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Its own planet

Easy money takes no getting used to—it goes down like a cold glass of lemonade. What requires constructive adaptation is the absence of easy money.

Now in progress is a speculation on the coming need for this very adjustment. Central bankers seem determined to forestall it, but liquidity droughts can occur spontaneously as well as by design—witness, across the Atlantic, the crisis of the formerly red-hot, £4.3 billion LF Woodford Equity Income Fund, a leading holder of the kind of biotech shares that don't trade when you need them to trade (*Grant's*, May 17). On June 3, management froze the fund, preventing withdrawals, because the investors' demands for cash overtaxed the fund's illiquid, depreciating assets.

Which brings us to Evotec S.E. (EVT), a Frankfurt-listed services provider to the worldwide healthcare field. Like the Woodford fund in its prime, Evotec is a bull-market baby. Its loss-making biotech clients pay their bills because their investors can write the checks.

Admittedly, such musings are not uppermost in the minds of the starry-eyed Evotec fan base. The shares change hands at 55.4 times estimated 2019 adjusted earnings and 31.8 times enterprise value to estimated 2019 earnings before interest, taxes, depreciation and amortization. No comparable business is valued close to it—Evotec occupies a valuation planet all its own.

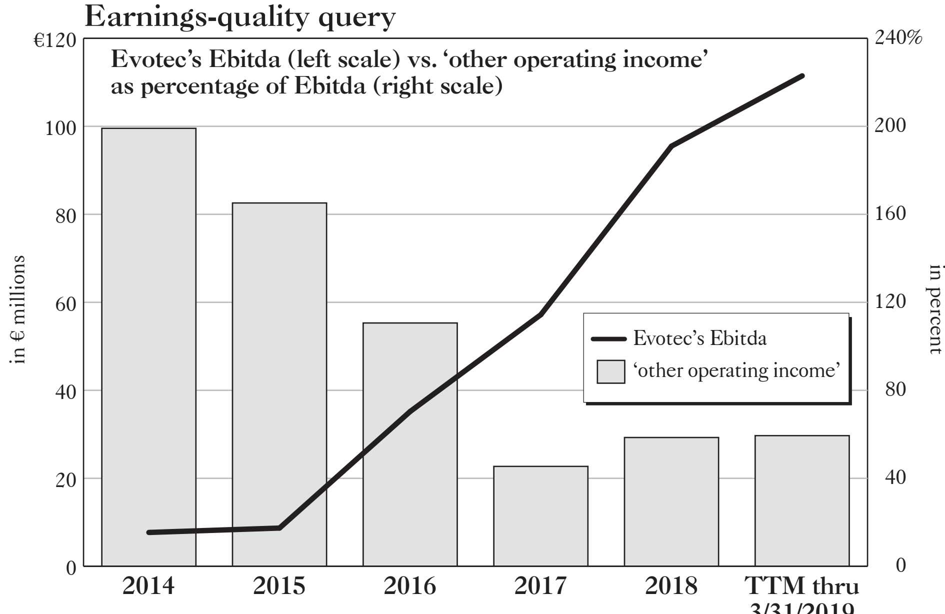
Scientists, including the Nobel Prize-winning chemist Manfred Eigen, founded this rare bird of plumage in 1993. They aimed to develop a device to automate the "screening of biochemical and cellular assays," to quote from an early press release. In 2000, with the acquisition of Oxford Asymmetry International plc, Evotec shifted operations to discover and develop new drugs.

In March 2009, within days of the post-Lehman stock-market bottom, Werner Lanthaler had the presence of mind to assume the Evotec corporate helm. While retaining Evotec's drug-discovery program, the new hire slashed the research-and-development budget and redirected the strategic focus to providing services to pharmaceutical companies.

Today, Evotec operates two business divisions: Execute and Innovate. Execute, which generated 80% of sales and 92% of adjusted Ebitda in the 12 months ended March 31, is a contract research organization (CRO) providing outsourced drug discovery and testing. Evotec's specialty is early-stage research, i.e., the process of identifying and validating a potential drug up to Phase I of clinical research. Innovate, which kicked in the rest of sales and earnings, partners with pharmaceutical and biotech companies to create Evotec's own drugs and intellectual property.

The bull case for Evotec proceeds from the fact that CRO providers are taking share from in-house efforts. Today, a little less than 10% of early drug discovery and development is outsourced. "There's nothing that indicates to us that in the next 10 years

Earnings-quality query



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this trend will not go way beyond the 20% to 30%," Lanthaler told a crowd at the J.P. Morgan Healthcare Conference on Jan. 10.

Evotec has grown through acquisitions. It bought Cyprotex plc and Aptuit in 2016 and 2017 for a total consideration of €322 million ($365 million at current exchange rates). It took over Sanofi S.A.'s in-house drug discovery labs in Toulouse and Lyon in 2015 and 2018, respectively (of which more later). And it announced the acquisition of Just Biotherapeutics, Inc., specializing in biologics, for $90 million including earnouts, the other day.

The bulls will tell you, too, that the CRO business is "sticky." Repeat business, 92% of the total in 2018, has ranged between 63% and 94% since 2014.

"There are 4,400 biotech companies," Lanthaler reminded his J.P. Morgan audience, "but only 1% of them is profitable. And why is this so cool? Because we can permanently reinvest and make our platforms and our drugs better out of our profitability." Those profitless strivers constitute a meaningful segment of Evotec's customer base.

Six of the eight analysts who hold an opinion on Evotec rate the company a buy. And in dutiful harmony with management's guidance of 10% revenue growth in 2019, the sell-side sleuths predict a topline increase of 10.4% in 2019 and 10.7% in 2020.

Evotec partners with pharmaceutical companies in hopes of earning royalties and milestone payments on its own intellectual property. If one of the corporate molecules winds up in an approved drug, Evotec stands to earn royalties, struck at between high single-digit and low double-digit shares of a drug's revenues.

In a May 22 note, Ladenburg Thalmann & Co. analyst Michael Higgins raised his price target to €33 from €29 per share (versus the current share price of €21.96), ascribing €18 per share in discounted future earnings from drug research and €15 per share for the value of Evotec's drug pipeline. "I'm less hung up on the valuation at the end of the day and more focused on pipeline and what's happening there," Higgins, who rates EVT a buy, tells colleague Evan Lorenz. "I spend more time on that than I do on the numbers."

You hear that a lot in listening to the analysts who cover Evotec. "If you try to do valuations based upon what they have (the profit-and-loss statement and discounted cash flows), you will never get to where the share price is at the moment," says Brigitte de Lima, who rates EVT a buy for goetzpartners securities Ltd.

A well-structured balance sheet completes the bull narrative: Net debt, including the present value of operating leases and the acquisition of Just Bio, sums to €139 million, or 1.2 times trailing Ebitda.

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"Evotec's business is much less durable than it appears at first glance," Lorenz writes. "According to a May 22 investor presentation, the average customer contract is only 1.8 years long. This is evident from Evotec's customer churn, a metric we can calculate from information provided in the annual report. Thus, Evotec had 760 customers in 2017 and added 263 new customers in 2018. However, the 2018 customer count dwindled to 707, implying a turnover of 316 customers or 42% of the 2017 customer count. Between 2013 and 2018, the churn has ranged between 27% and 45% per annum.

"Those unprofitable biotech companies occupy a bigger and bigger share of Evotec's book of business," Lorenz proceeds. "In the first quarter, biotech customers accounted for 46% of revenues, up from 22% of revenues in full-year 2015. To pay such CRO providers as Evotec, these companies must tap the capital markets."

Which speaks to the relevance of Woodford, a major provider of capital to early-stage healthcare companies in Britain. And to SoftBank Group Corp., which is having no easy time raising money for its second Vision Fund, according to *The Wall Street Journal*. Lanthaler himself, recalling the "nuclear winter" of 2008, acknowledges, "That is what can happen in the future when the IPO window closes, the private funding window is difficult and regulatory authorities are not easy."

Evotec faces more-immediate headwinds than the prospective tightening of financial conditions. One such gust is that the aforementioned lucrative lab deals with Sanofi will soon be expiring.

Prior to transferring its underachieving Toulouse site to Evotec in 2015, the French pharma giant had spent four years trying to close it. French politicians resisted. So did the staff scientists, who took to the streets to perform the New Zealand haka, the make-believe warriors still donning their lab coats. So it was that Sanofi paid Evotec €50 million per year for five years to take the problem off of its hands. It's a material sum in the context of Evotec's total revenues (€397.6 million in the 12 months ended March 31) and adjusted Ebitda (€111.5 million). As the Toulouse deal sunsets, it will fall to Evotec to replace the substantial lost revenue with other CRO work.

Sanofi is contracting for approximately €20 million of services from the Toulouse location, according to Lanthaler. "The rest is this cost subsidy," observes a bear who asks to go nameless, "so you have around €30 million disappearing in the spring of 2020 on an annual basis."

Subsequent deals with big pharma point to future revenue cliffs. For instance, on July 1, 2018, Evotec acquired Sanofi's 500-plus-person lab in Lyon. While the acquirer earned a one-off fee of €61 million, it held out no greater prospect for success than to project five years of Ebitda breakeven. A May 21 deal with Celgene Corp. to research new cancer-related treatments was concluded with a $65 million upfront payment.

"As a result of such transactions," Lorenz relates, "Evotec's deferred revenue (a liability for cash the company has received for work yet to be completed) jumped to a high of €121.4 million in the third quarter of 2018, up from €44.8 million in calendar 2017. The balance declined to €79.7 million on March 31. Evotec has been unable so far to replace deferred revenue as it burns off."

Evotec's pipeline of partnered drugs draws comparisons to *Grant's* pick-not-to-click Ligand Pharmaceuticals, Inc. (LGND on the Nasdaq; see issue dated Jan. 11). But Ligand is a better business, licensing its intellectual property to other pharma companies rather than spending to develop potential drugs. Then, too, 45% of Ligand's revenues in the first quarter came in the form of royalties on approved drugs.

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Evotec generates no royalty income because no company-owned IP has led to an approved drug. There are four drug candidates in (or about to start) Phase II trials, seven in Phase I trials and a large cohort in preclinical stages. Some of the clinical-stage drugs appear to have been stuck in limbo for years. For example, Evotec itself completed a Phase II trial of EVT201 for treating insomnia in 2005 and partnered with Chinese pharma company JingXin Pharmaceutical Co. Ltd. in 2010 to develop the drug further. It's still in Phase II.

Other drugs listed on Evotec's pipeline actually seem not to belong there, e.g. CT7001, an oncology target that's the property of Carrick Therapeutics, Ltd. Evotec owns a 4.3% equity stake in closely held Carrick, but does not own the IP behind the drug.

"The early stage of most of Evotec's pipeline limits its net present value," Lorenz observes. "Say that one of Evotec's drug candidates wins regulatory approval and becomes a blockbuster with €1 billion in sales. Further assumptions: an 8% royalty rate, €300 million in milestone payments and a 10% discount rate. If it takes 10 years to get approval, that drug is only worth €1.85 per share today.

"Quality of earnings presents another problem," Lorenz goes on. "In 2018, 2017 and 2016, Evotec generated €95.5 million, €57.2 million and €35.2 million in adjusted Ebitda, respectively; over the same period, 'other operating income,' a component of Ebitda, summed to €55.9 million, €26 million and €39 million. What, exactly, is this line item that accounts for half, or more, of earnings each year? In 2018, €27 million of the €55.9 million in 'other operating income' was sourced from Sanofi, largely as a result of the Lyon deal. The remainder consists of R&D-related tax credits in Europe.

"Under U.S. GAAP," Lorenz notes, "these tax credits would show up as an offset to taxes paid. Under International Financial Reporting Standards, Evotec is able to classify them as operating income, arguing that the credits 'are akin to a government grant' in the footnotes to its annual report. The tax credits are a function of Evotec's R&D expenditures, which have vaulted, as a result of the Sanofi/Lyon deal, to €14.4 million in the first quarter of 2019, from €4.6 million in the first quarter of 2018. Thus, a Catch-22: When the Lyon reimbursements end in 2023, Evotec can pare back R&D outlays (at the expense of tax credits and, therefore, other operating income) or maintain that spending and face lower earnings but keep the tax credits."

Not all the sell-side analysts who study Evotec do it for the love of truth alone. Goetzpartners publishes paid research, with Evotec being the one that pays it. Evotec pays RX Securities Ltd., too, though not, directly, for the reports on Evotec which it distributes for free to institutional clients, but rather for "advisory" work. Coincidentally, both firms rate EVT a buy. In 2018, Evotec management presented at an average of more than two investor conferences a month.

The insiders seem not to read the research they pay for. At least, over the past 12 months, they have sold a total of 597,696 shares for proceeds of €11.9 million. March 29, 2016, when the stock changed hands at €3.10, was the date of the last insider purchase.

"Evotec's CRO peers—Charles River Laboratories International, Inc., ICON plc, PRA Health Sciences, Inc., Syneos Health, Inc. and IQVIA Holdings, Inc.—trade at an average of 14.2 times 2019 Ebitda," Lorenz closes. "Applying that multiple to the 2019 Evotec estimate (and making no adjustment for the quality of those earnings) gives a per share value of €9.24. In order to justify its current €21.96 share price, the Innovate business would need to produce seven blockbuster drugs with peak sales in excess of €1 billion."

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