TOP IDEA

6/19/2023

Friends of Laughing Water Capital,

As you may recall, my Q1 2023 letter was devoted almost entirely to one stock: Lifecore Biomedical Inc. (LFCR). The crux of the thesis as presented at that time (misplaced bankruptcy risk) has played out through a new debt agreement, and shares have rallied significantly. Yet, **I believe shares still represent an incredibly asymmetric special situation with the potential for making ~150% from here over the next 1-3 months.**

Please see previous writeups for more complete background on the company and recent happenings, but in brief:

1) LFCR is a specialty CDMO with expertise in highly viscous liquids, and fill finish / drug product capabilities (prefilled syringes, vials etc.). Until recently it was paired with a number of unattractive food assets that distracted the market from the quality of the CDMO. The food assets have been divested.
2) In March the company was in technical default of its debt covenants after hitting a speedbump with revenue tied to major customers adjusting their timing at the same time. I am going to quitclaim a defense of this as the simple fact is that CDMOs are great businesses over reasonable periods of time, but they can be lumpy Q to Q. We have to assume that a buyer would put a multiple on normalized EBITDA and look past this one-time stumble because air pockets are part of life in CDMO land.
3) Also in March the company announced a major expansion of business with ~40 year client Alcon AG (ALC).
4) Concurrent with announcing that covenants had been tripped, the company announced a strategic review and likely sales process (that could not be concluded until the debt situation was resolved).

WHERE ARE WE NOW

On May 22nd the company announced that it had entered into a new $150M financing agreement with Alcon that saw existing term loans repaid, a sale lease back of equipment, and a 10 year agreement with Alcon to supply Hyaluronic Acid (HA), which is a super viscous (think like the consistency of Vaseline or peanut butter) excipient that is the base of many of Alcon's drugs. Primary end markets for HA are anything having to do with the eye and joint damage (arthritic knees), meaning that HA demand is set to benefit directly from an aging population.

In my view, this resolution was an absolute homerun as it 1) came with no upfront dilution, while many were thinking that the previous lenders might demand as much as 20% dilution in the form of penny warrants and 2) locked in a very valuable piece of business with a very valuable customer for a decade.

While details of the arrangement have not been made public, my understanding is that the HA business can be 70-80% gross margin, and Alcon did not realize preferred pricing to any great degree. This is because historically Alcon had two suppliers of HA, (LFCR and *unknown*) but *unknown* has had several missteps, and more recently informed Alcon that they would be discontinuing their supply to Alcon within

18 months as they would be redirecting that supply to their own internal needs. Lifecore is the only integrated CDMO that can provide HA fermentation and fill finish, so Alcon basically had nowhere else to go. An additional piece of Alcon business is tied to fill finish of certain Alcon syringes that had historically been dual produced by LFCR and in a Belgian facility that Novartis elected to keep during the 2019 spinoff of Alcon from Novartis. Alcon entered into a CDMO relationship with Novartis at the time of the spin, but that agreement had a tail that is about to run out. As that tail is running out, Alcon has elected to move the entirety of the business to LFCR.

It is unusual to see a pharmaceutical company play investment banker to a supplier, and I think this transaction demonstrates the strategic value of Lifecore's assets. **Essentially, I believe Alcon was between a rock and a hard place, and Lifecore was the only way out.**

With debt concerns in the rearview mirror, the company is now free to fully execute a sale process, which had previously been announced back in March. The whispers are that initial bids are due by the July 4th holiday weekend, and I would expect that everyone would love to put a bow on this before the August doldrums. In recent years, biologic CDMOs have traded hands at high teens to low 20s EBITDA multiples consistently. While LFCR is not *technically* a biologic CDMO because they do not manufacture biologic APIs, basically all biologic drugs are injectable, so LFCR's expertise in injectables makes it a biologic derivative, and deserving of *at least* a comparable multiple. **However, there is strong evidence to suggest that LFCR deserves a significant premium due to tremendous strategic value.**

STRATEGIC VALUE: SUPPLY, DEMAND, COMPLIANCE and CONCENTRATION

Lifecore's strategic value can best be demonstrated by exploring macro-industry trends.

First, with 55% of all drugs in development being injectable, it is estimated that demand for injectable drugs is growing at a 10% CAGR. However, at a 13% CAGR, demand for prefilled syringes is outpacing the demand for injectable drugs.[i] In other words, **not having prefilled syringe capability puts a CDMO at a mathematical disadvantage when it comes to winning new injectable (biologic) business.**

The demand for prefilled syringes can be further illustrated by examining commentary from suppliers of picks and shovels to the CDMO industry. Namely, at the recent Keybanc Capital Markets life sciences conference Eric Green, CEO of West Pharmaceutical Services Inc. (WST) said, "the fastest growing sector is the pre-filled syringe" and "the demand in that area of the business is growing faster than we had really anticipated."

The reason for this demand is simple; any drug is only as good as the patient's compliance. Simply stated, pre-filled syringes make life easier for patients through at home self-administration, which increases compliance. Medical professionals also of course benefit from not having to fill their own syringes, which introduces some element of risk, and takes time.

Second, the trend in basically all non-orally administered drugs is toward increased concentration of drug substance (the active pharmaceutical ingredient). Once again, the reasoning is simple. A low concentration drug needs to be administered intravenously, which means patients sitting around for 4-5 hours at a time with a drip line plugged into their veins. Conversely, a higher concentration drug can be administered subcutaneously in a matter of seconds. Clearly patient quality of life is much higher if they

are able to give themselves a quick jab rather than having to sit around for 4 hours watching re-runs of Seinfeld.

The problem however is that for biologic drugs, as concentration increases linearly, viscosity increases exponentially. In brief, as proteins in solution become more concentrated, they tend to cling to one another, which makes it difficult to force them through a needle.[ii]

Lifecore specializes in ultra-high viscosity drug substance and product. In fact, Lifecore is adept at dealing with pharmaceuticals that are so viscous, one could even argue that their skill set is not relevant in this debate. To quantify, viscosity is measured in centipoise, with water at 20 degrees C being 1 centipoise. On the HA side, Lifecore deals with product that can be as much as 100,000 or 150,000 centipoise (again, think peanut butter). While some would argue this specialized skill set is not relevant to the evolution of biologics from intravenous to subcutaneous, the contra to that argument is that some fill finish CDMOs struggle with biologics that are maybe 100 or 150 centipoise. For LFCR, 100-150 centipoise is a walk in the park. Importantly, LFCR's specialized equipment can be used on 100-150 centipoise drug substance, but standard equipment cannot be used on LFCR's more specialized products. It is also worth noting that only about 50% of LFCR's CDMO business is tied to HA, with the rest presumably being maybe 150 centipoise and below.

To summarize the macro, Lifecore has front row seats to two of the most important trends in biologic drugs 1) prefilled syringes and 2) high viscosity capability. **This makes the asset strategically important, and deserving of a premium multiple.**

PRECEDENT TRANSACTION ANALYSIS & PENDING CAPACITY ADDITIONS

Switching to the micro front, it is worth examining specific transactions from the list of precedent transactions. Arguably the most relevant historic transaction was Catalent Inc.'s (CTLT) 2017 acquisition of Cook Pharmica (private) for $950M ($750M upfront, 4 annual installments of $50M each thereafter). To frame the transaction, lets see what Thomas Catellano, CFO of Catalent had to say about it at the recent Keybank conference:

> *Sterile fill finish has always been a strength of the company, whether you're talking about mRNA, monoclonal antibodies, gene therapies, any of these large molecule modalities, they all essentially end with an injection into a patient. So having vial, syringe cartridge, capability and expertise is a part of the market that we viewed as very attractive and we went after it in an aggressive way in terms of building out capability, and our real entrance into that was in 2017 when we acquired the Cook Pharmica business […]*

The headline multiple on this deal was 17.3x trailing EBITDA, which when applied to a fully diluted LFCR (prefs converted, options, RSUs and 6 months of PIK counted, $20M in debt change of control included in the EV) implies a value of ~$12.00 a share for LFCR using $33,750 in EBITDA (mid point of initial 2023 guidance with my estimate of the portion of corporate expense that is allocated to the segment added back).

This implies about 45% upside likely inside of 2-3 months which by itself is better than a stick in the eye.

However, applying the 17.3x multiple ignores the strategic macro value, which has really only become apparent in the years after the Cook Pharmica transaction, and also ignores the specifics of the Cook Pharmica transaction.

As for those specifics, Cook Pharmica had:

1) 31.6% gross margins
2) 1 year trailing growth of 1.4%
3) Capacity Utilization of 40%
4) 60% of the business was fill finish
5) 40% of the business was drug substance
6) **ZERO additional capacity coming online near term**.[iii]

In contrast, LFCR has:

1) 40% gross margin
2) 1 year trailing growth of 11.5%
3) Capacity utilization of ~45%
4) 79% of the business is fill finish
5) 21% of the business is highly specialized HA fermentation substance
6) **Additional capacity coming on in the next few months that will more than double existing capacity.**[iv]

In other words, in order to think that Cook Pharmica's multiple is relevant to LFCR, you have to believe that:

1) Lifecore's higher gross margins have no value
2) Lifecore's faster organic growth has no value
3) Lifecore's highly specialized HA capability (high viscosity) has no value
4) **Lifecore's doubling of capacity in the near term has no value**

Additional factors that drive high multiples in the space include potential for physical expansion, relationships with blue chip clients that can lead to cross selling opportunities for CDMO platforms, access to skilled labor, and commercial mix.

LFCR scores highly in all of these areas.

Their main facility sits on 29 acres, most of which is unused. A secondary facility is adjacent to 100k square feet of warehouse space that they can expand into / convert. Alcon does ~$750M a year in R&D, meaning cross sell opportunities should be plentiful for a platform CDMO. LFCR is just outside of Minneapolis / St. Paul, also known as "Medical Alley," where the concentration of bio-engineers is 4x the national average.[v] Lastly, with 29 commercial products across 14 clients, LFCR has a high commercial mix, which means reduced impact from the biotech funding cycle. All of these factors contribute to higher multiples when CDMOs trade hands.

Additional factors that could drive a high multiple for LFCR specifically include that there are likely a lot of opportunities for efficiencies to be realized by a platform CDMO. From 2010 until just a few months ago Lifecore was stuck under the Landec umbrella, where it never got 100% of management's focus, and

where it was competing for investment capital with other assets that prior management prioritized. In fact, LFCR did not even have an outbound salesforce until 2022, instead relying on word of mouth. Despite this, revenue CAGR was 15% from 2015-2022, and EBITDA CAGR was 25% over that period.[vi]

As for the non-fill finish piece of the business, I would argue that LFCR's HA substance business is considerably more valuable than Cook Pharmica's drug substance business would have been at the time. First, HA, which is most often used in ocular/cataract applications and joint repair/replacements, is directly tied to the trend of an aging population, which is attractive. Second, while details are not public, a 10 year supply contract to Alcon is likely somewhat annuity like in that it is not subject to the vagaries of the biotech funding cycle, and it likely comes with some sort of minimum guarantee and payments to reserve capacity. Third, Lifecore effectively has a monopoly on the highest grades of HA at this point as they are the only company with integrated capabilities.

More importantly, this new Alcon HA business is not accounted for in the $12.00 per Lifecore share referenced above, as that estimate is based on initial '23 guidance, and this new business was only recently announced. **I believe this business could easily boost LFCR's normalized EBITDA by 25 to 30%.** This is based on commentary from the Company that implies the new piece of business with Alcon would be equivalent to the most important piece of business in company history. Disclosures around historic customer concentration suggest that this business could be worth more than $30M in revenue, which could translate to $8-10M in EBITDA.

In summary, the CTLT Cook transaction happened at a high teens multiple largely because of the opportunity to double Cook's business within their existing capacity. Lifecore also has that potential – and in fact management has stated they believe they can double the business with the existing pipeline (even before new Alcon wins) but **Lifecore also has the potential to double the business once again based on capacity that will be online within months.**

For those who are new to the space, in CDMO land when capacity is added, it is almost always due to direct requests from customers who know their own future needs tied to their own drug development pipeline. This can be illustrated by yet another quote from the recent Keybanc conference, where Pierre-Alain Ruffieux, CEO of Lonza Group AG (LONN.SW), said

> *for large assets, we want to make sure that we have the vast majority of the capacity committed before we build. We never provide an exact figure and it can depend from asset to asset, but its probably in the range of [60-80%].*

Lifecore will be bringing on 2 new filling lines within months that will take their theoretical capacity from 22M to 45M units. Importantly, not only is this new capacity likely mostly spoken for, the lead time to install new filling lines is 3 to 4 years from initial design to FDA approval.

VALUING FUTURE CAPACITY: EYE POPPING MULTIPLES

With current capacity utilization of ~45%, a doubling of existing capacity provides line of sight to a ~4x in revenue. Clearly a buyer of LFCR will ascribe some value to this pending capacity, but how much?

For answers we can look to the October 2021 purchase of LSNE (private) by PCI Pharma Services (private), which happened at 39.5x trailing EBITDA, and perhaps not coincidentally was mentioned as a comp to LFCR in a recent Deal Reporter piece.[vii] The source for the Deal Reporter piece was anonymous, but if you are at all familiar with Deal Reporter, then you know the source was almost certainly someone from LFCR's Board, or one of their bankers, which at the very least tells you they think this transaction is relevant.

LSNE (Lyophilization Services of New England) specializes in (you guessed it!) lyophilization, which is essentially freeze drying the biologic API in order to increase drug shelf life. This is a specialized capability, which perhaps in part explains the eye-popping 39.5x multiple. Interestingly, if you study the industry you will see lyophilization and high viscosity expertise mentioned as strategically important subsectors of the CDMO world.[viii]

While lyophilization is undoubtedly strategically important, industry reports predict demand for lyophilization will CAGR at ~8%, significantly below the expected CAGR for pre-filled syringes.[ix]

The real reason for the 39.5x multiple for LSNE was likely that at the time of the transaction, LSNE had already lined up large additions to their capacity.[x] In other words, the buyer was paying up for capacity which had not yet even arrived because everyone in this industry knows that capacity that has not yet arrived is likely already spoken for. Presumably a buyer with access to the data room would have full knowledge of who would be filling pending capacity.

Clearly 39.5x is an aspirational multiple, but it is also demonstrably within the realm of possibility given the highly strategic nature of LFCR's assets, and the potential to double the trailing business into existing capacity, and then double the business once again into the capacity that will be arriving within a few months. At 39.5x LFCR shares would be worth ~$24 based off of actual 2022 segment EBITDA, or more than $30 based on initial 2023 segment guidance with my estimate of corporate allocated to the segment added back.

Said differently, a buyer of LFCR has a not perfectly clear, but also not totally murky line of sight to approximately $120M in EBITDA. If we give it a Cook Pharmica exit multiple of 17.3x (which is likely conservative given the strategic value here), you are talking about the equivalent of $51 a share, assuming that the acquiror doesn't do anything else smart over the next few years. However, given the physical geography of LFCR's assets and abundant access to skilled labor, a platform CDMO with deep pockets would have ample opportunity to invest additional capital at high rates of return.

For example, adding lyophilization or biologic drug substance capabilities to the existing fill finish capabilities would be a natural fit, and come with high ROIC. To quantify, Lonza Group AG (LONN.SW) has said they expect to achieve ROIC of "30% or more" at peak when considering growth CapEx.[xi]

This is because demand for CDMO capabilities is expected to grow at an 11% CAGR until 2026, while supply is expected to grow at only 7%.[xii] As such, thinking that a PE buyer with an eye toward an exit in a few years paying north of $20 a share today is not at all crazy, especially when you realize that there are several existing PE backed CDMO platforms out there that are looking to add unique capabilities (high viscosity) to their arsenal in order to cross sell to big pharma.

Importantly, this LSNE transaction is not all alone on an island. According to Deal Reporter, the January 2023 purchase of Alcami (private fill finish business) by GHO Capital and The Vistria Group happened at

30x EBITDA. Similar to LSNE, Alcami had additional capacity about to come online at the time of the transaction, suggesting once again that buyers pay up for pending capacity additions.[xiii] Interestingly, Morgan Stanley – who is running the LFCR process – was also the banker for Alcami. Also of note, until about 2 years ago Alcami's CEO, Patrick Walsh, was on the board at Landec (LFCR's previous parent co) and was the Chairman of the Lifecore Innovation Committee. He is certainly familiar with LFCR's assets, so integration risk would be minimal. At 30x this year's initial guidance, LFCR would be worth more than $22.

ANTICIPATED PUSHBACK

Yes, there is additional capex required to fill out existing capacity, and the capacity that will be coming online in the next few months. This was also true for LSNE and Alcami so maybe no adjustments need to be made. But maybe we need to knock the value down from (finger in the air) ~$23 to $21 or something like that. I can live with that.

Yes, this year's EBITDA is a disaster. As stated at the beginning of the writeup, I am not really interested in defending what happened this year, and you have to believe that a buyer will be buying "normalized" EBITDA. If you want to do more work here you can piece together some of the details by checking on the launch of SYFOVRE by Apellis Pharmaceuticals (APLS) which was delayed due to FDA labeling adjustments. The delay impacted LFCR, but all signs now suggest that the launch has gone better than expected, just on a delayed timeline. Another one worth looking into is ZYNRELEF from Heron Therapeutics (HRTX). Management has not confirmed that the recent air pocket is tied to these two drugs, but I am fairly convinced that they are the culprits.

Yes, the multiples I am talking about are very high. That is because I am applying them to trailing and current numbers, as was done in the transactions highlighted above. At 30x this year's initial guidance (with my estimate of corporate expense that is allocated to the segment added back) you get a $23 stock. If the 30x multiple scares you, remember that the reason for the high multiple is that the EBITDA number we are using does not incorporate the recent Alcon win or the 2 new filler lines that will be installed within months. If you want, you can give them credit for that pending growth and then give them a lower multiple. You can even give them credit for completely filling their existing capacity – which I believe is what the recent Deal Reporter piece did - and say that the deal is being marketed on $70M in EBITDA. This still gives them no credit for the fillers that are about to arrive, but a 14x multiple – more befitting of a commoditized small molecule CDMO - gives you a $22 stock. In my view, it is six of one, half dozen of another, and mostly a waste of time to dwell on.

Yes, I realize that this is not 2021, and credit conditions are not as favorable now as they were then. That being said, the Alcami transaction was five months ago, and Baxter (BAX) sold their fill-finish CDMO at 7.1x forward revenue a mere 6 weeks ago. The BAX business historically was a LSD grower, and more recently has been shrinking due to Covid runoff. They did however have capacity additions planned, which once again suggests that buyers will pay up for pending capacity.[xiv] At 7.1x this year's initial revenue guidance LFCR would be worth about $20. It is also worth noting that news reports make it clear that the BAX transaction was competitive, as was the LSNE transaction. There is simply a lot of demand for these types of assets.[xv]

Yes, the public price will likely act as an anchor for any transaction price. I think the way to think about it now is that a price of $8.28 today suggests that the market thinks that a deal will maybe happen at approximately $12.

And maybe it will.

Afterall, ultimately LFCR will be worth what a buyer will pay for it. However, at $8.28 I think Mr. Market is lazily assuming that LFCR will get an average multiple from well publicized public comparable transactions, without digging into the specifics, and without considering the upside scenarios in those transactions that included pending additions to capacity like those illustrated above. If I am wrong on what I believe is tremendous strategic value for these assets, and I am wrong that buyers will pay up for pending capacity as they have done in the past, and we "only" get 45% upside in 3 months, that won't be a terrible outcome.

RISKS

The chief risk of course is that a deal doesn't happen. I view this as very unlikely because:

1) For years I have heard from industry participants that this is a very attractive asset, but no one could buy it because it was attached to an avocado business and a salad business. I have no doubt there will be buyers. The price is of course the question.

2) Board members / activist investors at LFCR represent ~36% of the equity. Among them are Legion Partners and 22NW, two funds that I hold in high regard, and that do not have track records of seeking permanent board seats. Rather, they are in the business of maximizing shareholder value, and then moving on. Cove Street Capital also owns almost 8% of the equity, and examining their public comments on LFCR suggests they are ready to move on.

   There is of course risk that if bids come in low, the board decides not to sell in order to keep the upside for themselves. However, barring a disastrously low bid I believe they would sell even if a premium bid does not materialize. This is because while the debt problem has been resolved for now, the business is still arguably over-levered, the new debt has a 10% PIK that will dilute the equity, and reaching the business's full potential will require additional capital that would be expensive in public markets.

   The fact is that the CDMO M&A market is red hot these days, and if a premium bid does not materialize now, it is unlikely to materialize later, so insiders are likely to hit whatever bid does come in. A premium bid depends on a competitive process, which I believe is likely due to the strategic nature of the assets, recent comparable sales that involved competitive processes, the line of sight to a 4x in revenues over the next few years, and the plethora of CDMO platforms in the market that are seeking to round out their offerings.

3) It also may be worth noting that LFCR is on the R2000 delete list, which may lead to some funky trading near term.

CONCLUSION

In summary, there is a fact-based argument here that LFCR could be worth more than $20 within a few months in a takeout scenario. At $8.28 there is a legitimate chance for 100%, 150%, or even 200% upside in the very near term, with very little chance of losing money. Setups like these do not come around every day, and in my view, it would be a mistake for us to not take a big swing at this very fat pitch. I would be remiss if I didn't note the reflexivity here as well. The higher that shares trade now pre-deal, the less of an anchor they are, which increases the odds of a fantastic outcome.

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[i] Public filings, Lifecore investor presentation, Lifecore conference calls
[ii] For more: https://www.coriolis-pharma.com/about-us/publications/high-concentration-protein-formulation-challenges-and-solutions
[iii] Public filings, Catalent conference calls. Note that disclosure on trailing revenue growth is limited to trailing 6m over 6m
[iviv] Public filings, Lifecore conference calls
[v] https://drug-dev.com/executive-interview-lifecore-biomedical-emerging-from-under-the-radar/
[vi] Company presentation
[vii] Deal Reporter is paywalled, and https://www.bourne-partners.com/wp-content/uploads/2021/10/PCI-LSNE-Deal-Profile.pdf
[viii] https://www.biopharminternational.com/view/focus-on-fill-and-finish
[ix] https://www.emergentcdmo.com/lyophilization-development
[x] https://www.lyophilization.com/news/lsne-expands-vial-fill-finish-and-lyophilization-operations-with-new-automated-fill-line/ expected completion: Q3 2021
https://www.lyophilization.com/news/lsne-expands-vial-filling-and-lyophilization-capacity-with-isolator-technology/ expected completion: 2H 2021
[xi] FY 2022 Lonza Group earnings call
[xii] BIOTRAK database
[xiii] https://www.prnewswire.com/news-releases/alcami-completes-cgmp-biostorage-expansion-in-new-hampshire-301806942.html
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[xiv] https://www.briefing.com/in-depth-analysis/content/article?ArticleId=IN20211111090755BAX
[xv] https://www.fiercepharma.com/manufacturing/baxter-attracts-thermo-fisher-celltrion-potential-buyer-biopharma-contracting
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