

Analyst comments – non-core

EPS (4282)

Structural growth; share price has corrected significantly

TP: N/a

POSITIVE

Company meeting

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Price: ¥327,000

Mcap: ¥28bn

- EPS is a contract research organisation (CRO) which undertakes clinical trial work for drug companies on a contract basis. It was established in 1991 and listed in 2001. The company originally had a high reliance on Sankyo for business, but is now well diversified with no one company accounting for more than 10% of its operations. All the Japanese majors are included among its client list, Eisai (4523) being the most recent edition.
- The industry includes three large firms, EPS, CMIC (2309) and Quintiles (unlisted), which together have about 50% of the total market. There are a large number of small firms making up the other 50%, but many of these are short-lived organisations founded by retiring drug industry employees. We are planning to visit CMIC also to give us better overall perspective on the industry (and to cross check some of the claims made by EPS at the visit), but our initial impression of EPS's business prospects is certainly favourable.
- EPS has a proven track record of growth independent of general economic cycles and of any government healthcare cost-containment policies. Sales have risen every year, and RP has risen every year but one in the 14 years since the company was founded. The CAGR for both sales and profits over the five years to FY9/04 was around 30%. It will get harder to keep up this average as the base gets bigger, but there is a good chance in my view of keeping growth in the 20%/year range.
- The CRO industry looks to be set for sustainable structural growth for several reasons
 1. **Efficiency:** A CRO has experts in a range of specific therapeutic areas who can be deployed whenever a given firm needs them. By contrast, if the experts are inside a single drug company, they may become superfluous once a given R&D project is complete. The use of a CRO allows a drug firms to turn fixed costs into variable costs, an important economic consideration when R&D costs seem to be relentlessly rising.
 2. **Speed and quality:** The CRO has expertise in a variety of different types trials and can often get the process going more quickly and to a higher standard than a drug firm which may, to some extent, have to "reinvent the wheel" every time it embarks on a new project, especially if the drug is in a category the drug firm has not handled for a long time.
 3. **Objectivity:** The CRO is an independent organisation whose financial interests are not directly at stake, regardless of the trial outcome. Regulators globally are looking at this as an intrinsically desirable feature after the various problems and drug withdrawals of the last few years.
 4. **Japan lagging global trend:** In the US, about 50% of trials are now conducted by CROs whereas in Japan the figure is only about 15%. This suggests there is substantial scope for further growth.
- Full year (FY9/05) results are due out on 11 November. We are expecting full year results to be about in line with company guidance (RP ¥1.82bn, NP ¥1.13bn).
- The share price has corrected by 45% since the high posted in July 2004 and underperformed TOPIX by 25% over the last 12 months. This has brought the PER down to 25x on FY9/05 consolidated earnings and would, in our view, represent good value if 20% CAGR can be maintained (eg, by F9/07, the multiple would drop back to only 17.5x). The chart shows good technical support in the 300,000-320,000 region.