

# Episurf Medical

Sector: Medtech

## Episurf Medical: With Focus Long-term

Redeye raises its valuation on Episurf Medical but lowers near term estimates due to the corona crisis, which has halted elective surgeries. Our medium to long term conviction is enhanced, however, as we find the company's extensive clinical pipeline promising and its substantial recent capital injection very reassuring.

### Revise our Estimates for 2020

Due to the corona crisis, we have revised our estimates downwards for the current year, on both the sales and cost side. Regarding sales, we now expect the first momentum in growth starting at the end of 2021.

### 2020 – A Transformational Year

From an operational perspective, we expect 2020 to be a milestone year, transforming the business from experimental surgery to clinically proven technology. In the end, it is all about getting the results published in well-renowned journals. The number of Episealer-patients in publications could well be +100 by the end of the year, from the current ten patients.

### Significant Upside Potential for the Long-term

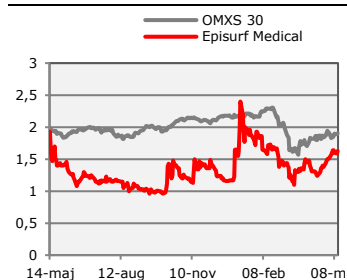
To reflect our enhanced confidence in the case, following the strengthened ownership base, the two-year cash runway, and the increased scope of clinical data, we raise our Base Case to SEK 3.0 (2.5) per share.

KEY FINANCIALS (SEKm)	2018	2019	2020E	2021E	2022E	2023E
Net sales	4	5	6	12	24	44
EBITDA	-53	-61	-64	-73	-56	-49
EBIT	-58	-69	-71	-79	-62	-54
EPS (adj.)	-1.8	-0.8	-0.4	-0.4	-0.4	-0.3
EV/Sales	-6.4	-5.2	36.5	22.7	14.6	9.2
EV/EBITDA	0.5	0.4	-3.2	-3.9	-6.2	-8.2
EV/EBIT	0.4	0.4	-2.9	-3.6	-5.6	-7.5
P/E	0.0	0.0	-4.0	-3.6	-4.5	-5.2

### FAIR VALUE RANGE

BEAR	BASE	BULL
1.5	3.0	6.0

### EPISB.ST VERSUS OMXS30



### REDEYE RATING



### KEY STATS

Ticker	EPISB.ST
Market	Small Cap
Share Price (SEK)	1.6
Market Cap (MSEK)	283
Net Debt 20E (MSEK)	-80
Free Float	78 %
Avg. daily volume ('000)	1

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## From 10 to +100

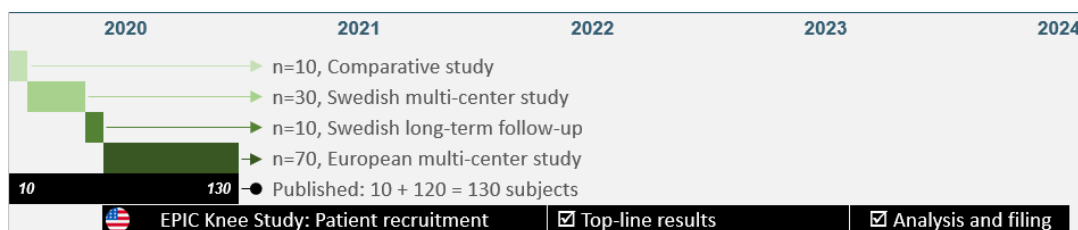
A large body of clinical evidence is a cornerstone for commercial success within Medtech. 2020 is a milestone year for Episurf Medical (Episurf) from that perspective. To be more specific, we expect 2020 to be the year where its Episealer technology transforms from experimental to clinically proven. Below are some highlights on upcoming publications:

- Positive results on implant safety and improvement on patient-reported outcomes, with an average follow-up time of 4.5 years from a Swedish study (n=30)
- Significant improvement in clinical score and low revision rate on 2-year data based on interim results from a European multi-center study (n=70)
- Good preliminary results from a comparative study with Episealer, healthy knees, and knees that have undergone surgery with knee prosthesis (n=10)
- Long-term data (5-7 years) is ongoing on the very first Episealer-treated patients with a focus on patient-reported outcome scores and the investigation of the progression of osteoarthritis, results expected in 2020 (n=10)

Adding to the current publication by Strålman et al., 2017 (n=10), which showed good- to excellent results based on patient-reported outcome measures and implant safety, the number of Episealer patients in scientific publications could well reach + 100 patients by the end of the year. Further, what appeals to us in the clinical pipeline above is the great variety of data points. In our view, the Episealer technology must prove itself from many aspects:

- Good patient-reported outcome - the patient must feel a significant improvement post-surgery based on validated, subjective scales
- Long-term data and implant safety – include low revision rates and excellent patient-reported outcomes on +5 years
- Comparable data – competitive data compared to, for instance, gold-standard treatments. It is interesting in this context to emphasize that the primary objective with the IDE-study (named 'Episealer Knee System IDE Clinical Study') is to evaluate the safety and clinical effectiveness compared to microfracture
- Health economic data – important to ensure satisfying, long-term reimbursement levels

### Episurf Medical: Clinical Pipeline



Source: Episurf Medical

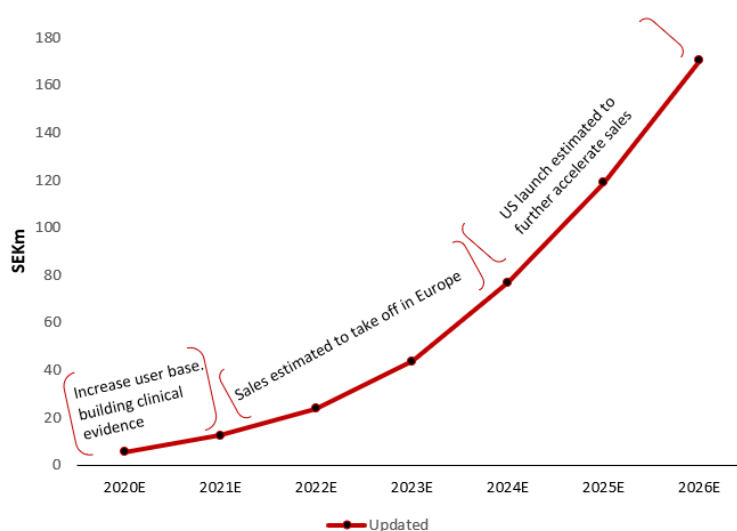
## Financials

### Sales Forecasts

Concerning the Corona situation, our current stance is that we predict a significant drop in sales in the current quarter, further a decrease in Q3, followed by a rebound in Q4. We find the macro situation as highly uncertain, and we are watching how the situation evolves closely. Indeed, focal chondral lesions are not life-threatening. But the pain is chronic, and the state of the condition is progressive. Hence, we firmly believe that joint resurfacing surgeries are postponed rather than being terminated. In the case of Episurf, it is important to acknowledge the early stage of the commercial phase, where sales are at low levels. Our primary focus is on operational metrics; clinical- and health economic data, the pathway to the US market, enabling high margins long-term, and increase the user base at surgeons and KOLs.

The Corona crisis aside, we still model top-line growth as an S-shaped trajectory, and where we start to see clear trends in top-line growth by the end of 2021. By that time, Episurf should benefit from an enriched scope of clinical evidence, and an increased base of surgeons and KOLs in Europe.

**Episurf Medical: Trajectory Curve of Sales Estimate**



Source: Redeye Research

### Total Forecasts

The IDE-study falls under 'Other External Costs' and represents a large portion of that item in 2020 and, especially, in 2021.

As we learned about in the Q1'20 report, Episurf has taken initiatives to cost savings, including short term layoffs. We, therefore, lower the estimated costs for personnel compared to our previous update (-30) for the current year. In total we anticipate cost-savings of SEK 3-4 million in 2020. Together with a postponement of costs for the IDE-study into 2021 (as surgeries are yet to start), despite our significant downward adjustment on top-line, we anticipate lower loss for FY'20 compared to our latest update.

Episurf Medical: Estimate changes									
(SEKm)	2020E			2021E			2022E		
	New	Old	Change	New	Old	Change	New	Old	Change
Sales	6	9	-3	12	15	-3	24	27	-3
EBIT	-71	-82	11	-79	-67	-12	-62	-64	2
Net profit	-71	-82	11	-79	-68	-11	-63	-65	2
Sales growth	14%	65%	-51%	123%	60%	63%	92%	80%	12%

\* Change in absolute values

Source: Redeye Research

Episurf Medical: P&L										
(SEKm)	2018	2019	Q1'20	Q2'20E	Q3'20E	Q4'20E	2020	2021	2022	
<b>Sales</b>	<b>4</b>	<b>5</b>	<b>2</b>	<b>0</b>	<b>1</b>	<b>3</b>	<b>6</b>	<b>12</b>	<b>24</b>	
CAGR %	61%	23%					14%	123%	92%	
<b>Operating costs</b>										
Merchandise	-3	-5	-2	0	-1	-2	-4	-8	-13	
Other external costs	-36	-40	-10	-9	-10	-14	-43	-51	-38	
Personnel costs	-27	-28	-7	-7	-6	-7	-27	-30	-33	
Other costs /income	0	1	0	0	0	0	0	0	0	
Capitalisation	10	6	1	1	1	1	4	4	4	
<b>Total operating costs</b>	<b>-57</b>	<b>-66</b>	<b>-17</b>	<b>-15</b>	<b>-16</b>	<b>-22</b>	<b>-70</b>	<b>-85</b>	<b>-80</b>	
<b>EBITDA</b>	<b>-53</b>	<b>-61</b>	<b>-16</b>	<b>-15</b>	<b>-15</b>	<b>-19</b>	<b>-64</b>	<b>-73</b>	<b>-56</b>	
Depreciation	-5	-7	-2	-2	-2	-2	-6	-6	-6	
<b>EBIT</b>	<b>-58</b>	<b>-69</b>	<b>-18</b>	<b>-16</b>	<b>-16</b>	<b>-21</b>	<b>-71</b>	<b>-79</b>	<b>-62</b>	
Financial net	0	-1	0	0	0	0	-1	-1	-1	
<b>Profit before tax</b>	<b>-58</b>	<b>-70</b>	<b>-18</b>	<b>-16</b>	<b>-16</b>	<b>-21</b>	<b>-71</b>	<b>-79</b>	<b>-63</b>	
Taxes	0	0	0	0	0	0	0	0	0	
<b>Net profit</b>	<b>-58</b>	<b>-70</b>	<b>-18</b>	<b>-16</b>	<b>-16</b>	<b>-21</b>	<b>-71</b>	<b>-79</b>	<b>-63</b>	

Source: Redeye Research

## Valuation

### Valuation Summary

We base our per share on an updated number of outstanding shares, following both the directed issue and the preferential share issue. We consider the cash position at Q1'20 + outcome from the preferential rights issue. Our lowered WACC, driven by strengthened finances and increased confidence in managements' execution capabilities, is an essential factor in our raised valuation.

Episurf Medical: DCF model				
Assumptions		DCF	SEKm Per share	
Tax rate	20.6%	2020 - 2022	-184	-1.0
WACC	13.0%	2023 - 2034	214	1.2
CAGR, 2020-2022	70%	Terminal	381	2.1
CAGR, 2023-2035	28%	Cash position	130	0.7
# of shares	178			
<b>Terminal values</b>		<b>Fair value</b>	<b>542</b>	<b>3.0</b>
Terminal growth	2%			
EBIT	40%			

Source: Redeye Research

\* Sum may not total due to roundings

#### Bear Case 1.5 (1.0) SEK

- We factor in additional delays in clinical results and start of IDE-study, due to the macro environment (Corona)
- We consequently factor in a much slower CAGR in the coming years

#### Base Case 3.0 (2.5) SEK

- See above

#### Bull Case 6.0 (6.0) SEK

- We assume a faster rampup, with a CAGR of above 80 percent 2020-22
- A strong uptake on the US market starting from 2024
- EBIT margin at terminal year of > 40 percent

#### Episurf Medical: Summary of scenarioanalysis

	Bear	Base	Bull
SEK per share	1.5	3.0	6.0
Potential / Risk*	1%	101%	302%

\* Based on closing price 14 May 2020: SEK 1.49

Source: Redeye Research

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## Investment Case

- Cash runway until 2022
- Business goal intact
- Corona cut momentum in order intake, comeback in 2021 expected
- Follow the money – Significant potential in the US

### Cash runway until 2022

We have gone on about Episurf being undercapitalized in the past, which has accordingly put pressure on the share. In the latest share issues, a directed share issue and a preferential share issue, Episurf raised gross proceeds of SEK 140 million and strengthened its ownership base significantly. Although we expect additional share issues until break-even, we conclude for now; problem solved, over and out.

### Business goal intact

Ever since its foundation, Episurf has had a clear business goal; to make resurfacing metallic implants a standard for the 'Treatment Gap' patient group (middle-aged patients suffering from focal cartilage lesions) and become a market leader in this space. 'Gap' patients respond inadequately to the available treatment methods and are at risk of joint cartilage defects developing into a full arthritis state if left untreated. Accordingly, the medical need of this group, which numbers millions, is substantial.

### Corona cut momentum in order intake, comeback in 2021 expected

On the back of an enriched clinical dataset, where the number of Episealer-patients in scientific publications could be well above +100, and an increasingly educated group by the millions of 'Treatment Gap'-patients, we see a two-front push for orthopedics to start using Episealers as standard. Actually, at the beginning of 2020, Episurf saw a glimpse of an increasing trend in order intake. The momentum was swept away by the corona crisis, which has put elective surgeries on halt. We expect a comeback in H2'21, with an apparent beginning of the S-shaped trajectory on top-line growth that we anticipate.

If (when?) Episurf succeeds in establishing its concept as treatment standard in the 'Treatment Gap', the orthopedic industry's slow-changing nature will turn to its advantage. Orthopedic surgeons that have adopted the Episealer concept will be unwilling to change a treatment method that has superior outcomes, leading to high switching costs and an enduring competitive advantage for Episurf.

### Follow the money – Significant potential in the US

The US is unarguably the most crucial orthopedics market. Not only is it the largest market by far, but many of the key opinion leaders are also based in the US, as well as the largest orthopedic companies (i.e., acquirers). The regulatory pathway to the US market follows a Pre-Market Approval Process (PMA). It is an extensive process, and unarguably the most important task Episurf has undertaken. The most crucial part of the PMA-process is a clinical study, a so-called Investigational Exemption Study (IDE). In Episurf's IDE-study, 180 subjects will be enrolled to evaluate the safety and clinical effectiveness of Episealer Knee in comparison to microfracture. This study will be conducted at several sites in the US and Europe, making it possible for Episurf to build a network among key surgeons in the field and secure reimbursement.

- The current status of Episurf's IDE-study is that we are still awaiting surgeries to be performed. We continue to estimate market launch in 2024, but with significant milestones along the road. The closer Episurf gets to the US launch, the higher the partner interest among the major players in the orthopedics field.

## Key Risks

### **Investor Perseverance**

The Medtech industry is well-known for its slow-changing environment. It is when the product is on the market where it all starts. On top, the orthopedic industry is among the most conservative in an already conservative Medtech industry. In other words, it takes time to build a market and change user behavior. Investors have to take this into consideration and factor in additional equity funding along the road.

### **The Corona Crisis / Short-term Delays**

The pandemic outbreak of COVID-19 is unparalleled, and the orthopedic industry has taken a significant hit. Almost all elective surgeries are on a halt. In the case of Episurf, we have taken actions on our estimates in the current year. If elective surgeries continue to be halted, and with spillover into 2021, we might have to revise our estimates downward again. Further, the pandemic could cause further delays in clinical results and ongoing trials, not least for the IDE-study.



## Catalysts

### **Clinical Evidence**

We expect to see a substantial increase in clinical and health economic data that supports the Episealer technology in 2020.

**Strength:** Major

**Time-frame:** 0-6 months

### **An Increased User Base in Europe**

We look for steady growth in the European user base of orthopedic surgeons that will build recurring revenues in the longer term but don't expect any heavy footprint on the financials in the next 1.5 years.

**Strength:** Moderate

**Time-frame:** 7-18 months

### **Regulatory Pathway to the US**

We expect to see regulatory progress towards the US market, even though the corona situation causes uncertainty at the moment.

**Strength:** Moderate

**Time-frame:** 7-18 months

## Summary Redeye Rating

The rating consists of three valuation keys, each constituting an overall assessment of several factors that are rated on a scale of 0 to 1 points. The maximum score for a valuation key is 5 points.

### Rating changes in the report: People (+1), Financials (+1)

#### People: 4

Episurf has had consistency in management during the last three years. We have confidence in CEO Ryfors; he has the attributes to drive commercialization efforts and handle the capital markets. Moreover, he has 'skin in the game' and is one of the largest shareholders. From an ownership perspective, the company strengthened the base with several institutions in the directed share issue (Jan20). Moreover, the founder is still a large shareholder, and the largest shareholder is a well-known, global entrepreneur in the orthopedic industry (Niles Noblitt). The rating is downgraded somewhat by the lack of a major (> 10 percent), active shareowner.

#### Business: 2

Episurf has a potentially groundbreaking technology in Episealer. The Episealer technology targets a niche segment, the so-called 'Treatment Gap,' which number millions of patients worldwide, in the knee joint reconstruction field. This segment is subject to high growth potential. We estimate the market potential for this segment to SEK 10 bn on an annual basis. At the current stage, Episurf only scratches on the surface of this potential in a few selected countries. Its sales are on low levels, and we expect break-even first in 2026.

#### Financials: 2

The latest share issues support the companies operations until 2022. We don't predict that the current cash position takes the company to break-even. Hence, investors need to factor in additional equity funding.

INCOME STATEMENT	2018	2019	2020E	2021E	2022E
Net sales	4	5	6	12	24
Total operating costs	-57	-66	-70	-85	-80
EBITDA	-53	-61	-64	-73	-56
Depreciation	0	0	0	0	0
Amortization	-5	-7	-6	-6	-6
Impairment charges	0	0	0	0	0
EBIT	-58	-69	-71	-79	-62
Share in profits	0	0	0	0	0
Net financial items	0	-1	-1	-1	-1
Exchange rate dif.	0	0	0	0	0
Pre-tax profit	-58	-70	-71	-79	-63
Tax	0	0	0	0	0
Net earnings	-58	-70	-71	-79	-63

BALANCE SHEET	2018	2019	2020E	2021E	2022E
<b>Assets</b>					
<i>Current assets</i>					
Cash in banks	28	25	81	2	0
Receivables	1	1	2	4	7
Inventories	2	2	2	4	6
Other current assets	3	2	2	3	5
Current assets	34	30	87	13	18
<i>Fixed assets</i>					
Tangible assets	0	0	0	0	0
Associated comp.	0	0	0	0	0
Investments	0	0	0	0	0
Goodwill	0	0	0	0	0
Cap. exp. for dev.	0	0	0	0	0
0 intangible rights	21	22	19	17	15
0 non-current assets	0	6	6	6	6
Total fixed assets	21	28	25	23	21
Deferred tax assets	0	0	0	0	0
Total (assets)	55	58	111	36	39
<b>Liabilities</b>					
<i>Current liabilities</i>					
Short-term debt	3	0	1	1	66
Accounts payable	2	6	2	5	5
0 current liabilities	6	7	1	2	4
Current liabilities	10	13	4	8	75
Long-term debt	0	0	0	0	0
0 long-term liabilities	0	4	6	6	6
Convertibles	0	0	0	0	0
Total Liabilities	10	16	10	14	80
Deferred tax liab	0	0	0	0	0
Provisions	0	0	0	0	0
Shareholders' equity	45	41	101	22	-42
Minority interest (BS)	0	0	0	0	0
Minority & equity	45	41	101	22	-42
Total liab & SE	55	58	111	36	39

FREE CASH FLOW	2018	2019	2020E	2021E	2022E
Net sales	4	5	6	12	24
Total operating costs	-57	-66	-70	-85	-80
Depreciations total	-5	-7	-6	-6	-6
EBIT	-58	-69	-71	-79	-62
Taxes on EBIT	0	0	0	0	0
NOPLAT	-58	-69	-71	-79	-62
Depreciation	5	7	6	6	6
Gross cash flow	-53	-61	-64	-73	-56
Change in WC	0	6	-10	-2	-6
Gross CAPEX	-10	-14	-4	-4	-4
Free cash flow	-63	-69	-78	-78	-66

CAPITAL STRUCTURE	2018	2019	2020E	2021E	2022E
Equity ratio	82%	72%	91%	61%	-107%
Debt/equity ratio	6%	0%	1%	6%	-159%
Net debt	-26	-25	-80	-1	66
Capital employed	19	16	21	21	24
Capital turnover rate	0.1	0.1	0.1	0.3	0.6

GROWTH	2018	2019	2020E	2021E	2022E
Sales growth	61%	23%	14%	123%	92%
EPS growth (adj)	-9%	-58%	-48%	11%	-20%

DCF VALUATION	CASH FLOW, MSEK	
WACC (%)	13.0 %	
Assumptions 2020-2026 (%)		
Average sales growth	76.9 %	Fair value e. per share, SEK
EBIT margin	-335.3 %	Share price, SEK
		3.0
		1.6

PROFITABILITY	2018	2019	2020E	2021E	2022E
RDE	-89%	-162%	-100%	-129%	0%
ROCE	-86%	-157%	-99%	-127%	-267%
ROIC	-402%	-355%	-440%	-371%	-299%
EBITDA margin	-1318%	-1254%	-1157%	-584%	-236%
EBIT margin	-1438%	-1405%	-1272%	-632%	-261%
Net margin	-1445%	-1424%	-1282%	-639%	-265%

DATA PER SHARE	2018	2019	2020E	2021E	2022E
EPS	-1.83	-0.77	-0.40	-0.45	-0.36
EPS adj	-1.83	-0.77	-0.40	-0.45	-0.36
Dividend	0.00	0.00	0.00	0.00	0.00
Net debt	-0.81	-0.28	-0.45	-0.01	0.37
Total shares	31.63	90.93	178.11	178.11	178.11

VALUATION	2018	2019	2020E	2021E	2022E
EV	-25.5	-25.3	203.2	282.3	349.1
P/E	0.0	0.0	-4.0	-3.6	-4.5
P/E diluted	0.0	0.0	-4.0	-3.6	-4.5
P/Sales	0.0	0.0	50.8	22.8	11.9
EV/Sales	-6.4	-5.2	36.5	22.7	14.6
EV/EBITDA	0.5	0.4	-3.2	-3.9	-6.2
EV/EBIT	0.4	0.4	-2.9	-3.6	-5.6
P/BV	0.0	0.0	2.8	13.0	-6.8

SHARE PERFORMANCE	GROWTH/YEAR		18/20E
1 month	22.3 %	Net sales	18.0 %
3 month	-7.6 %	Operating profit adj	11.0 %
12 month	-17.6 %	EPS, just	-53.2 %
Since start of the year	35.9 %	Equity	50.1 %

SHAREHOLDER STRUCTURE %	CAPITAL	VOTES
Sacajo Investments LLC	6.4 %	6.2 %
Banque Pictet & Cie (Europe) SA	5.1 %	5.1 %
Rhenman & Partners Asset Management	4.4 %	4.0 %
Avanza Pension	3.5 %	3.5 %
Cbny-National Financial Services LI	2.6 %	2.5 %

SHARE INFORMATION	
Reuters code	EPISB.ST
List	Small Cap
Share price	1.6
Total shares, million	178.1
Market Cap, MSEK	283.2

MANAGEMENT & BOARD	
CEO	Pål Ryfors
CFO	Veronica Wallin
IR	
Chairman	Dennis Stripe

FINANCIAL INFORMATION	
Q2 report	July 17, 2020
Q3 report	October 23, 2020

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## Redeye Rating and Background Definitions

### Company Quality

Company Quality is based on a set of quality checks across three categories; PEOPLE, BUSINESS, FINANCE. These are the building blocks that enable a company to deliver sustained operational outperformance and attractive long-term earnings growth.

Each category is grouped into multiple sub-categories assessed by five checks. These are based on widely accepted and tested investment criteria and used by demonstrably successful investors and investment firms. Each sub-category may also include a complementary check that provides additional information to assist with investment decision-making.

If a check is successful, it is assigned a score of one point; the total successful checks are added to give a score for each sub-category. The overall score for a category is the average of all sub-category scores, based on a scale that ranges from 0 to 5 rounded up to the nearest whole number. The overall score for each category is then used to generate the size of the bar in the Company Quality graphic.

### People

At the end of the day, people drive profits. Not numbers. Understanding the motivations of people behind a business is a significant part of understanding the long-term drive of the company. It all comes down to doing business with people you trust, or at least avoiding dealing with people of questionable character.

The People rating is based on quantitative scores in seven categories:

- Passion, Execution, Capital Allocation, Communication, Compensation, Ownership, and Board.

### Business

If you don't understand the competitive environment and don't have a clear sense of how the business will engage customers, create value and consistently deliver that value at a profit, you won't succeed as an investor. Knowing the business model inside out will provide you some level of certainty and reduce the risk when you buy a stock.

The Business rating is based on quantitative scores grouped into five sub-categories:

- Business Scalability, Market Structure, Value Proposition, Economic Moat, and Operational Risks.

### Financials

Investing is part art, part science. Financial ratios make up most of the science. Ratios are used to evaluate the financial soundness of a business. Also, these ratios are key factors that will impact a company's financial performance and valuation. However, you only need a few to determine whether a company is financially strong or weak.

The Financial rating is based on quantitative scores that are grouped into five separate categories:

- Earnings Power, Profit Margin, Growth Rate, Financial Health, and Earnings Quality.

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## Disclaimer

### Important information

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### Redeye Rating (2020-05-14)

Rating	People	Business	Financials
5p	13	11	4
3p - 4p	104	79	30
0p - 2p	8	35	91
Company N	125	125	125

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### CONFLICT OF INTERESTS

Anders Hedlund owns shares in the company : No

Oscar Bergman owns shares in the company : No

Redeye performs/have performed services for the company and receives/have received compensation from the company in connection with this.