EDISON

aap Implantate AG

Trading update

Biomaterials for sale as LOQTEQ growth takes off

Healthcare equipment & services

We expect aap to sustain solid growth driven by the international roll-out of LOQTEQ. Re-investing the proceeds of the planned divestment of Biomaterials by the end of Q1 should augment growth in Trauma. Our fair value is €3.17 per share. A €35-40m sale of Biomaterials may prompt a rerating of the fast-growing Trauma business with potential upside to €3.8 per share.

Year end	Revenue (€m)	PBT* (€m)	EPS* (€)	DPS (€)	P/E (x)	Yield (%)
12/13	28.6	8.8	0.29	0.0	8.5	N/A
12/14e	30.7	1.1	0.04	0.0	70.9	N/A
12/15e	35.2	2.5	0.08	0.0	35.6	N/A
12/16e	40.5	5.2	0.15	0.0	18.4	N/A

Note: *PBT and EPS are normalised, excluding intangible amortisation, exceptional items and share-based payments. 2013 and 2014 sales are for continuing operations only.

Robust growth driven by LOQTEQ in FY14

aap's like-for-like sales rose by 7% in FY14. Continuing the trend seen earlier in the year, the main growth driver was the 27% increase in Trauma product sales to €12.3m, to which the 63% growth in LOQTEQ sales (€8.2m) was the chief contributor. The solid growth was achieved mainly from growing sales with existing customers in China, Russia and Turkey. The LOQTEQ range is due to be rolled out in new markets, such as the US, Brazil and South Africa, supporting our view of a favourable growth trajectory in 2015.

Sale of Biomaterials under review

aap is reviewing its strategic options for its Biomaterials division and expects to complete a transaction by the end of Q115. We estimate a sale could raise €35-40m (8-9x EBITDA). The resulting cash could be deployed to support growth in Trauma (acquisitions and organic growth) as well as to buy back shares for up to €3m pa (10% of subscribed capital permitted). Also, a business more focused on IP-protected trauma products may make aap a more attractive acquisition target.

US market entry under evaluation

A sale of Biomaterials would bolster aap's ability to establish its own support structure in the US to promote the launch of the already FDA-approved LOQTEQ. aap is in negotiations with various companies about a US distribution deal, which looks like the most likely starting point. We believe the recent awards of intellectual property protection of LOQTEQ and the antimicrobial silver technology in the US strengthen aap's position.

Valuation: DCF based €3.17, upside from disposals

We value aap at €97m or €3.17 per share, based on our DCF. The potential sale of Biomaterials could crystallise further value. Assuming €35m net proceeds, we see potential for 2015e EV/Sales for aap Trauma to expand from its current 2.2x to 4.2x (orthopaedic average of 3.8x) suggesting a pro forma value of €3.8 per share.

13 February 2015

Price	**€2.70**
Market cap	**€83m**

Net cash (€m) at end FY14e	8.0
Shares in issue	30.7m
Free float	34%
Code	AAQ
Primary exchange	Xetra
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	3.2	19.9	(4.2)
Rel (local)	(7.5)	1.1	(16.3)
52-week high/low		€3.65	€2.20

Business description

aap Implantate is a German medtech company, focused on developing, manufacturing and selling products for bone fractures. These include the recently launched LOQTEQ trauma plating system, in addition to bone cements.

Next events

FY results	31 March 2015
Possible Biomaterials transaction	Q115

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Outlook: Growing focus on Trauma enhances growth

Mid-teens growth set to continue in coming years

With this note we reintroduce our financial forecasts for aap Implantate. Given published FY14 sales of €30.7m for continuing operations, we forecast EBITDA of €2.0m (guidance €2.0-4.5m) in FY14 including costs for the planned sale of Biomaterials. We forecast 15% sales growth in 2015 (16% CAGR 2014-17) for the group in its current structure with the EBITDA margin expanding by 2-3 percentage points per year in 2014-17, driven by Trauma. Our modelled 1% sales CAGR in Biomaterials masks 31% sales CAGR in Trauma 2014-17, which would come to the fore with a sale of Biomaterials. We see potential for LOQTEQ to reach 5-10% share of the $1.5bn global trauma plating market, representing c €15m profits by 2020. We forecast group sales of €79m in 2020. According to the 4 February outlook statement for 2015, aap Implantate expects sales to total between €33m and €35m with EBITDA between €2.5m and €3.5m. Our forecasts for the year are the upper end of this guidance, explained by strong expected LOQTEQ growth.

In Q414, Trauma sales of €3.9m (+25%), of which LOQTEQ sales represented €3.0m (+56%), continued to drive top-line growth. Conversely, Biomaterials Q4 sales slumped by 38% to €3.7m, owing to exceptionally high deliveries relating to a new contract in the prior year. We forecast aap to hold €8m in net cash by year end 2014, greatly boosted by the final instalment from the sale of the Dutch contract manufacturing business, EMCM.

aap has recently been focusing on optimising its supply chain management. Having improved its delivery capacity in screw production earlier in 2014, it has lately been able to boost production volumes of plates. It plans to hire more manufacturing personnel, with the purpose of promoting sales growth in the medium term. Moreover, it has initiated a range of cost reduction measures, aiming to reduce administrative and manufacturing costs as of 2015. These measures, in addition to our expectation of mid-teens sales growth, underpin our and the company's expectations of significant margin improvement in 2015.

Biomaterials sale would create a pure-play trauma business

Following the divestment of EMCM for €18m in 2013 (1.5x sales, 9x EBITDA), aap is mulling the sale of its Biomaterials business (€17.7m/53% of forecast group revenues in 2014). For illustrative purposes, we estimate this business could fetch an equity value of €35-40m (8-9x EBITDA). In spite of its low book value of €3.5m, the capital gains tax liability would likely be modest (€1.3-1.8m), owing to a likely 5% tax rate on capital gains. As the last in a long list of divestments since 2008, such a deal would conclude aap Implantate's strategic refocusing on orthopaedic trauma.

Exhibit 1: Narrowing down of business focus through divestments – focus on Trauma

Business	2008	2009	2010	2011	2012	2013	2014	2015e
Dental	+							
Analytics	+	+						
Medical Aesthetics	+	+						
Reconstructive Orthopaedics	+	+	+	+	+			
Contract Manufacturing	+	+	+	+	+	+		
Biomaterials	+	+	+	+	+	+	(+)*	(+)*
Trauma	+	+	+	+	+	+	+	+

Source: aap Implantate. Note: *Planned divestment of Biomaterials by end of Q115e not yet concluded.

We expect a divestment of Biomaterials would prompt aap to deploy its surplus capital. It faces a range of options, in our view:

- Accelerate organic growth in Trauma by expanding the product portfolio, distribution channels as well as manufacturing capacity. If aap were directly involved in the marketing and distribution of its products outside Germany, it would additionally require considerable investments in instrument sets and working capital.

- Pursue strategic acquisitions to expand the Trauma business.
- Initiate a share buyback programme of up to 10% of subscribed capital per annum equivalent to circa €3m per annum.

While Biomaterials is a useful cash cow, it is subject to a slow attrition of its customer base. Large orthopaedics customers are gradually internalising the manufacture of biomaterials/bone cement rather than buying from third parties, such as aap. We envisage this trend to persist and forecast a modest 1% sales CAGR 2014-17. Despite the challenging comparison in Q4, Biomaterials sales jumped by 10% in FY14, benefiting from a new agreement established in 2013 to supply PMMA bone cement to a global orthopaedics company.

Another important rationale behind divesting such a substantial and cash-generative part of the business would be that it masks the strong growth of aap's Trauma business and thus weighs on the group's valuation multiple.

Until any further announcement, we are retaining Biomaterials in our forecasts and valuation.

Major potential for LOQTEQ in the US

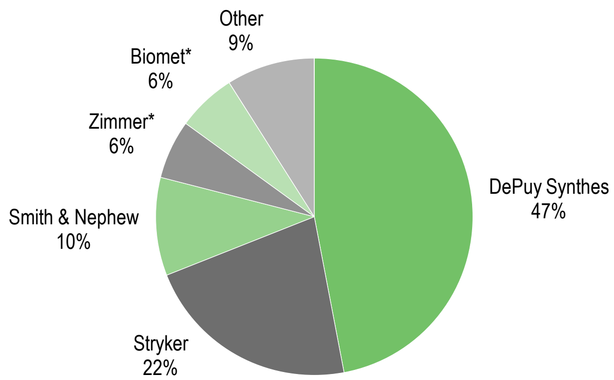
aap is reviewing its options on how best to capitalise on the significant opportunity that the $1bn US market for orthopaedic plates represents for LOQTEQ. In conjunction with Q3 results, aap declared it is in talks or negotiations with various US distributors concerning sales of the entire aap trauma portfolio in the US.

We believe the 8 October Notice of Allowance from the US Patent and Trademark Office for core patent claims covering the latest and currently marketed core technology of LOQTEQ strengthens aap's position as regards a US market entry. Moreover, the European Patent Office will shortly grant a key patent for the core technology of LOQTEQ, strengthening its global patent protection.

The global market for locking compression plates is dominated by DePuy Synthes (part of Johnson & Johnson), which controls 47% of the global trauma market overall and an even higher share of the segment for locking compression plates (LCP). Before its acquisition by Johnson & Johnson, Synthes' launch of LCP in 2004 sustained several years of 15-20% annual sales growth, starting off a revenue base in excess of $1bn.

We expect aap to secure up to a 10% global market share with LOQTEQ, which should contribute as much as €15m to profits by 2020. Our estimate is based on the assumption that half the profits from end-customer sales accrue to aap and the rest to a supposed distributor and that LOQTEQ is launched at a 20% discount to DePuy Synthes' LCP.

Exhibit 2: Global market for orthopaedic trauma



Source: Smith & Nephew. Note: *Proposed merger between Zimmer and Biomet under regulatory review.

One of LOQTEQ's key selling points is the reduced risk of cold welding, ie the undesired jamming of the screw in the plate, likely resulting from applying excessive torque on the screw at insertion. Cold welding makes the removal of the plate, which may sometimes be necessary, complicated. An interim analysis, presented at the EFORT Annual Congress in June 2014, suggested no cases of cold welding with LOQTEQ so far. Previously published data have suggested other locking compression plates may result in extraction complications in up to 17% of cases.

Valuation

We value aap at €97m or €3.17 per share, based on DCF. The key assumptions in our DCF valuation are a 10% discount rate and a 2% long-term growth rate after a two-stage forecast period, 2015-19e and 2020-29e (growth phased down from 12% to 2%). For illustration, we estimate the mooted sale of the Biomaterials division could yield net sales proceeds of €35m after tax of €1.3-1.8m in addition to forecast net cash of €8m by end of 2014. This would yield a pro forma enterprise value of €40m (current EV €75m), leaving the remaining fast-growing trauma business trading at 2.29x Trauma sales of €17.5m in 2015e versus 3.83x for its global orthopaedic peers (3.48x including aap Implantate, see Exhibit 4). Weighing both its superior growth but likely inferior profitability relative to its orthopaedic peers, we consider aap without Biomaterials could be valued at 4.2x EV/Sales (€74m enterprise value), a modest premium to its peers. On this multiple, the addition of €43m in cash gives a market cap of €117m and a valuation per share of €3.8.

Exhibit 3: DCF valuation (€m)

PV forecast period (2015-19e)	3.1
PV interim period (2020-29e)	39.3
PV residual (2030e-)	46.9
Enterprise value	**89.3**
- Net debt/(cash)	(8.0)
Equity value	**97.3**
Shares in issue (m)	30.7
Share valuation (€)	**3.17**

Source: Edison Investment Research

Exhibit 4: Orthopaedic company P/E multiples

Company	P/E 2015e	P/E 2016e	EV/Sales 2014e
aap Implantate	35.6	18.4	2.44
Smith & Nephew	20.5	18.5	3.93
Stryker	18.6	16.9	3.51
Zimmer	16.0	13.9	4.05
Average	**20.4**	**16.9**	**3.48**

Source: Bloomberg, Edison Investment Research. Note: Priced as at 11 February 2015.

aap's faster growth justifies a premium valuation to its global orthopaedic peers; it trades at 35.6x 2015 P/E versus global orthopaedics at 20.4x and its own historical three-year average of 21.6x. We believe this reflects its superior revenue growth prospects, at over twice the rate its peers, and the likely value crystallisation from the mooted sale of the Biomaterials division.

Exhibit 5: Financial summary

€000s	2012	2013	2014e	2015e	2016e	2017e	2018e
Year-end 31 December	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS							
Revenue	26,965	28,573	30,700	35,246	40,510	47,790	56,614
Total Output	29,384	29,611	33,200	37,846	43,220	50,621	59,578
Cost of Sales	(8,724)	(8,282)	(10,881)	(12,737)	(14,650)	(17,578)	(21,015)
Gross Profit	18,241	20,291	19,819	22,508	25,860	30,212	35,599
EBITDA	4,085	10,188	2,000	3,447	6,264	8,680	12,256
Operating Profit (before amort. and except.)	3,011	9,001	1,069	2,371	5,041	7,298	10,694
Intangible Amortisation	(2,837)	(8,282)	(1,498)	(1,614)	(1,728)	(1,843)	(1,737)
Exceptionals	1,015	0	0	0	0	0	0
Other	(290)	13	0	0	0	0	0
Operating Profit	899	732	(430)	757	3,314	5,455	8,958
Net Interest	(138)	(171)	17	135	140	120	150
Profit Before Tax (norm)	2,873	8,830	1,086	2,506	5,181	7,418	10,844
Profit Before Tax (FRS 3)	761	561	(413)	892	3,454	5,575	9,108
Tax	185	131	83	(178)	(691)	(1,115)	(1,093)
Profit After Tax (norm)	2,768	8,974	1,168	2,328	4,490	6,303	9,752
Profit After Tax (FRS 3)	946	692	(330)	713	2,763	4,460	8,015
Average Number of Shares Outstanding (m)	30.7	30.7	30.7	30.7	30.7	30.7	30.7
EPS - normalised (€)	0.09	0.29	0.04	0.08	0.15	0.21	0.32
EPS - (IFRS) (€)	0.03	0.02	(0.01)	0.02	0.09	0.15	0.26
Dividend per share (p)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Margin (%)*	64.8	68.8	64.6	63.9	63.8	63.2	62.9
EBITDA Margin (%)	15.1	35.7	6.5	9.8	15.5	18.2	21.6
Operating Margin (before GW and except.) (%)	11.2	31.5	3.5	6.7	12.4	15.3	18.9
BALANCE SHEET							
Fixed Assets	44,921	22,394	24,771	26,866	28,698	30,748	32,996
Intangible Assets	39,403	14,502	15,450	16,153	16,778	17,342	18,037
Tangible Assets	5,107	5,906	7,336	8,727	9,935	11,420	12,972
Investments	411	1,986	1,986	1,986	1,986	1,986	1,986
Current Assets	23,669	42,843	29,128	25,904	27,496	30,690	37,239
Stocks	13,943	9,429	11,328	12,535	13,161	14,534	16,213
Debtors	4,226	6,866	5,405	6,052	6,955	8,205	9,720
Cash	3,698	1,580	10,360	5,284	5,346	5,917	9,272
Other	1,802	24,968	2,034	2,034	2,034	2,034	2,034
Current Liabilities	(13,018)	(13,671)	(7,249)	(5,249)	(5,753)	(6,378)	(7,002)
Creditors	(7,429)	(11,037)	(4,915)	(5,249)	(5,753)	(6,378)	(7,002)
Short term borrowings	(5,589)	(2,634)	(2,334)	0	0	0	0
Long Term Liabilities	(4,706)	(3,115)	(781)	(781)	(781)	(781)	(781)
Long term borrowings	(2,389)	(2,334)	0	0	0	0	0
Other long term liabilities	(2,317)	(781)	(781)	(781)	(781)	(781)	(781)
Net Assets	50,866	48,451	45,869	46,740	49,661	54,279	62,452
CASH FLOW							
Operating Cash Flow	7,088	3,547	1,202	2,021	5,268	6,734	9,849
Net Interest	0	0	17	135	140	120	150
Tax	0	0	95	(113)	(563)	(1,009)	(1,098)
Capex	(1,205)	(3,944)	(2,361)	(2,467)	(2,431)	(2,867)	(3,114)
Acquisitions/disposals	261	14,735	14,907	0	0	0	0
Financing	(101)	0	0	0	0	0	0
Dividends	0	0	0	0	0	0	0
Net Cash Flow	6,043	14,338	13,860	(425)	2,415	2,978	5,787
Opening net debt/(cash)	3,627	4,280	3,388	(8,026)	(5,284)	(5,346)	(5,917)
HP finance leases initiated	0	0	0	0	0	0	0
Other**	(6,696)	(13,446)	(2,446)	(2,317)	(2,353)	(2,407)	(2,432)
Closing net debt/(cash)	4,280	3,388	(8,026)	(5,284)	(5,346)	(5,917)	(9,272)

Source: Edison Investment Research, company accounts. Note: **Other in cash flow includes capitalised development costs.

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