**Market data**

EPIC/TKR	COS
Price (p)	3.8
12m High (p)	5.1
12m Low (p)	2.0
Shares (m)	324.5
Mkt Cap (£m)	12.4
EV (£m)	13.4
Free Float*	70%
Market	AIM

*As defined by AIM Rule 26

Description

COS develops, manufactures and supplies medical grade-collagen biomaterials, tissues and devices. Its products are used in research, *in vitro* diagnostics, medical devices and regenerative medicine. The company provides R&D and contract services to a global and diverse customer base.

Company information

CEO	Jamal Rushdy
CFO	Hilary Spence
Chairman	David Evans
	+44 141 648 9100
	www.collagensolutions.com

Key shareholders

Directors	17.5%
Seneca	13.3%
Calculus Capital	9.5%
Rathbones IM	4.8%
Living Bridge	4.6%
Helium Rising Stars	4.0%

Diary

1H'19	ChondroMimetic
	CE marking
Jul'19	Finals

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COLLAGEN SOLUTIONS

Exciting growth

Collagen Solutions (COS) is a biomaterials company developing and manufacturing biomaterials for use in medical devices, research, and regenerative medicine. A number of investment initiatives have been introduced to accelerate the rate of growth, including global commercial infrastructure and the development of a pipeline of proprietary finished medical devices, the first of which will be ChondroMimetic for repair of small cartilage lesions. Benefits of the investment in marketing were very apparent in the results for 1H'19, with like-for-like sales up 55% and a large reduction (48%) in EBITDA losses.

- **Strategy:** Management has embarked on a series of initiatives to increase the growth opportunities. This strategy is moving COS from solely a collagen supplier to one that also develops OEM and proprietary products to reach profitability sooner, as evidenced from the sales mix in recent 1H'19 results.
- **ChondroMimetic:** COS has re-submitted ChondroMimetic to its Notified Body for CE marking, supported by excellent eight-year clinical data. Timing is difficult to predict, given the external regulatory process. Several initial commercial distribution partners have already been announced for Europe and Asia.
- **Trading update:** Reported product sales in 1H'19 were up 13% despite the known expiration of a supply contract in Korea. On a like-for-like basis, sales increased 55%, with an improved mix. Additionally, restructuring and a greater focus of resources resulted in a 48% reduction in EBITDA losses to -£0.62m.
- **Risks:** All companies focused on leading-edge technology carry risk. However, there are a limited number of suppliers of medical-grade collagen and tissues which, once-embedded in a customer product, is difficult to replace. Also, COS will soon have ChondroMimetic de-risked through CE marking in the EU.
- **Investment summary:** ChondroMimetic fulfils COS's stated strategy to move further up the value chain. The imminent re-validation of ChondroMimetic via CE marking will represent an important milestone and allow management to conclude further commercial deals with a de-risked proposition. COS commands an EV of just £13.4m, which means that it is trading on a prospective EV/sales of only 2.7x, which does not reflect properly the growth opportunity.

Financial summary and valuation

Year-end Mar (£000)	2015	2016	2017	2018	2019E
Sales	973	3,130	3,946	3,505	4,007
Underlying EBITDA	-663	-374	-1,209	-1,517	-948
Underlying EBIT	-793	-721	-1,658	-2,044	-1,426
Underlying PBT	-920	-983	-1,790	-2,428	-1,749
Statutory PBT	-1,102	-866	-1,614	-2,619	-1,817
Underlying EPS (p)	-0.98	-0.64	-1.04	-0.74	-0.53
Statutory EPS (p)	-1.17	-0.57	-0.95	-0.80	-0.55
Net (debt)/cash	3,282	2,384	7,072	2,098	-1,078
Capital increase	5,422	207	6,462	0	0
P/E (x)	-3.9	-5.9	-3.7	-5.1	-7.2
EV/sales (x)	13.8	4.3	3.4	3.8	3.4
EV/EBITDA (x)	-	-	-	-	-

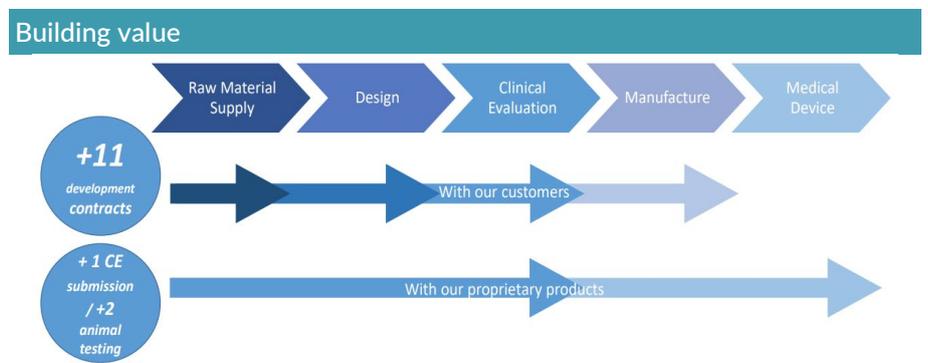
Source: Hardman & Co Life Sciences Research

Investment case

Moving up the value chain

COS is on the cusp of achieving its goals

COS's core strategy has been to transition from a respected supplier of quality medical-grade collagen and tissues to the medical device and regenerative medicine industries into a company that develops and manufactures finished products for itself and OEM customers, thereby retaining more of the margin. The company is on the cusp of achieving this goal with the anticipated CE marking of ChondroMimetic for cartilage repair. In addition, it has ongoing projects in novel bone graft substitutes and in wound healing for the burns and woundcare markets, respectively, but at earlier stages of development. Evidence of moving up the value chain was seen in 1H'19 sales, with 50% being derived from development projects (vs. 8% 1H'18). These projects will transition to contract manufacturing once the products are approved, at a multiple of sales potentially 2x-5x the current development revenue.



Source: Collagen Solutions, Hardman & Co Life Sciences Research

ChondroMimetic update

Approval of re-submission for CE marking expected within next three months

In September 2015, COS acquired the assets of ChondroMimetic and associated IP for £200k plus a single-digit royalty, from its founder. Although ChondroMimetic had previously received CE marking in 2008, this had been allowed to lapse. The aim of COS was to re-apply for CE marking on the back of additional clinical data and to re-launch it as the company's first proprietary product. ChondroMimetic is best described as a clever, bi-layered and easy-to-use sponge that allows the regeneration of cartilage and bone.

In February 2018, COS reported exceptional results from 15 patients (out of 17) from an original trial in 2009-10, which had been re-assessed for clinical outcomes. Eight years after implantation, the ChondroMimetic scaffold had produced a sustained long-term regeneration of cartilage, undifferentiated from native cartilage, with improved clinical symptoms. These data have been used to support COS's re-submission for CE marking, which is expected any time in the next three months.

Latest news

- ▶ **20 February 2019:** COS has sold its minority stake in Jellagen, a marine biology company developing collagen biomaterials from jellyfish, for £215k in a private transaction.
- ▶ **31 January 2019:** COS announced that it had signed a distribution agreement for ChondroMimetic with PT Rajawali Mutiara Sejahtera, initially for Indonesia, but with the potential to expand the agreement for other countries in SE Asia.
- ▶ **15 January 2019:** COS announced that it had signed a new agreement with Olaregen Therapeutix Inc to manufacture Excellagen, an advanced FDA 510(k)-cleared wound healing product indicated for treatment of hard-to-heal wounds.

- ▶ **7 January 2019:** COS was awarded a £1.54m Scottish Enterprise Grant to support its future R&D investment of £3.96m into several early-stage and future proprietary product R&D programmes to fuel COS's growth strategy.

Benefits of investment in marketing were very apparent in the results for 1H'19

Trading update

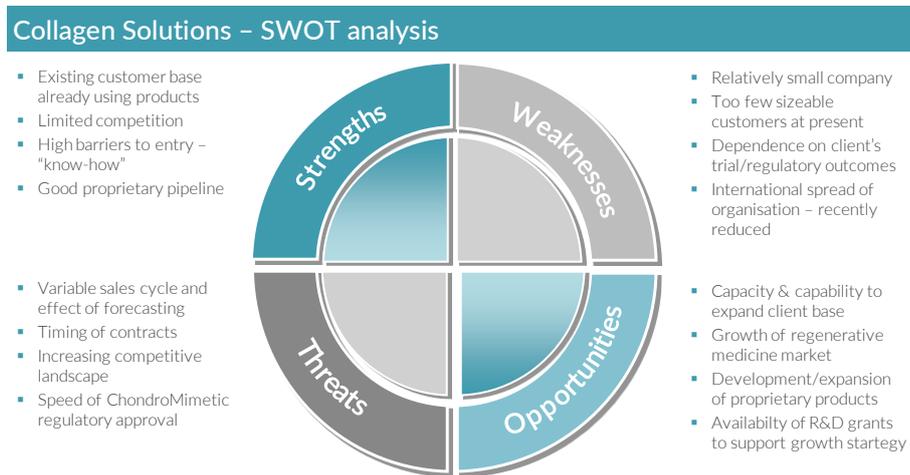
In December 2018, COS reported its interim results for fiscal 2019 which demonstrated strong commercial progress, having signed nine new customer contracts and initiating supply of value-added collagen material to 16 new/recently-signed customers. This progress was expected to continue in the second half, given its investment in sales and marketing, which was ramped-up two years ago.

- ▶ **Sales:** Product sales increased 13% to £1.95m (£1.73m) on the back of supply activity with new customers, despite the previously stated expiration of a supply agreement with a Korean customer. On a like-for-like basis, sales growth was 55%.
- ▶ **EBITDA:** The increased sales level, improving sales mix and a more focused use of resources led to a 48% drop in EBITDA losses to -£0.62m (-£1.20m). This is expected to reduce even further in 2H'19 and turn positive in fiscal 2020.
- ▶ **Cash:** COS had cash of £2.56m at 30 September 2018, which represented a significant reduction in the rate of cash burn. This is forecast to improve further in 2H'19, such that COS looks set to end the year with cash of £1.4m.

Outlook

Restructuring the business through the closure of the group's activities in New Zealand, and a greater focus of resources, have greatly reduced the rate of cash burn for the group and moved it much closer to EBITDA break-even and overall profitability, which we are forecasting for fiscal 2020 and fiscal 2021, respectively.

SWOT analysis



Source: Hardman & Co Life Sciences Research

Current EV of £13.4m does not reflect the growth opportunity

Investment conclusion

COS is at a very interesting juncture. First, strategic investment in sales and marketing two years ago is really starting to bear fruit, reflecting the relatively long sales cycle. Secondly, the recent agreement with Olaregen for the supply of Excellagen highlights the importance of embedding COS technology into high value-added products. Thirdly, the imminent CE marking of ChondroMimetic will de-risk this opportunity and permit the launch of COS's first proprietary product; it will also allow management to conclude commercial deals with leading players in regenerative medicine to maximise shareholder returns. Taking all these points together, the current EV of £13.4m does not reflect this growth opportunity, in our view.

Financial summary

Summary financial forecasts					
Year-end Mar (£000)	2015	2016	2017	2018	2019E
GBP:USD	1.574	1.459	1.307	1.328	1.328
Profit & Loss					
Sales	973	3,130	3,946	3,505	4,007
COGS	-214	-811	-984	-1,039	-1,080
Gross profit	759	2,319	2,962	2,465	2,927
Gross margin	78.0%	74.1%	75.1%	70.3%	73.0%
SG&A	-1,325	-2,440	-3,722	-3,484	-3,578
R&D	-160	-367	-594	-825	-596
Underlying EBITDA	-663	-374	-1,209	-1,517	-948
EBITDA margin	-	-	-	-43.3%	-23.7%
Depreciation	-130	-347	-449	-527	-478
Underlying EBIT	-793	-721	-1,658	-2,044	-1,426
EBIT margin	-	-	-	-58.3%	-35.6%
Net interest	-128	-262	-132	-385	-323
Underlying pre-tax profit	-920	-983	-1,790	-2,428	-1,749
Tax	-21	-114	-142	27	25
Underlying net income	-942	-1,097	-1,932	-2,401	-1,724
Weighted av. shares (m)	96.4	171.2	185.8	324.4	324.9
Underlying EPS (p)	-0.98	-0.64	-1.04	-0.74	-0.53
Fully-diluted EPS (p)	-0.98	-0.64	-1.04	-0.74	-0.53
Balance sheet (@31 Mar)					
Share capital	1,755	1,759	3,288	3,290	3,290
Reserves	11,099	12,137	16,998	13,592	11,800
Provisions	285	253	222	193	164
Debt	109	109	1,906	2,924	2,484
less: Cash	3,391	2,493	8,978	5,022	1,406
Invested capital	14,176	14,203	15,786	16,170	16,550
Net cash/debt	3,282	2,384	7,072	2,098	-1,078
Cashflow					
Underlying EBIT	-793	-721	-1,658	-2,044	-1,426
Change in working capital	-228	422	-130	-455	103
Tax & interest	-28	-191	-102	-503	-269
Operational cashflow	-1,180	-338	-1,360	-1,705	-1,514
Capital expenditure	-159	-464	-137	-422	-401
Free cashflow	-1,326	-801	-1,497	-2,127	-1,916
Acquisitions	-2,192	-207	-342	-1,846	-976
Share issues	5,422	207	6,462	-4	0
Change in net debt	1,790	-898	4,687	-4,974	-3,176
Hardman & Co. FCF/sh. (p)	-1.22	-0.20	-0.73	-0.53	-0.47

Source: Hardman & Co Life Sciences Research

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