Zacks Small-Cap Research

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Ceapro Inc. (V.CZO - TSXV)

Reports 71% sales growth in 1Q:16 and continued margin strength.

Based on our forward looking multiple of earnings model and a 20x 2017 EPS multiple, CZO is valued at approximately C$2.20 per share.

Current Price (8/25/16)	$2.11
Valuation	**$2.20**

OUTLOOK

Ceapro Inc. manufactures two lead products which include beta glucan and avenanthramides, both natural ingredients that are derived from oats and are currently being used in products such as Aveeno, Burts Bees, and Nexxus.

The company also heralds its Pressurized Gas eXpanded (PGX) technology which allows for advanced conversion of liquids to powder, fiber or other solid.

CZO is expanding its capacity through the construction of a new 30,000 square foot GMP bio-processing extraction facility which is expected to be operational by 4Q:16.

Ceapro is a “green” growth-stage biotechnology company that develops and commercializes health and wellness products through its proprietary extraction technology platform and natural, renewable resources.

We increase our price target to C$2.20 per share based on our increase in earnings estimates and target multiple.

SUMMARY DATA

52-Week High	**$2.47**
52-Week Low	**$0.19**
One-Year Return (%)	**955**
Beta	**4.25**
Average Daily Volume (sh)	**297,740**
Shares Outstanding (mil)	**62.9**
Market Capitalization ($mil)	**$153**
Short Interest Ratio (days)	**0.18**
Institutional Ownership (%)	**N/A**
Insider Ownership (%)	**N/A**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**19.2**
Earnings Per Share (%)	**53.6**
Dividend (%)	**N/A**
P/E using TTM EPS	**23.6**
P/E using 2016 Estimate	**23.4**
P/E using 2017 Estimate	**19.2**
Zacks Rank	**N/A**

Risk Level	**Above Average**
Type of Stock	**Small-Growth**
Industry	**Med-Biomed/Health**

ZACKS ESTIMATES

Revenue
(In millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2015	$1.7 A	$2.4 A	$3.1 A	$3.4 A	$10.7 A
2016	$4.1 A	$4.2 A	$4.3 E	$4.4 E	$16.9 E
2017					$18.5 E
2018					$20.1 E

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2015	-$0.00 A	$0.01 A	$0.01 A	$0.03 A	$0.05 A
2016	$0.02 A	$0.02 A	$0.02 E	$0.02 E	$0.09 E
2017					$0.11 E
2018					$0.12 E

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WHAT'S NEW

Earnings Update

Ceapro Reports Accelerating Growth

On August 24, 2016, Ceapro Inc. (TSXV: CZO) released second quarter 2016 revenues and earnings. Sales increased by 71% in the second quarter, achieving a quarterly company record of $4.2 million (note that all currency herein is denominated in Canadian dollars). This exceeded our estimates which anticipated revenues of $3.8 million.

Better than expected growth continued to come from strong sales of beta glucan in Asia with year over year increases in all regions. In Canadian dollar terms, the largest growth geography was the United States which saw a $826 thousand and a 55% increase over 2Q:15. Sales to Germany increased by $783 thousand from sales to partner Symrise. Ceapro's distribution partner, Symrise, conducts sales not only in Europe but also beyond Europe's borders. A material but undisclosed proportion of sales classified in the Germany segment are passed on to Asia, and more specifically China, as demand for anti-aging cosmeceuticals is increasing considerably, driving the growth observed in the quarter.

Gross margins increased both sequentially and year over year to 72.3%. This compares to 2Q:15 levels of 71.7% and 1Q:16 levels of 69.7%. High output from favorable quality feedstock and from higher utilization at the factory have led to the improvement. Volume growth also helped leverage fixed costs over a greater level of revenues, as did input costs sourced in Canadian dollars compared to sales in the stronger US Dollar.

General and administrative expense declined to $0.5 million from $0.6 million or 17%, due to lower salaries and benefits expense. In the second quarter of 2015 there was a large non-cash share-based payment granted to employees and officers. 2Q:16 lacked any significant non-cash share-based expenses and also saw a decrease in Board of Directors' compensation. Several costs did increase year over year including accounting & audit fees, expenses related to subsidiary Ceapro Veterinary Products folding into the larger company, higher public company costs, as well as increased communication and website development costs. Total amounts were lower than our estimate of $0.7 million

Research and development was a credit of $61 thousand in the quarter due to the receipt of grant funding for expenses incurred in the first quarter and from the recognition of scientific research and development tax credits. Grant funding was also provided to support the salaries for some employees in the Pressurized Gas Expanded (PGX) Technology group offsetting actual expenditures. Patent renewals were lower in 2Q:16 vs. 2Q:15. Some R&D expenses were higher year over year, including salary costs from a greater number of staff working in R&D. The credit of ($61,000) compares to our estimate of an expense of $0.3 million.

Despite the strong growth, cash levels on the balance sheet declined more than expected due to a build in receivables and the recognition of deferred revenue. As of June 30, 2016 cash was $0.9 million. Cash generated from operating activities was $0.8 million tempered by the aforementioned balance sheet items. Capital expenditures and leasehold improvements were ($1.7) million in the second quarter compared to ($1.6) million in 1Q:16 and ($0.7) in 2Q:15. Repayment of long-term debt also reduced cash levels resulting in cash used in financing of ($371,000) in the quarter. Total debt carried on the balance sheet fell sequentially from $4.2 million to $4.0 million.

Free cash flow was negatively impacted in the second quarter of 2016 due to working capital items, continued capital spend and investment in the new plant. Capital investments and leasehold improvements were ($1.7) million in the quarter vs. ($0.6) million in 2Q:15. 2Q:16 free cash flow was a ($1.0) million draw, below the ($0.3) million in 2Q:15.

2016 Estimates

Our forecasts for 2H:16 reflect a continuation of sales trends observed in the first half of the year. Global demand has been consistently strong, exceeding 20% on the topline every year since 2013. Demand for natural products has been increasing as concerns over the impact of chemicals in products has pushed quality conscious consumers towards brands that use Ceapro inputs. Additionally, the increasingly consumer oriented Asian markets, especially

China, are using more health and beauty products, where a premium is expected for quality products. To satisfy this demand growth, Ceapro is building new manufacturing facilities with initial validation trials currently in progress and eventual production expected by 4Q:16. The company is required by its agreements with customers to run both the old and new facilities simultaneously for the first six months; however, if the specifications of the beta glucan and avenanthramides output consistently meet specifications, management will attempt to shorten this period to leverage the higher level of efficiency anticipated with the new manufacturing plant. We forecast higher levels of utilization and more efficient processing to support the continuation of 1H:16 gross margin levels for the remainder of the year. When the new facilities are operating at normal capacity, we anticipate higher efficiencies, automation and throughput to support higher gross margin levels over the longer term.

Research and development costs are anticipated to increase slightly in 2H:16 as clinical trials are launched for beta glucan (cholesterol reduction) and safety and bioavailability studies are conducted. We have conservatively forecasted $1.2 million of expenses here. General and administrative costs should fall slightly below 2015 levels as the prior year saw relatively large non-cash share based compensation which is not expected to continue into 2016. Sales and marketing expenses are considered to be close to zero in 2016 as the company exclusively uses distributors for selling its product.

As of the end of the second quarter, Ceapro anticipates approximately $550 thousand in additional plant expenses to complete construction, commissioning and validation work.

Recent Material Events

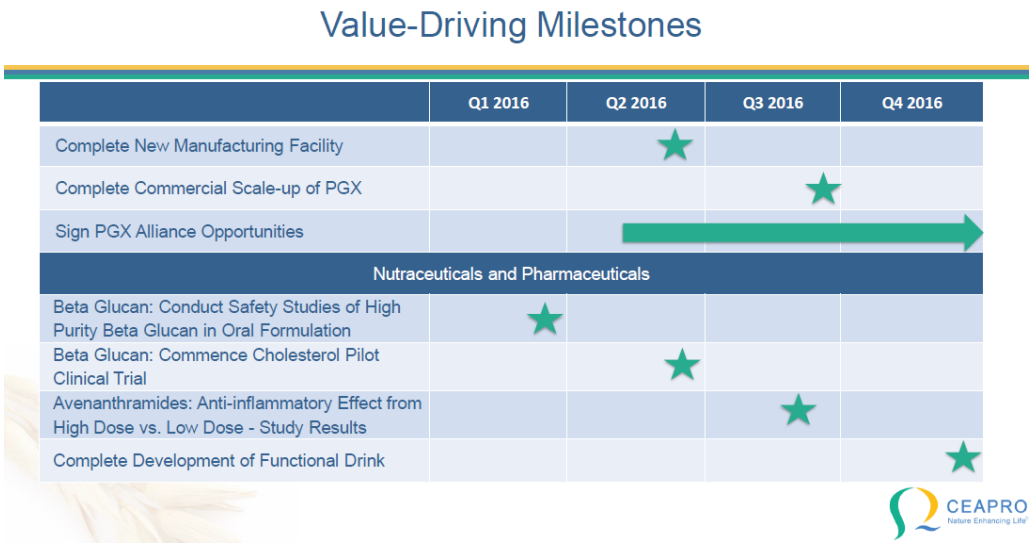
On July 14, 2016 Ceapro's appointed agent, Echelon Wealth Partners, closed the final tranche of a private placement of $10 million. A total of 9.4 million shares were issued at $1.06 and 4.7 million warrants were also issued with an exercise price of $1.50. 660,000 broker warrants were granted to Echelon at an exercise price of $1.06. Broker warrants also include another half warrant which total 330,000 shares at a strike price of $1.50. Given the sharp rise in the shares, all warrants are in the money and total dilution from this transaction is expected to be 15.1 million shares. Ceapro also paid Echelon 7% on gross proceeds yielding a $700,000 commission.

In early May, Ceapro's senior research scientist Bernard Seifried, Ph.D. presented the PGX Technology at the 15th European Meeting on Supercritical Fluids. His presentation, entitled "PGX Technology: An Enabling Technology for Generating Biopolymer Fibrils, Particles Aerogels and Nano-Composites," discussed the detail behind the Pressurized Gas eXpanded Liquid Technology describing the key advantages over conventional drying and purification technologies that can be used to process biopolymers into high-value, nano-sized polymer structures and novel bio-nanocomposites.

Ceapro announced a continuation of its relationship with the German-based Symrise on April 6, which, along with Ross Organic in California, comprise near 90% of corporate sales. This is an agreement for the distribution and commercialization of Ceapro's active ingredients in the cosmetic markets. Additionally, the company has an outstanding loan agreement with Symrise for Euro 1 million.

On February 3, 2016, Ceapro announced that it received issuance from the U.S. Patent and Trademark Office (USPTO) for U.S. Patent No. 13/638,254 titled, "Supercritical Fluid Treatment of High Molecular Weight Biopolymers." The patent covers proprietary methods related to the production, impregnation and micro-encapsulation of micro- and nano-particles, agglomerates and fibers from high molecular weight water-soluble biopolymers generated by applying Pressurized Gas eXpanded (PGX) supercritical fluid technology. Not only does this strengthen Ceapro's intellectual property portfolio, but also helps expand the company's reach into the pharmaceutical and nutraceutical arenas in addition to advancing strategic alliance collaborations in various industrial applications.

Below, we share some of the key milestones expected in 2016 with regard to the manufacturing facility and some of the research the company is conducting on the health benefits from its key products.



PGX Research Programs Update

On November 12, 2015, Ceapro announced that the National Research Council of Canada (NRC) through its Industrial Research Assistance Program (IRAP) made a contribution of up to $350,000 for the development, demonstration and testing of Ceapro's PGX technology, which will support salaries of researchers dedicated to the building of a fully functional skid in Alberta for processing a wide range of feedstock using PGX equipment. Ceapro's researchers will focus efforts on completing the design of process equipment, fabricating and commissioning the demonstration skid, testing of biopolymer samples, assessing and determining the biopolymers with the best value proposition for further development and commercialization. In addition to in-house applications that have been developed with beta glucan using PGX technology, the other expected deliverable will be a system that will allow assessment of various materials originating from different companies or organizations on a worldwide basis.

Review of PGX Technology

On May 20, 2014, Ceapro signed a Development and Licensing Agreement with the University of Alberta for the use of PGX. Ceapro intends to use PGX to develop dry powder formulations of active ingredients in order to enable the transition to other sectors that mostly require the production of dry formulations in the form of tablets and capsules, such as cosmeceuticals, functional food, nutraceutical and pharmaceutical industries. Subsequently, on February 11, 2015, Ceapro announced an expansion to the license agreement with the University of Alberta, granting worldwide rights to the company to develop and commercialize PGX Technology in all industrial fields.

In May 2015, Ceapro announced that it would embark on a scale-up of its PGX technology to commercial and demonstration levels. The scale-up is estimated to cost around $2 million, and the company has received additional funding from Al Bio, this time in the amount of an $800K funding contribution, in order to help support the project. Similarly, as mentioned above, Ceapro was also awarded a research contribution from the National Research Council of Canada (NRC) through its Industrial Research Assistance Program (IRAP) of up to $350k for the project. Management believes that the implementation of PGX at a commercial scale has the potential to generate many novel bio-based products with improved functionality and purity.

Update on Avenanthramides Program

Ceapro's flagship product, avenanthramides (AVA), has applications in the cosmetics and personal care industries, and when taken orally, AVA could be beneficial in inflammatory conditions. These findings supported the research and development of AVA as an active pharmaceutical ingredient (API). Ceapro has initiated a bioavailability study with the University of Minnesota, comparing low-dose vs. high-dose AVA which has now completed. Ceapro expects the study results to be published in a journal, the name of which is yet to be announced. Management believes that this bioavailability study will pave the way for future clinical study protocols, and is currently conducting a bioefficiency study also at the University of Minnesota. The study is examining exercise-induced inflammation and is orally administering the active ingredient in this dose finding effort.

Update on Oat Beta Glucan Program

Beta glucan is known for its cholesterol lowering properties (Othman, *et al.,* 2011), and Ceapro aims to develop beta glucan as a cholesterol reducer. It will conduct studies to assess high purity beta glucan when taken orally and will conduct a pilot clinical trial program on cholesterol reduction beginning 4Q:16. We believe the study will take 12 months to complete. There is currently a library of research that upports the health beneifts of beta glucan and many regulatory agencies in Canada, the US, Australia, the EU and New Zealand already recognize the benefits of the soluble fiber, which should provide for a low-risk approval following the studies.

Bio-Processing Extraction Facility Currently in Commissioning

In 2011, Ceapro originally planned to construct a new 21,000 square foot GMP bio-processing extraction facility in Edmonton, Alberta. The scope of the original planned manufacturing facility was redefined in later years to take advantage of new manufacturing process design opportunities with an expanded production area specifically designed to house a commercial and demonstration scale PGX skid and ethanol recycling system, and as a result, Ceapro is added an additional 10,000 square feet to the facility. The goal is to be able to host all of Ceapro's enabling technologies under one roof, and the facility is currently undergoing the commissioning and validation process. Management anticipates product that meets all specifications to be available by year end.

The new facility will hold a Natural Health Products license from Health Canada, and will allow Ceapro to leverage its bio-processing technique and generate additional revenue from custom bio-processing for third party customers that have their own products and extraction processes. Currently, Ceapro has the ability to manufacture 3-4 tonnes of product per week (approximately 100-200 tonnes per year) using batch mode processes. Ceapro's plan is to implement a more efficient process at the new facility, with semi-continuous and continuous manufacturing processes which will allow for the simultaneous production of multiple products, and the production of five to six times more material than the government-owned bio-incubator the company is currently using. The first validation batch trials are currently being conducted, and the facility should be producing by the fourth quarter. As per customer requirements, Ceapro is required to operate both the old and new facility for six months to ensure steady flow of product.

Summary

Ceapro utilizes a proprietary plant extraction based manufacturing process to supply ingredients that are currently used in multiple household products in the personal care and cosmetics industries. We can find Ceapro ingredients inside well-known branded products like Aveeno, Burts Bees, and Nexxus. Ceapro's active ingredients are manufactured from proprietary oat varieties and various natural sources grown in many regions around the globe. The company's flagship product, avenanthramides, and its value driver, beta glucan, are two oat-derived compounds that make up the core of Ceapro's product line. Ceapro is the only worldwide commercial manufacturer of natural AVA.

Over the last ten years, the main priority of the company has been to provide novel, natural, environmentally friendly ingredients to cosmetic and personal care product manufacturers and developers of human and animal therapeutics. Ceapro extracts are currently used in the cosmeceutical (cosmetics that have medicinal or drug-like effects) market, with the hope for entry into the pharmaceutical and nutraceutical (derived from food sources that purport health benefits such as vitamins, minerals, herbals, and functional foods and beverages) sectors in the relative near term. The company has plans to involve a steady pipeline of innovative products for both the human and animal healthcare industries.

Ceapro has been able to generate strong earnings growth through a combination of accelerating topline and improving margins. We believe there is potential to expand into the functional food/nutraceutical, and possibly the pharmaceutical markets, augmenting the current organic growth the company has achieved through its distributors over the last few years. The PGX technology may be able to cross over into other industries and provide upside potential from licensing revenues. The U.S. patent for PGX technology that was issued on earlier this year further strengthens Ceapro's patent portfolio. We think that Ceapro may have the opportunity to sub-license PGX technology to third parties and/or serve as a contract manufacturer. As per management, several multinational organizations in a variety of different industries have already executed confidentially agreements with Ceapro to assess their material with the proprietary PGX technology.

Although the company does have significant customer concentration, we believe its partnership with Symrise in particular, will assist them in selling the additional manufacturing capacity once the project is completed. We have

assumed only modest growth in 2017 and 2018 compared to levels achieved over the last several years despite the completion of the additional manufacturing capacity.

Our valuation model does not include revenues for the commercialization of Ceapro's avenanthramides or beta glucan as pharmaceutical products, however we do increase our target multiple from 15x to 20x forward earnings to recognize the strong earnings growth from current sales channels and to anticipate continued growth beyond the forecast period from the several programs currently being incubated. In the near future, we expect to see results from the studies and trials that are being conducted that support efficacy for treating high cholesterol and inflammation. If these potential candidates are eventually approved, we anticipate an increase to our sales and earnings estimates.

Our target price is derived using a 20x multiple of earnings ratio applied to 2017 earnings per share of $0.11. Our selection of the 20x multiple is guided by analysis of the growing perpetuity formula assuming a 15% discount rate and a 10% growth rate over the medium term.[1] We assume that cash flows are equivalent to earnings for the purposes of our model.

For comparison, we look at the most recent historical PEG ratios provided by Dr. Aswath Damodaran for the healthcare products sector of 2.07[2] compared to our PEG of 2.0.[3] We also place this in the context of the broad major US indices and calculate a PEG ratio of of just under 7, clearly high by historical standards.[4] Based on these valuation constraints we see our 20x earnings multiple and 2.0 PEG ratio as reasonable metrics to generate our target price.

Based on our revisions to the model and multiple, we increase our target price from $1.24 to $2.20 per share.

[1] Growing perpetuity formula = Cash Flow / (Discount Rate – Growth Rate) = x / (15% - 10%) = x / 5% or 20x. This is equivalent to a 2.0x price to earnings growth (PEG) ratio, which we justify using Dr. Damodaran's data set.
[2] http://pages.stern.nyu.edu/~adamodar/ Data is for healthcare products and includes 261 companies as of January 2015.
[3] 20x P/E ÷ 10% EPS growth = 2.0
[4] We calculate the S&P 500 PEG ratio using the growth rate for the index over the 2014 to 2017 period. The one year forward growth rate is estimated to be 8.2% (2017 S&P 500 operating earnings of 127.76 divided by 2016 operating earnings of 117.97 using mean broker analyst estimates), which is too high and not representative of the medium term S&P 500 operating earnings growth rate. We note that S&P 500 operating earnings growth has been very low in the last 3 years, and therefore we average the one year forward growth rate with the growth rates since 2014. This results in a three year average growth rate of 2.5%. (2017 S&P 500 operating earnings of 127.76 divided by 2014 S&P 500 operating earnings of 119.52 with the quotient taken to the 1/3 power and subtracted by one to derive the annual growth rate). We then calculate the forward S&P 500 price to earnings ratio. The S&P 500 is trading at 2,182.6 as of August 26, 2016 and forward earnings are estimated to be 127.76, which yields a price to earnings ratio of 17.08x. Our PEG ratio is therefore 17.08/2.5 = 6.83. Admittedly, we are comparing the PEG ratio of a large cap US index against a small Canadian biotech company; however, the quality of the data for this index is much higher and has greater depth than for microcap ex-US issuers. The relative PEG ratios justify the numbers we use to generate our target price.

PROJECTED FINANCIALS

Ceapro Inc. - Income Statement

Ceapro Inc.	2015 A	Q1 A	Q2 A	Q3 E	Q4 E	2016 E	2017 E	2018 E
Total Revenues	**$10.7**	**$4.1**	**$4.2**	**$4.3**	**$4.4**	**$16.9**	**$18.5**	**$20.1**
YOY Growth	*20%*	*137%*	*71%*	*40%*	*28%*	*59%*	*9%*	*9%*
Cost of goods sold	$3.6	$1.2	$1.2	$1.4	$1.5	$5.3	$5.6	$6.0
Product Gross Margin	*65.9%*	*69.7%*	*72.3%*	*67.0%*	*67.0%*	*69.0%*	*70.0%*	*70.0%*
R&D	$0.6	$0.3	($0.1)	$0.3	$0.3	$0.9	$1.3	$1.4
G&A	$2.5	$0.5	$0.5	$0.6	$0.6	$2.2	$2.3	$2.4
S&M	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Finance costs	$0.2	$0.1	$0.0	$0.1	$0.1	$0.3	$0.3	$0.3
Income from operations	$3.6	$1.9	$2.5	$1.9	$2.0	$8.3	$9.1	$10.0
Operating Margin	*34%*	*47%*	*60%*	*45%*	*45%*	*49%*	*49%*	*50%*
Other operating loss	$0.2	($0.2)	($0.1)	$0.0	$0.0	($0.3)	$0.0	$0.0
Pre-Tax Income	$3.8	$1.7	$2.4	$1.9	$2.0	$8.0	$9.1	$10.0
Income Taxes Paid	($1.1)	$0.5	$0.7	$0.4	$0.4	$2.0	$1.8	$2.0
Tax Rate	*-28%*	*30%*	*31%*	*20%*	*20%*	*25%*	*20%*	*20%*
Net Income	**$4.9**	**$1.2**	**$1.6**	**$1.5**	**$1.6**	**$6.0**	**$7.3**	**$8.0**
Net Margin	*46%*	*30%*	*39%*	*36%*	*36%*	*35%*	*39%*	*40%*
Reported EPS	**$0.08**	**$0.02**	**$0.02**	**$0.02**	**$0.02**	**$0.09**	**$0.11**	**$0.12**
YOY Growth	*196%*	*-687%*	*128%*	*48%*	*-53%*	*252%*	*20%*	*10%*
Adjusted EPS	**$0.05**	**$0.02**	**$0.03**	**$0.02**	**$0.02**	**$0.10**	**$0.11**	**$0.12**
YOY Growth	*85%*	*-806%*	*229%*	*85%*	*-15%*	*277%*	*12%*	*10%*
Basic Shares Outstanding	62.7	62.6	62.9	63.7	64.5	63.4	64.4	64.4
Diluted Shares Outstanding	65.2	65.7	66.5	66.8	67.6	66.6	67.5	67.5

Source: Company Filing // Zacks Investment Research, Inc. Estimates

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HISTORICAL STOCK PRICE

Ceapro Inc. - (TSXV: CZO)



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