Simulations Plus, Inc.

NASDAQCM:SLP

Analyst: Brian McCune
Sector: Health Care

BUY

Price Target: $7.42

Key Statistics as of 5/1/2015

Market Price:	$5.78
Industry:	Health Care Technology
Market Cap:	$98.6 M
52-Week Range:	$5.27-$7.15
Beta:	0.58

Thesis Points:

- Increasing usage of software and analytics for drug discovery and development
- limited market penetration leaves room for growth
- Ability to expand product line
- Undervalued

Company Description:

Simulations Plus, Inc develops simulation software used in pharmaceutical research during the drug discovery and development process. In addition to their line of modeling software, Simulations Plus also provides contract consulting services. The company licenses their products to major pharmaceutical, biotechnology, and chemical companies as well as government agencies around the world. In early 2015, the company acquired Cognigen Corporation, a leading provider of population modeling and research services. Simulations Plus was founded in 1996 and is based in Lancaster, California.

Thesis

I believe that Simulations Plus, Inc. develops software which will become an industry standard within the next five years. With a market cap of approximately $99M the company is a small fish in a highly competitive pond, which has scared some risk-averse investors away, resulting in a largely undervalued stock. I believe that their smaller size is less of a risk and more of an opportunity. The company will continue to further penetrate their current primary market of pharmaceuticals while also expanding their product line to new markets. Revenues will continue to grow as pharmaceutical testing shifts towards computer simulations and modeling.

Overview

Products

Simulations Plus offers six software products: GastroPlus, DDDPlus, MembranePlus, ADMET Predictor, MedChem Designer, and MedChem Studio. The first three products are simulation programs which quickly solve complex equations, while the last three products are used to model static properties of chemicals at various stages of development. Simulations Plus' software has seen an increasing amount of validation in their industry through peer reviews and customer testimonials. Additionally, GastroPlus and DDDPlus do not currently face any serious competition from other companies. This creates a significant competitive advantage over other firms in the industry, since Simulations Plus software works best in concert with each other. Prospective customers will be more likely to choose the Simulations Plus design software (which operates in a more competitive environment) to maximize efficiencies.

In addition to their line of software products, Simulations Plus also provides contract research and consulting services, demand for which has steadily increased in recent years. The company reported that all of the top five pharmaceutical companies commissioned their consulting services to solve complex problems in various aspects of drug development. Software and consulting contracts typically last one year, with a reported contract renewal rate of 93% in Q2 2015.

Simulations Plus Inc. Software Products		
GastroPlus v.9	Simulates absorption, pharmacokinetics, and pharmacodynamics of drugs administered to humans and animals.	Simulation Software
DDDPlus	Simulates in vitro laboratory experiments which measure drug dissolution rates under a variety of conditions.	
MembranePlus	Simulates laboratory experiments which measure permeability of drug-like molecules through various membranes.	
ADMET Predictor	(Absorption, Distribution, Metabolism, Excretion and Toxicity) Uses molecular structures and user inputs to predict approximately 145 different properties for them at high speeds.	Admet Design Suite
MedChem Designer	Molecule drawing software which allows chemists to "sketch" and modify molecular structures.	
MedChem Studio	Multi-use cheminformatics software used for data mining, *de novo* molecular design, and lead optimization.	

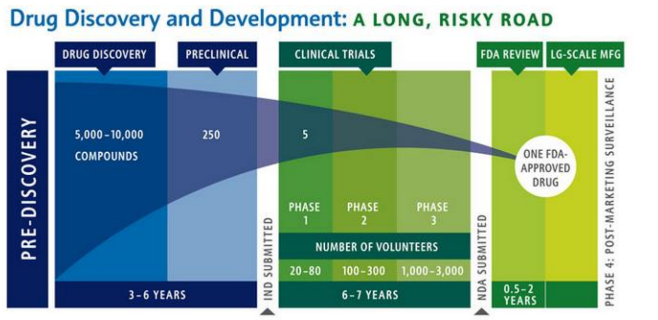
Market Outlook

The Biosimulation market is driven primarily by pharmaceutical companies continued efforts to:

- Reduce R&D costs per drug.
- R&D expenditures in the pharmaceutical industry.
- Social pressures to eliminate animal testing in research.

The company's products are currently used primarily by pharmaceutical companies and various pharmaceutical regulating agencies. The Biosimulation market continues to grow as pharmaceutical companies look for additional ways to reduce costs associated with drug discovery and development. Biosimulation software reduces costs in two primary ways; lead optimization, and reduced time-to-market. Lead optimization refers to the elimination of poor molecular structures and highlighting the most promising structures. This process has historically been a trial and error system which is inefficient and time consuming. By eliminating unusable drug compounds, customers are able to enter into pre-clinical and clinical trials more quickly with higher rates of success.

A survey conducted by "EvaluatePharma" shows global pharmaceutical R&D spending increasing from $141B in 2014 to over $160B in 2020. In the pharmaceutical industry, the majority of these R&D costs are paid out-of-pocket before any revenue is recognized. Considering the research and development process for a successful drug can take nearly 15 years and cost between $800M-1B, this presents a significant level of risk, especially for those smaller companies without existing revenue streams. This is why simulation and modeling tools will become increasingly important in the future.



Source: Pharmaceutical Research and Manufacturers of America

Opportunities

The company has recently discussed the possibility of shifting their current software products into the increasingly popular software-as-a-service space, a move which would improve margins through reduced costs of sales and create new creative subscription and contract options.

Simulations Plus has also looked into possible applications of their current modeling and simulation programs in the aerospace industry. The company is currently in development of their "AEROModeller", a predictor of aerodynamic force coefficients on various missile shapes at different speeds and angles. They have looked for additional funding from Tier 1 aerospace companies like Boeing and Lockheed to complete development of this product. If completed, this new product will diversify the company into a completely new sector that offers incredible room for growth.

Financial Performance

Simulations Plus has shown signs of financial strength in recent years with consistent year-over-year revenue growth and steady margins. This trend should be expected to continue through 2015 and beyond. Revenues in 2014 were $14.3M, a 13.8% increase over the prior year. I expect revenues to grow by approximately the same amount in 2015, primarily driven by pharmaceutical R&D spending and their addition of Cognigen services and products. Revenues beyond 2015 will be "kick-started" by advancements to current product offerings, expansion into new markets and products, and increased acceptance of computer modeling in pharmaceutical testing. My long-term growth rate is set to 7% which reflects the industry's historical growth rate.

Key Stats - Highlights

	Q:2014 A	Q:2013 A
For the period ending	2014-8-31	2013-8-30
Market Capitalization	109.87	76.63
Cash & Equivalents	8.61	10.18
Preferred & Other	0.00	0.00
Total Debt	0.00	0.00
Enterprise Value	101.26	66.45
Revenue	11.46	10.07
Growth %, YoY	13.80	6.58
Gross Profit	9.83	8.42
Margin %	85.79	83.65
EBITDA	5.48	4.84
Margin %	47.79	48.05
Net Income Before XO	3.03	2.89
Margin %	26.40	28.66
Adjusted EPS	0.19	0.18
Growth %, YoY	5.56	0.00
Cash from Operations	5.31	2.56
Capital Expenditures	-0.02	-0.05
Free Cash Flow	5.28	2.51

The bulk of Simulation Plus' operating expenses come from SG&A, which until 2014 had been steadily decreasing. The bump in SG&A spending in 2014 can be explained by one time occurrences like legal fees and overlapping salaries due to employee transitions. SG&A costs should not be expected to be significantly reduced moving forward, as many of the costs included, such as travel to trade shows and commissions for salespeople (those not included in CoGS) are beneficial to the company's long term growth efforts. As a percentage of sales, SG&A should decrease from 38% in 2014 to the 35% level maintained in previous years. R&D expenses should also be expected to increase slightly from approximately 8% total revenue in 2014 to roughly 11% total sales moving forward. When valuing the firm, I proposed the company's adjusted operating costs as a percentage of total sales to revert to 65%, even though this figure has historically been closer to 60%.

Analytics - Profitability

	O:2014 A	O:2013 A
For the period ending	2014-8-31	2013-8-30
Returns		
Return on Common Equity	20.39	19.65
Return on Assets	16.33	17.28
Return on Capital	20.39	19.65
Return on Invested Capital	18.27	17.44
Margins		
Gross Margin	85.79	83.65
EBITDA Margin	47.79	48.05
Operating Margin	38.74	40.44
Incremental Operating Margin	26.40	74.01
Pretax Margin	39.38	42.27
Income before XO Margin	26.40	28.66
Net Income Margin	26.40	28.66
Net Income to Common Margin	26.40	28.66
Additional		
Effective Tax Rate	32.96	32.19
Dvd Payout Ratio	101.57	138.61
Sustainable Growth Rate	-0.32	-7.59

Simulations Plus is debt free and holds $6.1M (6.7% TEV) in cash and short term investments as of February 28th, 2015. Their current debt-free balance sheet, cash position, and relatively small size could make the firm a target for acquisition by a larger firm in an adjacent industry. I believe that this could be a positive for investors considering the firm's growth outlook, any purchasing firm would have to pay a significant premium. A debt-free balance sheet also limits downside potential posed by default risk.

Why Buy?

Simulations Plus, Inc. has proven to be a leader in simulation and modeling software in the pharmaceutical industry. As M&A activity in the pharmaceutical industry inevitably begins to slow down in the coming months, pharmaceutical firms will look to new ways to create value. This will need to happen through cost reduction via increased outsourcing of complex problems and improved efficiencies in the drug development process. I believe Simulations Plus is well positioned to capitalize in both of these areas. Their software product offerings will help pharmaceutical companies reduce out of pocket costs of drug development through improved efficiencies and reduced time-to-market, while their growing consulting business will be able to tackle complex issues.

The company's history of financial strength will continue through 2015 and beyond. Though their smaller size may present more volatility and risk to investors, I believe that any downside potential is hedged by their debt-free capital structure and overall industry outlook. The stock is currently trading around 9.67% above their 52-week low and approximately 18% below their intrinsic share value, without any obvious reason. This creates a great value buying opportunity for investors.

For these reasons, I am calling Simulations Plus, Inc. (Nasdaq:SLP) a **BUY** in 2015 with a one-year target price of $7.42.

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Simulations Plus, Inc.	SLP	Analyst	Current Price	Intrinsic Value	Target Value	Divident Yield	Target Return	BULLISH
		Brian McCune	$5.85	$6.83	$7.45	4%	1-y Return: 31.1%	

General Info

Sector	Healthcare
Industry	Health Care Technology
Last Guidance	(Invalid Identifier)
Next earnings date	7/10/2015

Market Data

Enterprise value	$92.48
Market Capitalization	$2,032.29
Daily volume	0.25
Shares outstanding	16.85
Diluted shares outstanding	16.80
% shares held by institutions	99.58%
% shares held by insiders	40.14%
Short interest	0.08%
Days to cover short interest	0.69
52 week high	$7.15
52-week low	$5.27
5y Beta	0.55
6-month volatility	23.33%

Peers	Market Cap.
OmniComm Systems Inc.	$18.45
Medical Transcription Billing, Corp.	$23.10
DATATRAK International, Inc.	$9.39
Computer Programs & Systems Inc.	$592.17
MedAssets, Inc.	$1,221.75
CareView Communications, Inc.	$54.34
Merge Healthcare Incorporated	$479.68
Streamline Health Solutions, Inc.	$41.66
Quality Systems Inc.	$940.16
Omnicell, Inc.	$1,285.80

Current Capital Structure

Total debt/market cap	0.00%
Cost of Borrowing	#DIV/0!
Interest Coverage	9.4x
Altman Z	9.40
Debt Rating	AAA
Levered Beta	0.97
WACC (based on market value weights)	8.01%

Management

Professional	Title	Comp. FY2012	Comp. FY2013	Comp. FY2014
Woltosz, Walter	Co-Founder, Chairman and Chief	$475,059	$363,221	$479,264
Woltosz, Virginia	Co-Founder, Treasurer and Secreta	$60,000	$60,000	$60,000
Kneisel, John	Chief Financial Officer	$0	$0	$169,061
DiBella, John	Vice President of Marketing and Sa	$162,117	$178,460	$324,290
Grasela, Thaddeus	President and Director	$0	$0	$0
Bolger, Michael	Chief Scientist	$197,028	$211,647	$0

Historical Median Performance

	SLP	Peers	Industry	All U.S. firms
Growth	8.8%	15.6%	11.7%	7.4%
ROIC	22.6%	9.1%	18.9%	14.3%
NOPLAT Margin	27.6%	12.8%	13.7%	10.4%
Revenue/Invested Capital	0.82	0.71	1.39	1.37
Excess Cash/Rev.	75.2%	25.4%	13.5%	12.9%
Total Cash /Rev.	75.2%	27.7%	12.3%	15.2%
Unlevered Beta	0.68	0.97	0.85	0.95
TEV/REV	3.7x	3.7x	4.2x	2.5x
TEV/EBITA	12.7x	27.4x	17.6x	13.1x
PE (normalized and diluted EPS)	22.5x	31.1x	35.7x	23.5x
P/BV	2.2x	3.2x	2.9x	2.2x

Past Earning Surprises

	Revenue	EBITDA	Norm. EPS
Last Quarter	-0.7%	0.0%	0.0%
Last Quarter-1	3.3%	0.0%	0.0%
Last Quarter -2	10.5%	0.0%	-50.0%
Last Quarter -3	6.9%	0.0%	0.0%
Last Quarter -4	0.0%	0.0%	-28.6%

Non-GAAP Adjustments in estimates computations

Operating Leases Capitalization	100%	Straightline	10 years
R&D Exp. Capitalization	100%	Straightline	10 years
Expl./Drilling Exp. Capitalization	0%	N/A	N/A
SG&A Capitalization	0%	N/A	N/A

Proforma Assumptions

Money market rate as of today	0.54%
Annual increase (decrease) in interest rates	0.1%
Yield Spread accelaration	1.2
Marginal Tax Rate	37.5%
Risk-Free rate	2.6%
Tobin's Q	0.80
Op. Cash/Rev.	2%
Growth in PPE	NPPE Growth follows Revenue Growth
Long term Growth	7.2%
Base Year Unlevered Beta	is equal to 0.97
Long term Unlevered Beta	0.97

Forecast

Period	Rev. Growth	Adj. Op. Cost/Rev	Invested Capital	NOPLAT Margin	ROIC	WACC
LTM	13.8%	59.0%	$18.75	28%	28.0%	8.0%
NTM	13.1%	59.5%	$20.47	31%	27.4%	8.1%
NTM+1	12.4%	60.0%	$21.63	29%	26.2%	8.2%
NTM+2	11.8%	60.5%	$22.64	28%	26.5%	8.3%
NTM+3	11.1%	61.0%	$23.68	27%	27.3%	8.4%
NTM+4	10.4%	61.5%	$24.97	27%	28.1%	8.5%
NTM+5	9.7%	62.0%	$26.30	26%	28.7%	8.6%
NTM+6	9.0%	62.5%	$27.66	26%	29.2%	8.6%
NTM+7	8.4%	63.0%	$29.06	26%	29.6%	8.7%
NTM+8	7.7%	63.5%	$30.49	25%	29.8%	8.8%
Continuing Period	7.0%	64.0%	$21.32	28%	18.0%	8.9%

Valuation

Period	Invested Capital x (ROIC-WACC)	Total Debt	Other non-interest bearing claims	Shares Outstanding
LTM	$0.00	$0.00	-$4.22	16.85
NTM	$3.61	$0.00	-$0.61	16.85
NTM+1	$3.69	$0.00	$0.83	16.85
NTM+2	$3.95	$0.68	$1.69	16.85
NTM+3	$4.27	$2.35	$0.56	16.85
NTM+4	$4.65	$4.49	$0.55	16.85
NTM+5	$5.03	$6.97	$0.48	16.85
NTM+6	$5.41	$9.78	$0.43	16.85
NTM+7	$5.77	$12.94	$0.36	16.85
NTM+8	$6.12	$16.51	$0.33	16.85
Continuing Value	$154.44			

Pricing Model

DCF (Weight = 100%)	Relative (Weight = 0%)	Distress (Weight = 0%)	Weighted Average Price Per Share
$7.79	$4.42	$7.22	$7.79
$8.20	$4.80	$7.60	$8.20
$8.49	$5.25	$7.89	$8.49
$8.82	$5.72	$8.00	$8.82
$9.21	$6.27	$8.26	$9.21
$9.58	$6.74	$8.58	$9.58
$9.89	$7.20	$8.93	$9.89
$10.22	$7.64	$9.35	$10.22
$10.55	$8.06	$9.84	$10.55
$10.82	$8.43	$10.41	$10.82

Monte Carlo Simulation Assumptions

	Base	Stdev	Min	Max	Distribution
Revenue Variation	0	10%	N/A	N/A	Normal
Op. Costs Variation	0	10%	N/A	N/A	Normal
Country Risk Premium	6%	N/A	5%	7%	Triangular
Long term Growth	7%	N/A	3%	16%	Triangular

Monte Carlo Simulation Results

	Intrinsic Value	1y-Target
Mean est.	$7.79	$8.20
σ(ε)	$0.32	$0.25
3 σ(ε) adjusted price	$6.83	$7.45
Current Price	$5.85	
Analysts' median est.		$7.55