success. And that's what we are driving within Action Plan

2022. Action Plan 2022 is bringing the megatrend of externalization into the R&D projects of our Pharma partners, our biotech partners, and our foundation clients. That's what we do to this industry and that's why it is so important at Evotec to keep the focus on R&D acceleration with our partners as the core business of this Company, and that's what we will grow going forward.

To get a bit of a deeper insight into this, I would like now to hand this over to Mario, who will guide you through EVT Execute's performance in H1 2018.

Mario Polywka

Thank you, Werner and good afternoon to everybody from steamy Hamburg. It's a pleasure to speak to you today on the continued good performance of the Company, and I will focus on the EVT Execute business segment. With a full six-month contribution now from Aptuit of € 53.6 m, a growth in the core Evotec business through new collaborations and expanding ongoing collaborations, revenue grew by more 60%, to € 163.3 m, supported by a strong concomitant growth in EBITDA. Enno will give you a further analysis of the results. However, with a different margin mix brought about through the acquisition of Aptuit, it is still an exceptional result to be at a >20% EBITDA margin on the segment.

Moving to slide 12, the integration of a significant business such as Aptuit, of course, is no trivial exercise. And it is gratifying to report that operationally this is on track, as well as commercially: the leveraging of the expanded development offering to our existing Evotec partner portfolio, the increased uptake to extended business development reach and the strengthening of our discovery offering by taking part much further along the value chain. We have now multiple examples of new discovery projects that no longer stop at PDC but go all the way through to IND and beyond. We have a program to expand our API production capacities in Verona and Abingdon, both of which are proceeding to plan and will be on-stream later this year. This will again drive our overall INDiGO capacity from next year and onwards.

On to slide 13, what is our customer mix? Well, compared to last year, the reliance of our revenues on a relatively small number of key projects has decreased. This is, of course, a welcome sign for any business risk, but our focus will still continue to drive larger strategic partnerships, as it is through such collaborations that we will find true operational and financial efficiencies. There has not been a huge change of the customer make-up of our revenues, except perhaps that the Aptuit acquisition has rebalanced the biotech–Pharma ratio. This is due to the strong reliance of biotech on the one-stop-shop that the Aptuit, INDiGO and subsequent integrated CMC offers, versus the more established manufacturing capabilities and capacities of larger pharma. This is again showing an increase in US revenues versus Europe, driven by the more buoyant US biotech market, and our strong client portfolio from this customer type.

On slide 14, what does our ongoing and new project pipeline look like? Well, the current portfolio of projects continues to perform strongly, whether this is large integrated projects such as Forge, Dermira, Bayer to name a few, or platform services and screening DMPK, through Cyprotex, and of course the development of new projects from Aptuit. Many existing collaborations have been extended or expanded in the first half. And, of course, we have a number of new collaborations such as Katexco, and a significant number that will be released in the coming weeks and months.

What does this mean for the outlook of 2018 and more importantly going forward, as Werner talked about, Action Plan 2022? In summary, the level of activity in H1, as well as the strong news flow that you'll see also in H2, gives us great confidence in the growth and outcome for the year and going forward into 2019 and beyond. I thank you all for your attention. And it's my pleasure now to pass you on to Cord and the EVT Innovate segment analysis.

Cord Dohrmann

Thank you, Mario, and good afternoon to everybody on the call. It is my great pleasure to give you an update on EVT Innovate. Within EVT Innovate's business segment, our focus is on building long-term financial upside through high-value Pharma partnerships. These partnerships let us participate in the successful development, and eventually, market entry of product opportunities through the achievement of development milestones, or ultimately, royalties. EVT Innovate started in 2018 with a very solid first quarter, and continued on this path in the second quarter as well. Based on this, we are on track for yet another great year for EVT Innovate, with very significant and accelerated growth. My first slide – slide 17 – summarizes EVT Innovate's financial performance in the first-half of 2018. Revenues from EVT Innovate have increased from about € 20 m in the first half of 2017, to € 32 m in the first-half of 2018. This constitutes an increase of revenues of more than 50%, which is based entirely on organic growth.

At the same time, EBITDA increased significantly to earning a slight profit, mainly due to the fact that we achieved a number of milestones in this half year. Overall, we do expect that the milestone contribution will continue to increase based on our continuously growing portfolio of partnered product opportunities. Nevertheless, it is important to keep in mind that we do not control the exact timelines the milestones are reached in individual projects, and therefore, the milestone contribution can and will vary significantly from quarter to quarter. Finally, R&D expenses are in line with prior years, but I expect them to increase due to a very significant expansion of our infectious disease project portfolio. So, in conclusion, we had an excellent start into 2018, which we believe will translate into another great year for EVT Innovate.

In addition to growing revenues, we continue to expand and grow financial upside for Evotec by continuously expanding our partner product portfolio. The following page, page 18, shows our current partner product pipeline. As you can see, we have significantly expanded our partner product pipeline from about 80 projects at the beginning of the year to now about 100 co-owned product opportunities. At the same time, we are expanding the portfolio. Many projects are advancing their development and quite a few have reached important development milestones. For example, together with Bayer, we were able to report the initiation of a Phase II study in chronic cough and the initiation of a third Phase I study out of a highly productive endometriosis alliance. In addition, we have also achieved very important milestones in our two iPSC alliances, with Sanofi in diabetes and Celgene in neurodegeneration. The very significant expansion of this co-owned product pipeline is primarily driven by our infectious disease partnership with Sanofi, but also through a new oncology partnership with Celgene. Overall, we are extremely pleased to see these developments, and optimistic that we will be able to continue on this path.

I just mentioned that the expansion of our partner product portfolio is to a large extent driven by our new Sanofi infectious disease alliance. With the next slide, page 19, I would like to shed a bit more light on what this infectious disease portfolio actually entails.

The complete portfolio includes about 18 projects that fall into three major categories or pipelines. These three major pipelines cover global health, severe bacterial infections, and antivirals. The project pipeline targeting severe bacterial infections addresses, in particular, the antimicrobial resistance crisis, which we all know constitutes a major threat to medicine as we know it. This pipeline is currently primarily focused on gram-negative bacteria and staphylococcus aureus. The second pipeline is focused on global health or diseases of the developing world. This pipeline includes in particular malaria, chikungunya fever, and tuberculosis. And the third pipeline is focused on antivirals, which is early stage. But here we believe that our hepatitis B projects are nevertheless very exciting and promising. The most advanced projects are currently in formal pre-clinical development, and it is our expectation that one of these projects will enter the clinical within the next 12 months.

With the next slide, page 20, I would like to shift gears and give a little update on various platform initiatives and partnerships that we continue to be very excited about and that have made great progress. First of all, we continue to invest and expand our iPSC platform and have made very good

progress in our iPSC alliances. We are committed to continue to build on these partnerships, and thereby, expand our product pipeline further and, in this context, we are very excited about our new oncology partnership with Celgene. We will continue to make equity investments into highly exciting start-ups or spin-out companies. And finally, we will continue to access cutting-edge science through our academic BRIDGE initiative, which we intend to expand further.

Moving on to page 21, we would like to report on the progress we have made in our iPSC-based drug discovery alliances. In the first half of 2018, both of Evotec's iPSC alliances have achieved very significant milestones. In our neurodegeneration alliance with Celgene, we achieved a $ 6 m milestone, which triggers an expansion of this alliance into additional cell lines. Similarly, we have achieved a very significant milestone in our diabetes alliance with Sanofi, where we pursue a beta cell therapy approach. Here, we achieved a € 3 m pre-clinical proof-of-concept milestone. This milestone was due to the successful establishment of a scalable manufacturing process for the generation of human beta cells. And we also demonstrated that these human beta cells can be encapsulated and function in diabetic animal models. We are very pleased about the progress that has been achieved. And the fact that both alliances have already achieved their second milestones further documents that we are on an excellent path in iPSC-based drug discovery.

Without going into great detail today, the next slide – page 22 – is just a reminder that we are convinced that our iPSC-based drug discovery platforms will be a key value driver for Evotec going forward. And we have consistently built and expanded our collaboration network and are committed to further invest into iPSC-based drug discovery platforms, as well as iPSC-based projects.

Beyond iPSC-based drug discovery approaches, we are continuously building disease-area-specific drug discovery platforms, such as, for example in oncology, as you can see on page 23. It was only in 2015 that we made a first but very significant step into oncology through the acquisition of an oncology-focused research site in Toulouse from Sanofi. Since then, we have been building capabilities, expertise and projects there, and have struck a first significant alliance with Sanofi in immuno-oncology based on our Target*ImmuniT* project, which was followed by additional collaboration with Exscientia and others. More recently, we have signed a oncology-focused collaboration with Celgene, in May 2018. To this date, this is the largest EVT Innovate drug discovery alliance signed by Evotec. We received an upfront payment of $ 65 m, and are eligible for additional financial upside through significant milestone payments, as well as tiered royalties on each licensed programme. This collaboration is, in particular, based on leading phenotypic screening platforms, as well as unique compound libraries and associated target deconvolution capabilities. The collaboration intends to leverage all of these capabilities with an initial focus on solid tumors. In summary, we believe that we have been very successful in building and expanding our initial oncology expertise and capabilities in Toulouse, through our first partnerships. And we will now continue to invest into oncology R&D projects in the field of immuno-oncology as well as DNA break repair, in order to further expand our growing oncology franchise and prepare for further partnerships.

In order to ensure that a constant stream of highly innovative R&D projects is taken care of, we continue to commit to our academic BRIDGE strategy, which is summarized on page 24. We have institutionalized the strategy in the last couple of years through strategic partnerships with Oxford University in the UK through LAB**282**, a strategic partnership with a whole slew of leading academic institutions in Toronto, Canada through LAB150, and most recently a strategic partnership with the Fred Hutchinson Center in the US through LAB591. This latest partnership is another commitment to innovation, in particular in the field of oncology, as Fred Hutchinson Center is – of course – one of the leading institutions in this particular area. We are looking forward to many more exciting projects out of LAB591, and hopefully to additional strategic partnerships with other leading academic institutions.

So let me conclude with my final slide – page 25 – and briefly summarize what you can expect from EVT Innovate going forward. First of all, we are looking forward to additional clinical starts and significant progress in our clinical stage pipeline. We intend to further expand our academic BRIDGE strategy in Europe, as well as in the USA. We expect significant progress in our R&D projects based on this additional EVT Innovate pharma partnerships, but also milestone achievements out of our existing EVT Innovate

partnerships. Finally, we are committed to our iPSC drug discovery platform, and will continue to build our network and invest into iPSC-based drug discovery projects. With this, I would like to thank you for your attention, and over to Enno.

Enno Spillner

Thank you, Cord. Today I have the great pleasure of presenting the first half-year and Q2 2018 numbers to you. Welcome to the call, and let me start on page 27 with the half-year review first. So the Group revenues increased significantly by 67% to € 174 m, compared to € 104 m during the same period of the previous year. R&D expenses for the first six months of 2018 increased by 17% to € 10 m, reflecting continued investment into R&D activities, currently mainly in the field of CNS and metabolic diseases, as well as having a focus on academic BRIDGE initiatives. SG&A expenses for the first half of 2018 increased as expected by 72% to € 27.1 m, compared to € 15.8 m in H1 of 2017, and these SG&A expenses were mainly impacted by the addition of Aptuit for the first half-year, and also by an increase in headcount in response to the overall growth of the organisation, our M&A activities, in particular, in connection with our Lyon ID activity, and other project-related costs for the implementation of new tools and software to grow the Company.

Evotec, unfortunately, also had to record impairments of intangible assets of € 4.2 m in total. The programme EVT770 was fully impaired, as the project was put on hold. However, at the same time, this € 4 m impairment is offset by a release of earn-out accruals related to this programme in the amount of € 2.3 m, which we have recorded under operating income. Thus, the net impact is about € 1.7 m. The developed assets within the Panion joint venture were also fully impaired, which is an impact of € 0.2 m, as it was decided to discontinue these programmes. I would also like to mention the other operating income, which in the first six months of 2018 amounted to € 12.7 m, and mainly resulted from higher R&D tax credits in France, in the UK, and in Italy. These amounted to € 10.3 m, thus showing a significantly higher amount than in 2017 H1, when we had € 5.6 m of R&D tax credits at that point in time. In addition, the impairment of intangible assets led to the just-mentioned release of earn-out accruals related to the programme EVT770. Evotec's adjusted group EBITDA increased significantly by 47% to € 38.6 m, translating into an adjusted EBITDA margin standing at 22.2% for the first half of 2018.

Now looking at our two segments, EVT Execute and EVT Innovate on page 28. The EVT Execute revenues are up 61% to € 163.3 m, and this increase was primarily attributable to the strong performance in the base business and the Aptuit contribution for the first six months of 2018. Included in this amount are € 21.5 m of intersegment revenues within the EVT Execute segment. EVT Execute recorded costs of revenues of € 126.8 m in the first six months of 2018, resulting in a gross profit of € 36.5 m and a respective gross margin of 22.4%. The drivers behind this change in gross margin are the same drivers that affect the Group gross margin, and I'll come back to this in a moment in a few slides. EVT Innovate revenues are up 52%, as Cord already mentioned, to € 32 m. The strong increase in EVT Innovate revenues resulted from several milestone achievements and key alliances, such as Celgene and Sanofi. In addition, the base revenue also showed a very positive upswing, clearly contributing to the positive development here. The EVT Innovate segment reported a cost of revenues of € 15.9 m, triggering a gross profit of € 16.1 m, and consequently resulting in a very attractive gross margin of 50.4% compared to 46.1% in the comparable period of last year. Adjusted EBITDA for EVT Execute stood at € 36.3 m, translating into an EBITDA margin of 22.2%. The EVT Innovate segment reported a positive adjusted EBITDA of € 2.3 m, mainly due to the just-described milestone achievements that we have achieved mainly in Q2 of this year.

Coming to the next slide, also coming from the Q2 2018 perspective, we can report a very strong performance. Overall, the principal messages are the same, like for the full first half-year numbers. So, Group revenues increased by 77% to € 94.8 m and the significant milestone achievements were also reflected in the gross margin, obviously, of Q2 2018, with a gross margin of 33.6%. Q2 2018 gross margin, excluding the total amortisation, amounted to 36.7%. Overall, Q2 2018 SG&A expenses remained at a similar level as in Q4 2017 and Q1 2018, which were the first full quarters following the

Aptuit acquisition. The adjusted Group EBITDA increased from € 12.8 m in the second quarter of 2017 to now € 24.6 m in Q2 2018, which is a 93% increase and indicates a 26% adjusted EBITDA margin.

Not on this slide, but as some of you may recall, at the end of July 2018 we announced the repayment of 50% of the € 140 m debt facility, which was taken in context of the acquisition of Aptuit in 2017. This repayment was enabled mainly through the strong cash inflow from Evotec's operational activities in the first half-year of 2018. Some of this repayment you will already find in this quarter report due to reduced liabilities. Some payments were conducted after the reporting period to cover the full € 70 m. Still, we maintain a very strong liquidity position at the end of Q2, showing roughly € 110 m on our accounts.

Briefly some comments on revenues and on gross margin on the next slide. This revenue growth is based on a solid mix, namely the successful contribution of Aptuit, which is close to € 54 m, further growth in our base business, significant and growing milestone contribution in existing alliances, and signing of new partnerships, for instance with Celgene in oncology. Milestones, upfronts and licences stand this first half year at € 15.5 m, which means a step up of 17% compared to the first half of 2017. Foreign exchange also was more favourable now in Q2, compared to Q1 of this year. In the first six months of 2018, the gross margin amounted to 28.9%, and this margin change compared to 2017 reflects the new business mix with different margin expectations following the acquisition of Aptuit, higher amortisation – as mentioned before – of intangible assets, and adverse FX events. Gross margin – here, again, excluding total amortisation – amounted to 32.5%.

Coming to the guidance, overall our guidance for 2018 can be well confirmed, with the exception of the anticipated R&D spending as already indicated by Werner, which will increase significantly for the remainder of the year due to our new Lyon R&D initiatives in ID. Guidance on Group revenues remains confirmed with >30%. Guidance on adjusted Group EBITDA, the same: confirmed. Guidance on R&D expenses will be increased, and following the closing of the agreement to take over Sanofi's ID unit, the financial R&D guidance for 2018 needs to be updated. We now expect total R&D expenses to range from € 35-45 m. Previously this was trending to € 20-30 m. Looking further ahead, this activity will also mean increased average R&D spending in the short- and mid-term years to come. So, this is not only an impact for 2018. However, the additional R&D efforts are not expected to impact the adjusted EBITDA, since these extra R&D expenses will be covered by other operating income, recognizing the context of this new agreement with Sanofi. And having said that, I'm handing over back to Werner. Thank you very much.

Werner Lanthaler

On page 32, you can see our future reporting dates. And by inviting you to follow us going forward, I also want to thank you for where you are motivating us, as one Evotec, to go. And with this, we're open for questions.

Operator

Thank you. Ladies and gentlemen, if you haven't already, if you wish to ask questions, can you press 0 and then 1 on your phone keypad now, in order to enter the queue. After I announce you, you can ask that question. If you find that question has been answered before it is your turn to speak, simply press 0 and then 2 to cancel. We go to the line of Falko Friedrichs of Deutsche Bank. Please go ahead. Your line is now open.

Falko Friedrichs (Deutsche Bank)

Hello. A couple of questions from my end, please. Firstly, the mid-point of your old R&D guidance should have equated to roughly 7% of sales in 2018. With the new guidance now, it's roughly € 15 m and more

in the second half of 2018. Can you help us how we should model this for the next years? Is it fair to assume that the underlying level of R&D expenses remains at the 7% of sales, and then there will be another roughly € 30 m per year on top of that, which will then obviously be compensated by Sanofi and the other operating income line? Meaning, can we expect a total R&D expense of around € 60 m in 2019, and then, growing in line with sales from then on?

Then, following on to that, is it fair to assume that starting from the second half of 2023, so five years from today, we will take out the Sanofi coverage in the other operating income line, and you will have the full EBITDA impact of these higher R&D expenses? Then my third question is: could you share the organic growth of the EVT Execute base business excluding Aptuit, for Q2, and also for H1? And then, a very quick last one: can you tell us what you plan with the EVT770 project now? Will you be looking for a new partner or will that be discontinued?

Werner Lanthaler

Thank you so much for the questions. Question number one will be handled by Enno and Cord. Question number two will be handled by Enno. Question number three will be handled by Mario. I will comment on question number four.

The most important principle for all the projects that we co-own with our partners is always that we want to ensure that every project is fully invested. So, projects can be terminated for different reasons. One is of course scientific reasons, because the project just doesn't work. Or there are strategic reasons that these projects are discontinued, or the indications that this project has been positioned in, are no longer the strategic indications where our partners are going. But the is typically a contract arrangement that we have where, once the full investment is not happening from our partner in such a project, the project falls back to us, so that we are allowed to open the portfolio of options, and see what we can do next with this project. We can then either make an own R&D project out of it and repurpose it, we can re-partner it, or, of course, we can completely stop it. To be specific on EVT770, the most important message we want to give you is that we just write it off. So with this you have a zero. And it turns from the value that you had on the balance sheet to a pure upside option if anything would happen to this project in the future. We have seen situations where we were able to re-partner projects that have come back to us. But on this one, I would at this stage just be cautious and give our R&D teams the chance to evaluate what would be the next step with this project. But again, for you, you should be cautious and just keep it at zero. When it comes to question number one, I will now hand it back to Enno.

Enno Spillner

Welcome, Falko. So about the R&D modelling, I think you're on the right track. So there will be a base commitment independent from the ID activity that we have in Lyon on the other fields amongst Evotec, which in the past years was in the area of roughly € 20 m or slightly below. And you can take this as a good common ground to continue these base activities. And then, obviously, if you take the mid of what we have now forecast for the second-half of 2018, that should be a good indicator for the time while we have the idea to achieve being fully supported and financed. That said, we will have to do a more in-depth review of our individual project efforts in the context of the new budgeting process, so this can be adjusted for the years to come. But that's the current stage where we are right now.
Coming to the second question right away about 2023, with regards to the R&D impact after that period, I think clearly we need to review at that point in time how far we got with our ID pipeline and if there's a return, and what we can afford from the EBITDA perspective. But we will not just allow this to just slide through into the EBITDA result, if there's no upside or future potential on the other side. So this will be reviewed at that point in time.

Werner Lanthaler

Let me – before I hand over to question number three – just add a sentence to the statement that Enno just made on the R&D expense. Many companies, where you make a percentage of sales as an R&D commitment, are typically Pharma companies that are selling products. When you look at Evotec's top-line, one could argue that almost everything that you see in this top-line is R&D spend, because what we are doing with our partners is investing into research and development and drug discovery. So, therefore, I would like to add a word of caution about saying that it's 7% of R&D expenditure from our top-line: no, it's not. This is close to 100% R&D. You just see it as R&D, which is accounted for in partner projects with our partners. And that's the power of Evotec going forward, that we are on the platform, learning, while our partners and us, together, are progressing this R&D platform forward. That's why I would not place us in the same box as other companies who are classical drug-selling companies, or other selling companies. Thank you for that comment that I was able to make. And now, I give to Mario on question number three.

Mario Polywka

So, the question here was the growth in the EVT Execute core business. H1 of 2018 compared to 2017, was significantly low on milestones, but the growth was around 6%. Going forward, H2 will be larger in milestones. And I think, overall for planning purposes around 10% growth year-on-year would be what we would expect.

Falko Friedrichs (Deutsche Bank)

Perfect. Thank you.

Werner Lanthaler

Thank you. With this, Falko, we hope that your questions are answered and we will hand over to the next question, please.

Operator

Yes, of course. That's of the line of Igor Kim at ODDO BHF. Please go ahead, Igor, your line is now open.

Igor Kim (ODDO BHF)

Yes, hello. Thanks. Congratulations on the good result. First, I've got a couple of questions on Cyprotex. Could you give a bit of colour on how the revenue has developed in the second quarter, and also margin year-over-year? And for Aptuit as well, it would be helpful if you could give a colour on Aptuit margin development and what proportion of revenues came from bigger projects in the second quarter, or in the first half of the year, whatever is more comfortable for you? And the last question: the R&D tax credits that we've seen in the first-half of the year was much higher. Should we expect a similar amount for the rest of the year? Thanks.

Werner Lanthaler

Question number three will go to Enno. Question number one and two will go to Mario. But let me first here caution you that we are not intending to divide out individual margins of individual segments of our business to an even further detail. Why? Because, what we bring to our partners are increasingly

integrated projects, where we come together for our partners as one platform. So therefore, the individual carved-out margin of, for example, DMPK/Tox testing in Cyprotex is not fully indicative of the value that we're generating with these integrated projects. And that, just to give you that as a starting point by handing over to Mario, who will give you a bit of a better colour on those businesses, and how they're performing.

Mario Polywka

Thank you, Werner. Hello, Igor. So, regarding Cyprotex growth, again, we have 5% or 6%, I would say for the first half of the year we have a tremendous margin increase. We don't give very specific detail on business line margins, but certainly Cyprotex is in the mid-40%, so I would say it's a strong margin contribution from Cyprotex over the last year. The portion on INDiGO, it is quite difficult to be very specific on that, because you have some complete INDiGOs, you have INDiGOs where the API is supplied versus being manufactured. But probably around 35% or so, 40% of Aptuit revenues will be INDiGO-related. Building up more capacity, we could probably think that we would then add another 10% or 15% of INDiGOs from next year.

Werner Lanthaler

But, of course, the overall strategic purpose is to increase our cross-selling activities from ongoing drug discovery projects out of EVT Innovate, partner with our project partners, and then translate them into DMPK/Tox testing from Cyprotex, and of course then into INDiGOs with Aptuit. And that flow of drug discovery projects into the INDiGO processes of Aptuit is, more than anything else, driving R&D efficiencies through speed. Then, what we bring to our customers is not purely people solutions. It's really that we are speeding up that process. And that's the key reason why we think this cross-selling offering for our partners with INDiGO is nicely picking up, as we see it today. But there is still a long way to go until we have the full market education done there. With this, I would like to hand over to the next question.

Enno Spillner

Maybe we still have a R&D tax credit question pending. So, Igor, coming back to your question regarding the tax credits, I think overall we are making really good progress and the overall increase comes now a) through the contribution of Aptuit, which is onboard new in that regard, claiming R&D tax credit for the first half-year; and b) obviously, we also try to increase our volume at the other sides, namely in UK and France as well, as revenue is growing here. And, as you asked for the Q1 versus Q2, I think Q2 is a good orientation here because in Q1 we still had some carryover effects from the past years, where we got notification of R&D tax credits which were still accounted for in 2017.

Igor Kim (ODDO BHF)

Okay, great. Thanks.

Operator

Okay. We're now over to the line of Brigitte de Lima at goetzpartners. Please go ahead. Your line is now open.

Brigitte de Lima (goetzpartners)

Good afternoon. Two questions from my side, if I can. The first one, as you mentioned how you are moving towards a certain scale, and how you can now work on bigger projects and be more ambitious, I was wondering if that has had any positive impact on your pricing power and if you see that you can start charging more and more per FTEs per project? And if so, can you quantify it to some extent?
And the second was on the iPSC platform, where there's obviously a lot of activity. And what I was wondering about is where you are in terms of attracting new partnerships with industry. Is this on the table that you intend to expand beyond Sanofi and Celgene and attract additional industry players to generate additional streams of milestones in the near-term? And should we expect something this year, potentially?

Werner Lanthaler

Hello, Brigitte. For the first question, let me just invite Cord to give you, as an illustrating example, how we look at this increased scale and flexibility model in partnering by, for example, looking at the latest oncology alignment that we have done with Celgene here. And Cord will also comment on the second part of your question.

Cord Dohrmann

So generally, we are looking for strategic partnerships with sufficient scale to create productivity and bring drug candidates forward to IND and beyond. And, as attrition is fairly high in early-stage drug discovery, especially on highly innovative projects, the appropriate scale here for these projects is – in our view – in the range of 50 people, five projects at least, to get there. And overall, I think, we have been very fortunate in crafting a number of these partnerships in this range, in this scale, with various balances in terms of risk and reward – so, in terms of how much risk we take in these partnerships and how much upside we take in these partnerships. We continue to put together proposals that are in this line, so we hope to attract additional partnerships of the similar scale in the future. Nevertheless, much of this also, of course, depends on our current partners – on our potential partners.

In regards to the iPSC platform, the iPSC platform has grown very significantly over the past three years, so we are now over 100 people in iPSC-based drug discovery, focused on this. We have a number of internal projects related to this, and we are continuously growing here. And we have various discussions on potential partnerships, also with potential industry partners. Here, however, we are trying to, of course, attract the best possible partners to all of our projects, and in that regard, I don't want to comment on exact timelines for these partnerships.

Mario Polywka

And this is Mario here to make another comment to follow-up on Cord's about scale of partnerships and efficiency. Even within the EVT Execute field, what we find now is that, with the extensive platform, with the therapeutic area expertise that doing your own focused internal R&D brings, you're able to take on big portfolio projects. And we'll be discussing some of those in the next few months. And then of course you're not tactically competing against WuXi or Syngene, because they don't have the know-how, the platform, the project management. So that means that now you're in a different discussion, where you talk about premium rates and even without your own IP.

Brigitte de Lima (goetzpartners)

That's very helpful. Thank you.

Operator

We are now over to the line of Joseph Hedden at RX Securities. Please go ahead. Your line is now open.

Joseph Hedden (RX Securities)

Good afternoon. Thanks for taking my questions. I've got two. Firstly, on your collaboration with CHDI, it's historically been an important contributor to EVT Execute, and I believe it expires this month. Can you just shed some light on any potential discussions you have over extending that, if you have any? And then secondly, the upfront payment from Sanofi for the infectious disease deal, how can we think about modelling that? Is that going to be deferred over the five years that you'll be receiving the research payments? Thank you.

Werner Lanthaler

To your first question, Mario, who is sitting next to me here, looks very confident on the progression of this very important alliance within the year 2018, when there's a natural term ending. The 50 people that are typically working in the Huntington's disease field have not achieved their goal, which is finding a new drug for Huntington's disease. And that's the pleasure of working with a foundation who has a clear mission, which we share, and that we are completely dedicated to. Together with the CHDI, we will not give up until we have found a drug for Huntington's disease, and that's also our commitment to our partner here. That's why we are very confident that we will see a prolongation, in one form or another, going forward here. On the second question, I will hand over to Enno.

Enno Spillner

Good. So, with regard to the upfront by Sanofi, which was in total € 60 m as we communicated, this is mainly to cover the initial cost when starting and ramping up the whole process, roughly for the first 9 to 12 months. But this amount consists of different blocks, so there's also some Capex in there that will be covered and some reserve, obviously, that we take over as we take on the long-term obligations for our new roughly 100 employees with regard to pensions and everything. So that is also covered in this, basically as a down payment, which will go straight into our balance sheet into liabilities here, respectively. So it's only for the starting point.

Joseph Hedden (RX Securities)

Okay. Thanks so much.

Werner Lanthaler

Okay, we invite the next question.

Operator

Yes, of course, that is Volker Braun, of Bankhaus Lampe. Please go ahead. Your line is now open.

Volker Braun (Bankhaus Lampe)

Yes, thank you. A follow-up on that new activity in infectious diseases. It seems to me that drug discovery in this area is at least a bit more developed than maybe in Alzheimer's disease. There are more disease models working, or predictable. What is Evotec able to add in that field? What are the characteristics of the development process in comparison to other diseases? And is it fair to assume that a potential partner in deal collaboration is to be expected rather sooner than later, or is it too aggressive?

Werner Lanthaler

Thank you so much. The question will go to Cord.

Cord Dohrmann

So, we have been active in the infectious disease space for quite some time. It was four years ago when we acquired Euprotec in the UK, as a smaller unit of back then roughly 20 people that has grown now to close to 80 people. And, through this move, we essentially acquired a lot of expertise and had a big learning curve in the field as well. Now, with the Sanofi transaction, we added another platform, but also projects and of course a lot of expertise in the field, which will help us tremendously going forward to drive the existing project forward, to hopefully key value points. However, in contrast to the EVT Innovate strategy we have had so far to partner projects early, we are a lot more cautious here. We are basically prepared to take projects forward all the way to human proof-of-concept, if necessary, before partnerships. And this is essentially how we modeled our plans. So we are not counting on early-stage partnerships at this point in time, but rather are looking forward to really developing these projects and then see if there are partnerships out there. But even in the long run, it might be an option to take projects all the way forward here into the market. In terms of what differentiates us now in the infectious disease space, I think overall, with this transaction, we now have access to probably the biggest infectious disease platform in the world, and we have one of the largest portfolios, which we are working on. We have a huge academic network that will supply further projects in the field. And I think it is clear to everybody here that there is a huge unmet medical need coming that needs to be served to some extent. So, we may not have mapped out all the details, but overall we feel like we are on the right track, and we have a very comfortable base to start with. And we feel extremely well-positioned to make that endeavour highly successful going forward.

Volker Braun (Bankhaus Lampe)

Can I add a few more? Did I understand it correctly, that you're prepared to take it to the proof-of-concept in human beings? That means clinical trials, Phase II, and taking also the financial implications? That's correct, or was it a wrong understanding?

Werner Lanthaler

So, for us, it means that we have collaborations in the form that are put together with Pharma partners – that's what you see in many disease areas where we're working – so we will have commercial partners, where possible. In the field of infectious diseases, proof-of-concept is very often necessary to come to a commercial case, because otherwise this field is commercially just not trivial. What we expect for this field, and that's also why we are out promoting this field, is that there will be significant public support for certain disease areas, which will help us carry the costs up to proof-of-concept trials, for example. And also please don't forget that there is significant support from Sanofi behind this platform to bring certain projects forward to their – potentially also clinically – infection points. So, in contrast to other disease areas where we typically want to have a partner on-board as early as pre-clinical stage, I would say, or even before that, in infectious diseases we have to open the vision a bit wider.

Volker Braun (Bankhaus Lampe)

Okay then, I have to ask another question. What is the characteristic of a typical infectious disease trial? Presumably, it's a larger number of patients but a shorter time frame? Because the modelling here would be done a bit different to what we are used to.

Werner Lanthaler

No, I would say here we are really shooting for proof-of-concept trials, and demonstrating early efficacy in a smaller number of patients rather than going for broad proof-of-concept trials. So I think it depends very much on individual projects, but especially in anti-bacterial infections, we are not going to go for large comparative trials, but rather an initial proof-of-concept.

Volker Braun (Bankhaus Lampe)

All right. Thank you.

Werner Lanthaler

A pleasure.

Operator

Okay. We are now over to the line of Victoria English of Evernow Publishing. Please go ahead. Your line is open.

Victoria English (Evernow Publishing)

Yes. Werner, in the beginning of your presentation you talked about wanting to keep the focus of Evotec on R&D acceleration. Now, what I'm trying to work out is whether the investment and effort that you're putting into the iPSC platform in the EVT Innovate part of your business has application to the EVT Execute part of your business, and whether you're planning to bring that over or integrate it in any way. The second part of the question is, in all these months I haven't heard anybody say anything about animal studies. Are you in fact, when you are working with your partners, still relying on animals to do a large part of your work?

Werner Lanthaler

Hello, Victoria. Good to hear you. To your second question, yes, of course, wherever there are predictive animal models applicable, we have a huge effort going in building translatable animal models. I think that's the key word here: for us the key is to have high-quality, translatable models going. Very often, for example, we have to educate our partners and ourselves that it's not always reliable to go to, for example, many academically published animal protocols and follow them. So that's why very often we build these things on our own. On iPSCs, specifically, the vision is, of course, to have the clinical trial in a dish, and to get completely out of animal models. But that's a long-term vision that is not applicable in all the fields, of course. And with this I will hand over to Cord on the, I would say, the synergy between iPSC and other fields. But the focus clearly is here on building our own big vision on iPSC together with our partners.

Cord Dohrmann

Victoria, this is Cord speaking. Thank you for your question. So, generally, I would say that with the iPSC platform that we have built at Evotec over many years, or the last few years, it is such a highly differentiated platform that we continue to differentiate via highly comprehensive phenotypic and molecular readout possibilities, as well as the data analysis tools that we're putting on top of that, that we feel that regardless whether you want to call it EVT Execute or EVT Innovate, for every project we run on these platforms, we feel that we are entitled to royalties. And, here, it becomes more a matter of how many opportunities can we pursue, with what potential partners, at this point in time. Because it's not that easy to continue to build the capacity at the speed that we have been building. But we are firmly committed to continuing on this path. And it is and it will be a platform going forward where significant learning curves and improvements are possible. And once again, also in this case, Evotec is extremely well-positioned at this point in time, and we intend to capitalize on this.

Victoria English

Thank you.

Werner Lanthaler

My pleasure.

Operator

We have a final question. And that is over to the line of Mick Cooper, Trinity Delta. Please go ahead.

Mick Cooper (Trinity Delta)

Good afternoon, everyone. Continuing on the theme of accelerating R&D, artificial intelligence is getting increasingly interesting in that field with regard to drug discovery, as you mentioned on slide 20. Can you provide some details on the strategic ventures in that area and your current use of AI in drug discovery?

Werner Lanthaler

Thank you so much. What you should see is that, in drug discovery, there is probably the most positive revolution ongoing for many, many decades, when you think about the power of iPS cells, when you think about the power of CRISPR, when you think about other tools coming into play that, ultimately, will make more specific answers possible way earlier in the drug discovery process. Artificial intelligence, for example – in chemistry, but also in many other areas of drug discovery – combined with other tools, all of a sudden make this process so much more insightful. We see so early on where we are going, that the risk that you take is now no longer only happening when you see and turn the card by the end of Phase II. You can now frontload the risk by having significantly better tools available that are integrated working here on, for example, patient-derived material, then in iPS cells, build assays for drug-discovery processes. Then together with CRISPR and other tools put together, and then, accelerated via target-based artificial intelligence in chemistry to go for the fastest and best molecules here. This should just illustrate to you where the power of our platform comes in, because Evotec has come to a critical size, through our EVT Execute platform together with our EVT Innovate platform and our strategic partners – for example, in artificial intelligence, a company called Exscientia that we co-own out of the UK. So, all of a sudden, these tools come on our platform and make the process, basically, a one-stop-shop highly data-driven, highly-efficient platform. And that's why it is important to look at the whole picture

here. CRISPR alone is one hammer. What we try to do is to integrate all the hammers, and nail down the disease as early as possible before we translate it into the clinic. That's our vision, and that's what our partners increasingly find attractive.

Mick Cooper (Trinity Delta)

Thank you for your comprehensive answer.

Operator

I apologize. There's a follow-up question from Brigitte de Lima at goetzpartners. Do you have time to take it?

Brigitte de Lima (goetzpartners)

Sure, always for Brigitte.

Operator

Please go ahead.

Brigitte de Lima (goetzpartners)

Sorry, this is so much of a can of worms in a way. You've just opened a can of worms. So, following on from Mick's question, because it's a fascinating field, but you've always been a visionary. So, if you look at what Evotec is doing in AI and how you're harnessing all this technology including for Exscientia, so if you look at Evotec five years down the line, what Evotec do you see? What are the big changes to Evotec in 5 or maybe 10 years we'll have compared to what we see now? Where do you see these efficiencies coming through? Is it a few people doing more projects? And you know, are you having greater profitability per person? I sort of find it difficult to predict that, but obviously, you must have a much better view than me. I will appreciate an answer.

Werner Lanthaler

The answer exists already. It's called Action Plan 2022, which is reading out for the next five years our vision in drug discovery. So this is really the acceleration of what we are currently doing in EVT Execute and what we're doing in EVT Innovate, to a bigger scale, and more integration in even more flexible, huge, formats with our biotech and Pharma partners. And I think that's really the nice thing about the Company at this stage that the fundamental ideas are already there. Also, we can already describe the fundamental experiments for many disease areas. Very often we don't have the exact formula how to solve it, but we have for many of these things laid out at least the beginning technologies, and now, we just have to execute on as many disease areas as possible on that. And that's why we will just do more of the same going forward, which is the most boring strategy on the planet but it works.

Brigitte de Lima (goetzpartners)

Thank you very much. Very insightful.

Operator

Okay. May I please pass the call back to you for any closing comments at this stage?

Werner Lanthaler

We would like to thank you all. And we hope to see you very soon in the best health. All the best.

Operator

This now concludes the call. Thank you all very much for attending. You can now disconnect.