ECO Animal Health Group

Positive surprises in year-end trading update

24 March 2023

Eco's pre-close trading update confirms revenue and EBITDA are ahead of current market expectations for FY23 that had previously anticipated modest growth relative to FY22. The better-than-expected results are being driven by an unexpectedly strong final quarter for Aivlosin in China combined with continued growth in South/Southeast Asia and Latin America. We now expect FY23 sales of £84.7m and an adjusted EBITDA of £7.0m based on our interpretation of the statement.

With an EV of £66m, Eco currently trades on an EV/sales ratio of ~0.78 and EV/EBITDA of 9.4 – both well below norms for the animal health sector.

- **Year-end trading update:** A surprise stronger final quarter (January to March) for its financial year, has led Eco to report that its FY23 revenue and EBITDA are likely to be above current consensus expectations (c £82.6m and £6.4m respectively). The statement is surprising as Chinese pork prices – which are normally a key determinant for Aivlosin demand in that market - have declined between November and February. However, we understand that demand for Aivlosin has been buoyed in recent months by use in managing porcine reproductive and respiratory syndrome (PPRS) outbreaks in China.

- **Further update possible in April:** As this trading statement is based on the February management accounts, we expect Eco to provide a further update to the market once it has closed the books on FY23, probably in late April. Audited results for FY23 are likely in July.

- **Chinese pork market prices:** Pork prices in China have been weak for most of FY23. There was some improvement in September to November, but prices seem to have fallen back over the last three months. Nonetheless, we understand at RMB15-16/kg they are currently still above levels where pork production is profitable for producers (this is a key determinant of whether producers will use Aivlosin on high value animals).

- **Financial forecasts:** ED's new forecasts envisage FY23 sales of £84.7m (+3% y-o-y) and an EBITDA of £7.0m (+35%), We expect further improvement in FY24, although this assumes some growth in China and trendline growth in the two fast-growing regions of South/Southeast Asia and Latin America.

- **Valuation:** Based on an EV of £66m, Eco's prospective EV/sales would be 0.78 and its EV/EBITDA is 9.4 – both are well below norms for the animal health sector. Our model suggests cash at the year-end will be £6m.

  Eco's shares remain at a close to a multi-year low and therefore appear to offer potential for a rerating, should sales and profits continue to improve in FY2023 and beyond.

Summary results and forecasts

y/e 31 March, £m	FY21	FY22	H1 FY23	H2 FY23e	FY23e
Sales	105.6	82.2	34.9	49.8	84.7
Adj. EBITDA*	21.3	6.4	1.7	5.3	7.0
Net cash	19.5	12.9	12.9	5.9	5.9
EV/Sales**	0.7	0.9	0.9	0.6	0.6

*Source: Company historic data * Adjusted earnings before interest, tax, depreciation, amortisation, exceptional items. Note EV calculated based on current market capitalised less year end cash.*

Company Data

EPIC	EAH
Price (last close)	109p
52 weeks High/Low	165p/85p
Market cap	£74m
Net cash (LBSD)	£12.9m
Sector	Pharma & Biotech

Share Price, p

Source: ADVFN

Description

The main product of ECO Animal Health Group plc ('Eco') is the macrolide antibiotic Aivlosin for the treatment of enteric and respiratory diseases in pigs and poultry. It also sells a suite of products to treat and prevent parasites in sheep, horses, cattle and pigs.

Eco operates through a combination of joint ventures and wholly owned subsidiaries in high volume animal production markets in North and South America, along with key pork-producing regions in Asia.

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Financial update

Eco has issued a trading statement based on its February management accounts that suggests it is seeing a strong final quarter (January to March) to its financial year and is likely to report FY23 revenue and adjusted EBITDA that are above market consensus expectations (c£82.6m and £6.3m respectively). We are publishing forecasts that suggest FY23 revenue of £84.7m and adjusted EBITDA of £7.0m.

The strong final quarter is attributed to growth of Aivlosin in China combined with continued growth in South/Southeast Asia and Latin America. We understand that demand for Aivlosin in China in recent months has been buoyed by use in managing porcine reproductive and respiratory syndrome virus (PRRS) outbreaks there (although PRRS infection is caused by a virus, bacterial co-infection is common and Aivlosin is understood to have a strong anti-inflammatory effect). This latter aspect has masked the impact of falling Chinese pork prices, which are usually a key determinant for Aivlosin demand. The China pork price has been weak for most of the financial 2023 and, after improving in the September to November period, has fallen back over the last three months.

The graphic below shows the pork price in China over Eco's 2022 and 2023 financial years.

Chinese pork price from April 2021-Feb 2023 in RMB/Kg

Source: Pig333.com

As a result of the statement, ED has revised its forecasts (albeit these were previously unpublished). New forecasts envisage FY23 sales of £84.7m (+3.% y-o-y) and an EBITDA of £7.0m (+35%). We expect continued growth in FY24, based on seeing modest growth in China and trendline growth in the two fast-growing regions of South/Southeast Asia and Latin America.

In the first half of FY23 (March to September 2022), Eco reported revenue of £34.9m (-9%), reflecting a steep decline in revenues from China (-46%), counterbalanced by strong growth in the rest of the world (+16%). **Our H2 forecast for sales is £49.8m (+14%).**

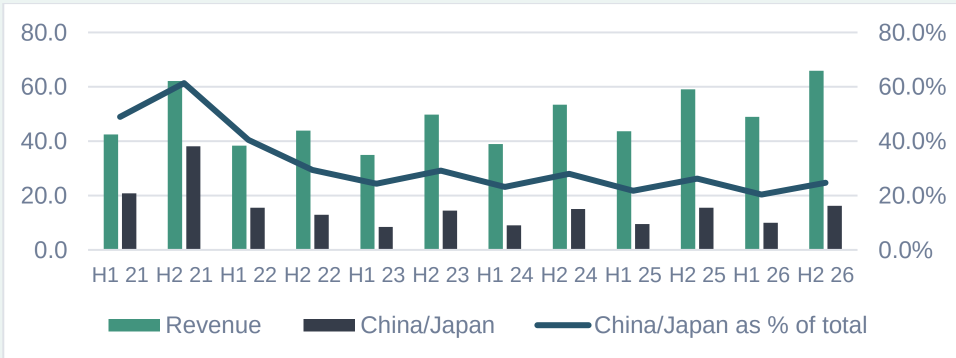
The longer-term trends for revenue by geography are examined in the graphics on page 3. Exceptional sales for the China/Japan segment (note Japan represents a very small proportion of this figure) distorted group sales in 2021 and has also been unusually low in the current year. The growth in rest of world segments has been broadly consistent with longer term trends, with high growth rates seen in Latin American and South/Southeast Asia (both ~25%) balanced by low growth in Europe.

Our forecasts suggest that the China/Japan segment will stabilise at around 30% of sales over the longer term (note that long term forecasts, and in particular those for 2026, should be considered illustrative). Also, note the H2 sales bias (reflecting demand in the northern hemisphere winter. At the same time, our forecasts suggest the two main growth regions (Latin America and South / Southeast Asia), will see an increase in their contribution, stabilising at around 45% of sales.

Revenue analysis FY2019-H1 FY2023 (£m)

Source: ECO Animal Health.

China/Japan and total sales (£m)



Source: Equity Development based on ED forecast sales

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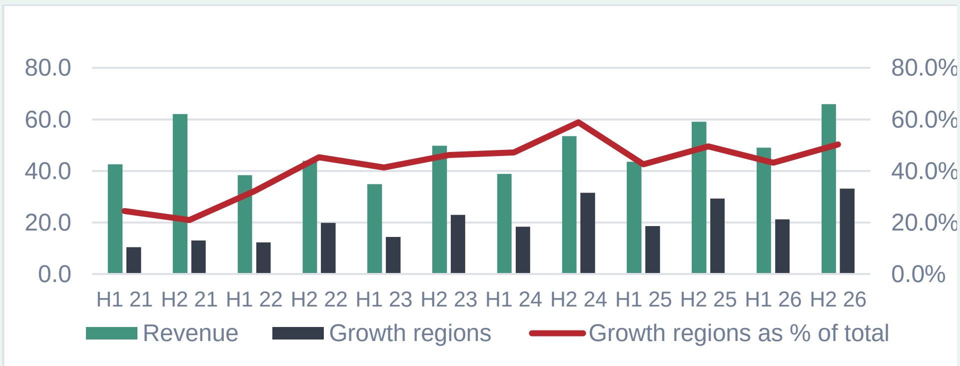
Growth Regions (Latin American/Asia) as % of total sales (£m)



Source: Equity Development, based on ED forecast sales

Administrative expenses in H1 were £11.9m, reflecting higher sales and marketing costs as well as a reclassification of technical support costs (~£100k) previously included in R&D. Our H2 forecast is £12.8m (+10%).

Expensed R&D was £2.9m in H1 and our H2 forecast is £3.1m. We expect the overall cash expenditure on R&D to grow slightly but fall as percentage of sales over time to a long-term average of around 10% of sales.

Admin expenses and R&D expenditure FY2019-H1 FY2023 (£m)

Source: Eco Animal Health and Equity Development including ED forecasts

Cash at the half year end was £12.9m, with £4.0m held in the 51% owned Chinese joint venture that has since been distributed as a dividend. Our model shows cash at the FY22 year-end of £5.9m.

Chinese pork market developments

China is the world's largest pork market and supports the world's largest commercial pig herd, so it is natural that this country should be the most important market for Aivlosin.

The size of the market there reflects both the large Chinese population but also the prominent place that pork has in Chinese culture and in the national diet.

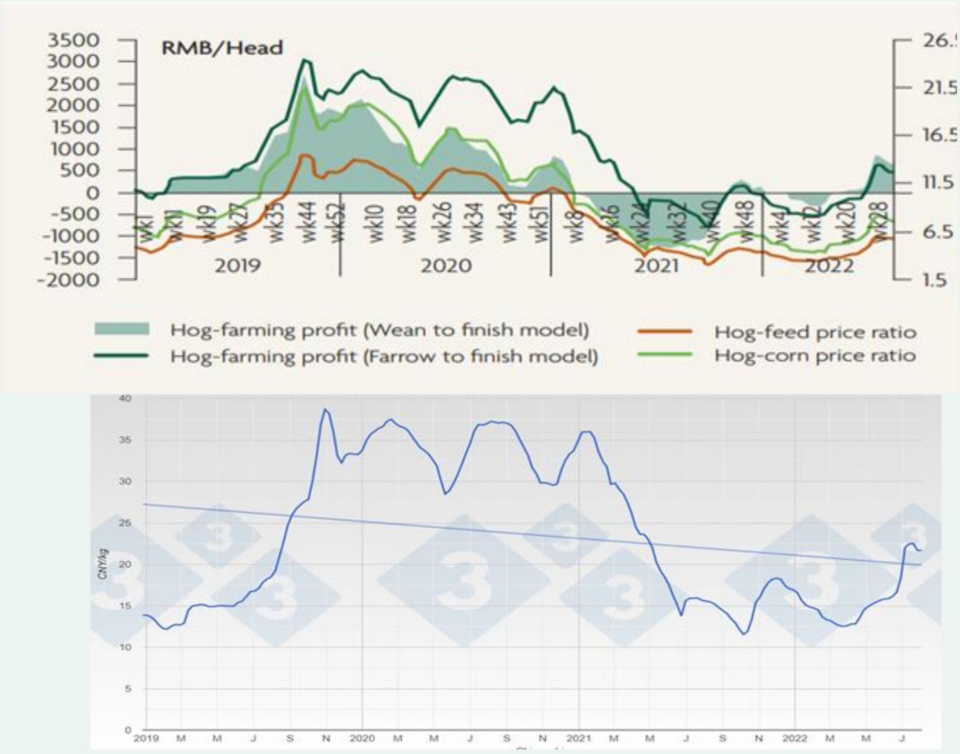
Aivlosin is most often used for high-value animals, such as breeding sows, and can only be used under veterinarian supervision. It is indicated for the treatment of swine enzootic pneumonia, caused by susceptible strains of Mycoplasma hyopneumoniae, in pigs and for porcine proliferative enteropathy (ileitis) or swine dysentery, caused by Brachyspira hyodysenteriae. The medicine is noted for its relatively simple administration – a key differentiator when dealing with large herds - and is used as an additive to animal feed for a period of seven days until the initial infection has cleared or dissolved in drinking water (water soluble granules).

Demand for Aivlosin in China has proven to be very sensitive to the economics of pork farming in the country and Eco's sales and profit in that country have followed these price trends over the past two/three years. Pig farming in China has in recent years been affected by an unusual boom-and-bust investment cycle, which has been caused by and/or exaggerated by first- and second order effects of an outbreak of African Swine Fever in 2019 and a shift in farming towards industrial mega-farms.

In terms of the pork market, the ASF outbreak initially led to shortage and thus exceptionally high prices while in the recovery phase, and then the situation moved to a state of over-supply in 2021-2 with unusually low prices. Furthermore, just as the market was showing signs of relative balance in late 2021, there was a significant reduction of demand caused by the country's then Zero-COVID policy.

The graphic below illustrates some measures of profitability of hog farming in China over the three years to mid calendar 2022, with the Chinese pork price shown below (aligned). It highlights the unusual profitability in the second half of 2019 and throughout 2020, but with a steep decline in early-to-mid 2021. An industry rule of thumb is that if the Hog-to-Feed Price Ratio (shown as the light green line) is above 5, farming is profitable, which occurred around week 22 (30 May) in 2022. This ratio is important as feed represents around 70% of costs for farmers. At the peak of the market in 2021, when all parties in the system (including ECO) experienced exceptional profitability, the pork-to-feed price ratio was as high as 12.

Hog farm profitability in China/Chinese pork price RMB/Kg 2019-2022



Source: Boyer Swine report, cited by ECO Animal Health and pig333.com.

R&D Pipeline

Eco's long-term strategy relies on its R&D pipeline as a means of **diversifying its revenue base from Aivlosin.** The company has invested heavily in R&D (as a proportion of sales) in recent years with the aim of developing new biological/vaccine products, as part of a strategy to diversify its revenue base (and ultimately reduce its dependence on Aivlosin) while remaining entirely focussed on the swine and poultry markets.

Eco has 13 programmes in active development, as depicted below. The two poultry vaccine protect against respiratory disease estimated to cost the poultry industry over £600m and will enter a vaccine market segment currently worth over £100m. It has two additional, albeit early stage, programmes that are being conducted in collaboration with academic groups. These are based on a novel self-amplifying RNA (saRNA) technology developed at Imperial College for vaccines against three important infectious disease targets (two viral and one bacterial) in pigs and a partnership with Moredun Research Institute to develop a vaccine for control of poultry red mite (PRM).

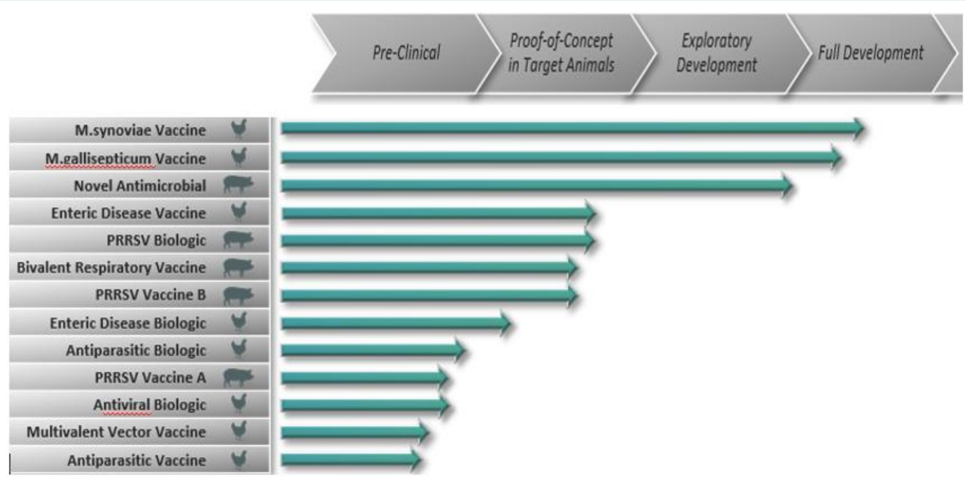
Poultry Red mite (Dermanyssus gallinae) is one of the most important causes of production losses in laying hens, including by acting as vectors for pathogenic bacteria (including salmonella, E. coli and mycoplasmas) and viruses.

ECO Animal Health R&D pipeline and projected year 5 peak sales

	Approval target	Projected 5-year peak sales	Source
Poultry			
M gallisepticum vaccine	2024/5	£15	Licensed from University of Georgia.
M Synoviae vaccine	2024/5	£11m	Licensed from University of Georgia.
Enteric disease vaccine	Q3 2026	£17m	Proprietary
Antiviral biologic	Q3 2026	£8m	Proprietary
multivalent vector vaccine (against Marek's disease virus, IBDV, NDV and ILTV).	Q1 2027	£21m	Proprietary.
Anti-parasitic vaccine	Q1 2027	£36m	proprietary
Enteric disease biologic	Q3 2027	£40m	proprietary
Antiparasitic biologic	Q4 2027	£24m	proprietary
Swine			
Novel antimicrobial	Q2 2025	£6m	Licensed from Agrinnovation and Yissum/Hebrew University of Jerusalem.
PRRSV Biologic	Q2 2026	£18m	proprietary
Bivalent respiratory vaccine	Q1 2026	£22m	proprietary
PRRSV Vaccine A	Q3 2026	£19m	Licensed from The Vaccine Group.
PRRSV vaccine B	Q1 2028	£15m	Licensed from The Vaccine Group.

Source: Adapted by Equity Development form ECO Animal Health Capital markets day (Feb 2022).

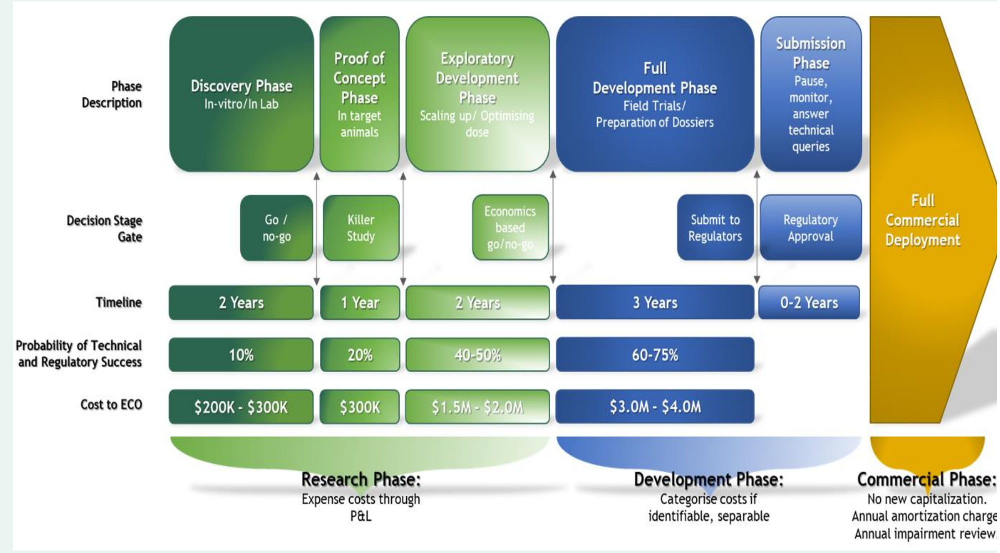
ECO Animal Health R&D pipeline schematic



Source: Adapted by Equity Development from ECO Animal Health capital markets day (Feb 2022).

Eco anticipates the costs of its project at up to **c $7m/project**, as detailed in the graphic below:

ECO Animal Health R&D model



Source: ECO Animal Health.

Investment summary

The investment case rests on Eco's **strong market position** as a supplier of a commercially important animal health product to swine and poultry producers combined with the potential to recover from current lows that reflect exceptional circumstances in its key market. Eco is the third largest player (with an c 20% share) in the c $1.5bn market for antibiotics used in swine and poultry farming and ranks in around 15th position globally in the wider animal health industry. This may make it attractive as an acquisition target for a larger animal health group – especially as it is a relatively small player in this highly consolidated segment, which is dominated by five global players.

Eco has a high dependence on Aivlosin, which accounts for the majority of its sales (89% in FY22). This product is approved in c 70 countries and, although it no longer has composition-of-matter IP, it has protection by virtue of its formulations, manufacturing know-how and other factors. Aivlosin is used for both swine and poultry, although the former accounts for around 80% of sales volume because of the relative size of herds and the larger amounts used in pigs. Its business has two key favourable economic drivers in the form of demographics and good animal husbandry.

Eco has a global distribution network with a **direct presence in 13 territories**, including wholly owned subsidiaries Japan, Mexico, Brazil, India, South Africa, Malaysia and the UK. Its most important market is China, where its activities are conducted through a 51%-owned joint venture (Zhejiang Eco Biok Animal Health). Eco's partner in this JV is Zheijang Huge Leaf, a domestic Chinese animal health company (market capitalisation: RNB9.0bn/$1.3bn).

Eco's marketing activities in the US, the second largest market, are conducted through a joint arrangement with Pharmgate LLC, a majority-owned US subsidiary of Jinhe Biotechnology of China (market cap: RMB4.1bn/$600m). This arrangement also covers Canada. Eco outsources its entire global supply of the active pharmaceutical ingredient for Aivlosin (tyvalosin) to a Chinese partner, Lukang Pharmaceuticals, with which it has a long-term contractual relationship. Eco has a wholly owned factory in China for formulation of the API into various product presentations for sale and distribution globally.

Sensitivities

Eco generates a high proportion of its revenue and profit in China and also relies to a high degree on its contacts with Chinese third parties. Thus, it is highly exposed to any possible deterioration in the political or commercial environment for Western companies with respect to China. The out-sourced business model means it may be exposed to business decisions by third parties over which it may have limited control.

Its single source for API manufacture is a large known risk that could affect its supply (Eco has built up a large inventory of API equivalent to 40% of sales to insulate it from any short-term supply disruption). Eco may also be exposed to any or all of the current macro-economic concerns (inflation, utility prices and currency movements etc) but does not appear to be disproportionately exposed to any one of these.

The company is emerging from a three-year period where demand for Aivlosin in its most important market has moved from exceptional highs to lows as a result of unusual macro factors. These now appear to be normalising but have highlighted Eco's current dependence on Aivlosin.

Valuation

Eco's shares have declined markedly since reaching an all-time high of 630p in July 2017 and have been at a more recent level of 350p as recently as July 2021. Currently they trade at levels little above the all-time low (seen in 2008).

We calculate Eco's current enterprise value to be £66m, based on a forecast year end cash of £5.9m, which suggests it trades on an EV/sales ratio of 0.78 and EV/EBITDA of 9.4 – both well below norms for the animal health sector. Eco is difficult to value based on an earnings multiple basis as its EPS have varied considerably in recent years, because of the performance of the business over time. In addition, the effect is exaggerated by the relatively large minority interest (effectively the share of earnings that is attributable to the minority owners of the Chinese subsidiary).

Historic results and ED forecasts for FY 2023 and FY 2024 are shown below:

Income Statement

Y/e March, £'000	2021	2022	2023e	2024e
Revenues	105,607	82,195	84,700	92,360
Cost of goods sold	-52,858	-47,059	-48,279	-52,645
Gross Profit	52,749	35,136	36,421	39,715
Other income	319	65	292	292
G&A Expenses (excl R&D)	-25,547	-22,421	-24,663	-26,390
R&D Expenses	-8,072	-8,762	-6,000	-6,300
Share based payments	123	342	350	350
adjusted EBITDA	17,807	5,176	7,042	7,756
Operating Profit	16,199	1,440	4,673	5,867
Interest income	-71	-142	-188	-180
share of profit of associate	38	43	102	100
Profit Before Taxes	20,284	1,389	4,587	5,787
taxation	-3,635	-2,094	-1,376	-1,736
Profit for year	16,649	-705	3,211	4,051
Profit attrib. owners of parent	8,491	-686	2,248	2,836
Minority interest	8,158	-19	963	1,215
EPS	12.5	-1.0	3.2	4.0

Source: Company historic figures/Equity Development estimates.

Balance sheet

Y/e March (£'000)	2021	2022e	2023e	2024e
Non-current assets	40,173	39,981	43,945	47,926
Intangible assets	36,108	34,304	36,504	38,628
Property, plant & equipment	2,181	3,465	5,629	7,701
Other non current	1,884	2,212	1,812	1,598
total non current	40,439	40,504	43,945	47,926
Inventories	20,504	30,142	34,391	34,616
Accounts receivable	32,452	25,969	27,847	30,365
Income tax recoverable	3,475	1,596	1,598	1,598
Cash and cash equivalents	19,523	14,314	5,906	10,871
Current assets	76,450	73,096	70,542	78,251
Accounts payable	-14,521	-12,954	-13,349	-14,556
current tax payables/provisions	-3,015	-224	-351	-351
Current Liabilities	-18,398	-13,864	-14,550	-15,757
Non-current liabilities				
deferred tax	-183	-183	134	134
Finance lease/other	-1,211	-1,513	-1,677	-1,677
Equity	81,901	82,064	84,890	88,941
Share capital	3,379	3,381	3,381	3,381
share premium	63,258	63,319	63,319	63,319
revaluation reserve	656	657	657	657
Other reserves	106	106	106	106
Foreign exchange reserve	1,092	2,188	2,188	2,188
Minority interests	13,410	12,413	15,239	19,290
shareholders' funds	81,901	82,064	84,890	88,941
Non-controlling interest	13,414	12,284	12,284	12,284
Total equity	95,315	94,348	97,174	101,225
Non-current assets	40,173	39,981	43,945	47,926
Intangible assets	36,108	34,304	36,504	38,628

Source: Company historic figures/Equity Development estimates.

Cashflow statement

Y/e March, £'000	2021	2022	2023e	2024e
Operating cash flow	29,702	10,874	3,475	10,878
Profit before tax	20,284	1,389	4,587	5,787
Non-cash adjustments	23,627	8,186	7,928	9,764
Change in working capital	-11,368	3,723	-7,214	-2,848
Interest paid	50	55	-270	-180
Taxes paid	-2,891	-2,479	-1,556	-1,646
Investing cash flow	-450	-1,802	-2,428	-2,556
CAPEX on tangible assets	-201	-1,621	-2,510	-2,636
Other investing cash flows	-249	-181	82	80
Financing cash flow	-684	-3,305	-2,342	-532
Proceeds from equity	378	63	0	0
Increase in loans	-122	-111	-132	-132
Dividends	-562	-2,886	-1,810	0
principal paid on lease liabilities	-378	-371	-400	-400
Net increase in cash	24,467	-5,473	-8,143	4,965
Cash at start of year	9,845	19,523	14,050	5,906
Cash at end of year	19,523	14,050	5,906	10,871
Net cash at end of year	16,325	13,907	5,689	10,654

Source: Company historic figures/Equity Development estimates

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