Zacks Small-Cap Research

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Ceapro Inc. (V.CZO - TSXV)

Sales Slowdown in 4Q; Focus Shifts to Development Programs

Based on our forward looking multiple of earnings model and a 20x 2018 EPS multiple, CZO is valued at approximately C$1.70 per share.

Current Price (4/10/17)	$1.40
Valuation	**$1.70**

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 states.

CZO has expanded its capacity through the construction of a new 30,000 square foot GMP bio-processing extraction facility which is currently completing validation trials.

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 reduce our price target from C$1.75 to C$1.70 per share applying our 20x target multiple to 2018 EPS.

SUMMARY DATAt

52-Week High	**$2.47**
52-Week Low	**$0.48**
One-Year Return (%)	**186**
Beta	**4.69**
Average Daily Volume (sh)	**187,011**
Shares Outstanding (mil)	**75.2**
Market Capitalization ($mil)	**$105.3**
Short Interest Ratio (days)	**3.96**
Institutional Ownership (%)	**N/A**
Insider Ownership (%)	**N/A**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**18.8**
Earnings Per Share (%)	**37.8**
Dividend (%)	**N/A**
P/E using TTM EPS	**27.6**
P/E using 2017 Estimate	**22.5**
P/E using 2018 Estimate	**16.5**
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	$3.0 A	$2.4 A	$13.7 A
2017					$15.3 E
2018					$19.0 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	$0.01 A	$0.00 A	$0.05 A
2017					$0.06 E
2018					$0.08 E

*Earnings adjusted for normalized tax rate

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WHAT'S NEW

Earnings Update

Ceapro Full-Year 2016 and Fourth Quarter Results

On April 6, 2017, Ceapro Inc. (TSXV: CZO) released full-year 2016 financial and operational results. 2016 revenues of $13.7 million rose 28% over the prior year and earnings of 5.1c posted a near 50% increase on an adjusted basis.[1] These results are below our estimates of $14.7 million in revenues and earnings of 6.2c (note that all currency herein is denominated in Canadian dollars).

By geography, on a year over year basis, 2016 sales increases in the US, Canada, Germany and Other were offset by declines in China. In the fourth quarter, sales fell 29% vs. Q4:15 as Germany and China did not maintain previous year sales' levels. The 4Q:16 vs. 4Q:15 difference was also attributable to a significant reduction in orders for beta glucan. Sequentially, Ceapro experienced quarterly declines in US, Germany, and Canada but increases in China and Other regions.

China sales, which relate to one verterinary products buyer, were $121 thousand in 4Q, a decline from the prior year. We note that Ceapro's distribution partner, Symrise, has sales attributed to Germany but also distributes Ceapro products to other European countries and beyond Europe's borders. The volatile movement in the topline overall was attributed to timing and unpredictable ordering patterns for new customers and the long supply chain between Ceapro and ultimate customers. Ceapro was not able to pinpoint the reasons for the volatility in sales over the last several quarters, but hypothesized part of it was related to customers building up inventories in advance of the shift to the new manufacturing facilities in Edmonton.

Gross margins for 2016 increased to 68.4% compared to 65.9% in 2015. For Q4:16, margins increased sequentially by 380 bps, but fell on a year over year basis to 68.4%. The increase in year over year gross margin was attributable to higher output from the use of favorable feedstock, efficiencies from additional shifts and an emphasis on controling expenses. In the fourth quarter, margins fell vs. 4Q:15 due to costs related to operator training and engineering runs at the new facility and product mix. We note that there is a material component of fixed overhead in cost of goods sold that provides a higher gross margin during quarters with higher sales, all else equal.

Full-year general and administrative expense fell by 13% to $2.2 million. Lower non-cash, share-based compensation for both employees and directors combined with fewer employees in 2016 vs. 2015 explain the contraction in G&A. Higher consulting fees related to additional compensation paid to an officer and public company costs related to investor relations, communication and website spend were offsetting factors. Investor relations efforts extended into additional travel for attendance at conferences and other corporate events. Lower legal fees were related to the conclusion of the evidentiary portion of the AVAC trial in 2015. Isolating the fourth quarter, expenses were up 13% on consulting fees paid to an officer of the company.

Research and development totaled $919 thousand in 2016 compared to $625 thousand in 2015. Note that amounts spent reflect a net value partially offset by investment tax credits. Ceapro began its clinical program for avenanthramides and a pilot study for beta glucan in 2016, driving the higher costs offset. R&D tax credit offsets also increase in magnitude in 2016. In the fourth quarter, total R&D was $388 thousand, up 177% from the $140 thousand in the prior year. Higher expenses in a number of areas, especially in the Other category, propelled the change.

Finance costs were essentially flat year to year with accretion of the convertible debenture offset by lower interest on long-term debt. Other operating loss varied to a much greater degree and saw an $840 thousand delta as a recognition of a tax credit in 2015 did not repeat in 2016 and plant relocation costs increased by $215 thousand. In the fourth quarter of 2016, Ceapro made a $47,000 investment in a quality management system to support meeting customer requirements in the nutraceutical and pharmaceutical markets.

[1] In 2015, Ceapro benefitted from a net tax recovery compared to a net tax liability in 2016, which was removed to calculate adjusted EPS growth.

Cash and equivalents levels at the end of 2016 were $9.2 million, increasing from $1.7 million in the prior year. $10 million worth of shares were issued in the third quarter, which reduced total debt from $4.4 million at year-end 2015 to $2.5 million at year-end 2016 and provided additional working capital. For FY:16, cash generated from operating activities was $4.7 million, up from $4.0 million in FY:15. Deferred tax expense and the add back of depreciation and amortization were the main line items contributing to positive cash flows and were offset by the recognition of deferred revenue and prepaid expenses. Capital expenditures of $2.3 million increased over the prior year's $1.5 million. Purchase of leasehold improvements, largely related to the new manufacturing facility were $2.6 million in 2016 and fell slightly from the $2.7 million in the prior year. Including the financing cash flows from the common share issuance, total cash levels rose from $1.7 million at the beginning of the year to $9.2 million as of December 31, 2016.

2016 Estimates

We reduce our revenue and earnings forecasts for 2017 due to the slowdown in revenue growth in the second half of the year and increased uncertainty in ordering patterns. Ceapro had seen substantial uptake of product sales in China in 1H:16 through partner Symrise, but sales here slowed in the as the year progressed. For the full year, demand for natural products increased as concerns over the impact of chemicals in products has motivated 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 quality commands a premium. To satisfy this demand growth, Ceapro opened its new bio-processing facility in September 2016, and has processed the first commercial batches of oat extracts at the new facility.

The company is required by its agreements with customers to run both the old and new facilities simultaneously for the six months following the completion of validation trials. These trials should be completed before the end of April implying a September or October 2017 departure from the old facility. We forecast higher levels of utilization and more efficient processing in support of improved gross margin levels in future quarters. When the new facilities are operating at normal capacity, we anticipate higher efficiencies, automation and throughput to support a further improvement of gross margin levels over the longer term.

Research and development costs are anticipated to increase in 2017 as clinical trials ramp up for beta glucan (cholesterol reduction) and safety and bioavailability studies are conducted for avenanthramides (inflammation). General and administrative costs are expected to be essentially flat in 2017 and sales and marketing expenses will continue to be close to zero going forward as the company exclusively uses distributors to sell its product.

Recent Material Events

- Holders of $960,000 of convertible debentures converted their instruments into common shares at $0.64 per share at year end 2016. 1.5 million common shares were issued to convertible holders to reflect the conversion as described in a January 4, 2017 press release.

- On September 28, 2016 Ceapro announced the grand opening of its new bio-processing extraction facility in Edmonton, Alberta which will use an ethanol recycling system, further enhancing the company's "Green" credentials. The new facility will also include a commercial and demonstration area for its PGX technology which was developed at the University of Alberta.

- 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.

- 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 €1 million.

Upcoming Milestones

- Provide readout on bioavailability study for avenanthramides inflammation indication
- Complete the development of a prototype for a functional coenzyme Q-10 drink in 2017
- Commence patient recruitment for 18-month pilot clinical study to develop beta glucan as a cholesterol reducer in 2017

PGX Research Programs Update

On September 21, 2016, Ceapro announced a $250,000 grant from the German-Canadian Center for Innovation and Research to advance the commercialization of PGX. The goal of the funding is to advance the sustainability of PGX by integrating an ethanol recycling system with the use of retention membranes developed by A. Junghans GmbH and Fraunhaufer IAP and Fraunhaufer IKTS.

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 been completed. 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 which is expected to provide results in 3Q:17. The study is examining exercise-induced inflammation and is orally administering the active ingredient in this dose finding effort.

This program could potentially provide a food additive product with sales in 2018 and a concentrated pill form in 2022, following a registrational trial and regulatory approval. Inflammation is a wide-ranging affliction that could provide substantial demand for a clinically proven product.

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 is planning a pilot clinical trial program on cholesterol reduction. Expenditures in 2H:16 related to this program were to develop the protocol and prepare the material for the pharmaceutical development stage. The 18-month study is expected to begin in early 2017 and should provide a topline readout by mid-2018. There is currently a library of research that supports 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.

If clinical trials are able to show a substantial reduction in cholesterol levels, Ceapro will be able to carve out a piece of the US$6+ billion statin market for itself. Even access to a small fraction of this market would provide a revenue stream many multiples of current sales levels.

Bio-Processing Extraction Facility in Final Stages of Validation

Ceapro's new manufacturing facility, which will host all of Ceapro's enabling technologies under one roof, was opened in September 2016. The facility has passed the commissioning stage and is expected to complete the final validation stages before the end of this month. Management anticipates that following validation, its product will meet all specifications in this GMP-certified plant.

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. In the legacy facility, 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 currently used. As per customer

requirements, Ceapro is required to operate both the old and new facility for six months to ensure steady flow of product and we expect this requirement to be met near the end of 3Q:17.

Summary

Our valuation model does not include a valuation component for the commercialization of Ceapro's PGX technology, CoQ-10 functional drink, avenanthramides or beta glucan as pharmaceutical products; however, we employ a 20x forward multiple on 2018 EPS 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 2018 earnings per share of $0.085. Our selection of the 20x multiple was discussed in depth in our 2Q:16 report. Based on our revisions to the model, we modify our target price to $1.70 per share.

PROJECTED FINANCIALS

Ceapro Inc. - Income Statement

Ceapro Inc.	2015 A	Q1 A	Q2 A	Q3 A	Q4 A	2016 A	2017 E	2018 E
Total Revenues	**$10.7**	**$4.1**	**$4.2**	**$3.0**	**$2.4**	**$13.7**	**$15.3**	**$19.0**
YOY Growth	*20%*	*137%*	*71%*	*-2%*	*-29%*	*28%*	*12%*	*24%*
Cost of goods sold	$3.6	$1.2	$1.2	$1.1	$0.8	$4.3	$4.9	$5.9
Product Gross Margin	*65.9%*	*69.7%*	*72.3%*	*62.7%*	*66.5%*	*68.4%*	*67.8%*	*69.0%*
R&D	$0.6	$0.3	($0.1)	$0.3	$0.4	$0.9	$1.2	$1.4
G&A	$2.5	$0.5	$0.5	$0.5	$0.6	$2.2	$2.2	$2.3
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	$0.0	$0.0	$0.2	$0.2	$0.2
Income from operations	$3.6	$1.9	$2.5	$1.1	$0.5	$6.0	$6.8	$9.2
Operating Margin	*34%*	*47%*	*60%*	*35%*	*22%*	*44%*	*44%*	*49%*
Other operating loss	$0.2	($0.2)	($0.1)	($0.2)	($0.2)	($0.6)	$0.0	$0.0
Pre-Tax Income	$3.8	$1.7	$2.4	$0.9	$0.4	$5.4	$6.8	$9.2
Income Taxes Paid	($1.1)	$0.5	$0.7	$0.2	$0.3	$1.7	$1.8	$2.5
Tax Rate	*-28%*	*30%*	*31%*	*28%*	*67%*	*33%*	*27%*	*27%*
Net Income	**$4.9**	**$1.2**	**$1.6**	**$0.6**	**$0.1**	**$3.6**	**$4.9**	**$6.7**
Net Margin	*46%*	*30%*	*39%*	*21%*	*5%*	*26%*	*32%*	*36%*
Reported EPS	**$0.08**	**$0.02**	**$0.02**	**$0.01**	**$0.00**	**$0.05**	**$0.06**	**$0.08**
YOY Growth	*196%*	*-687%*	*128%*	*-46%*	*-97%*	*99%*	*23%*	*36%*
Basic Shares Outstanding	62.7	62.6	62.9	71.8	73.5	67.7	75.5	75.5
Diluted Shares Outstanding	65.2	65.7	66.5	76.6	76.6	71.3	79.5	79.5

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

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HISTORICAL STOCK PRICE

Ceapro Inc. - (TSXV: CZO)



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