thebigpicture

guideposts for the private investor

Week Commencing 25 August 2003

Biotechs: Boom Or Malaise?

With around 80 companies listed on the Australian stock market making a bid for medical history, investor excitement should be running high. However, the experience of Australian biotech companies is a sobering mixture of failure, disappointed promise and, at best, modest accomplishment. They have been too small, too far away and too poorly funded. The vultures are now circling.

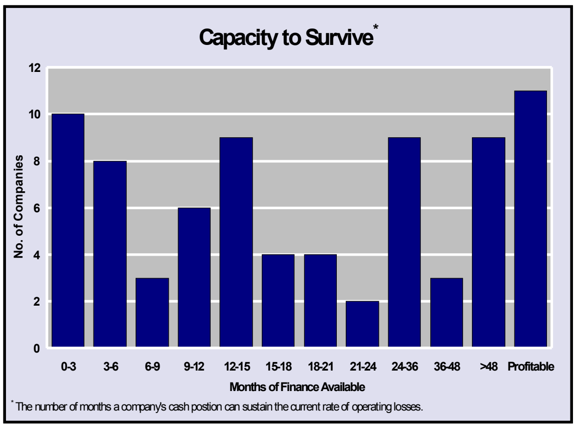
Whether they are seeking cures for specific diseases, undertaking research with more general applicability or developing techniques for making existing drugs more efficacious, the typical Australian biotech company usually has to proceed through six steps on the path to commercial success:

- establishing a relationship with an internationally recognized research institute through which fundamental research can be undertaken (or taking the more costly route of establishing an internal facility);
- funding research to prove an underlying business proposition
- persuading international pharmaceutical companies of the commercial merits of a product;
- establishing a joint venture or partnership of some form to gain access to markets in north America or Europe;
- gaining the various regulatory approvals in the respective market; and,
- obtaining a positive response from medical professionals or patients who must use the new drug or procedure.

"…. Australian investors are confronted with an array of biotech companies at similar stages in their corporate life cycles making losses and having only limited financial capacity to carry on."

Each of these steps is a substantial hurdle in its own right and the budding pharmaceutical major can fall at any of them. Biota Limited, one of the earliest and most celebrated of the Australian biotech investments, is a case study of a company making it all the way to the sixth before falling and having to redefine its business to stay alive.

Having such an array of potentially killer milestones emphasizes how risky the course can be for potential investors. Certainly, the returns can be great. The elusive cure for cancer could be a bonanza. There could be share price increases the likes of which might never have been seen before. But which of the 80 companies will be the one? How much money will be lost waiting for it to happen?



In taking a decision to buy into biotech, investors need to recognize where in this six stage development chain a company is currently positioned to be able to assess the risks and, importantly, how long before

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Publishing and Subscription Information

thebigpicture guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

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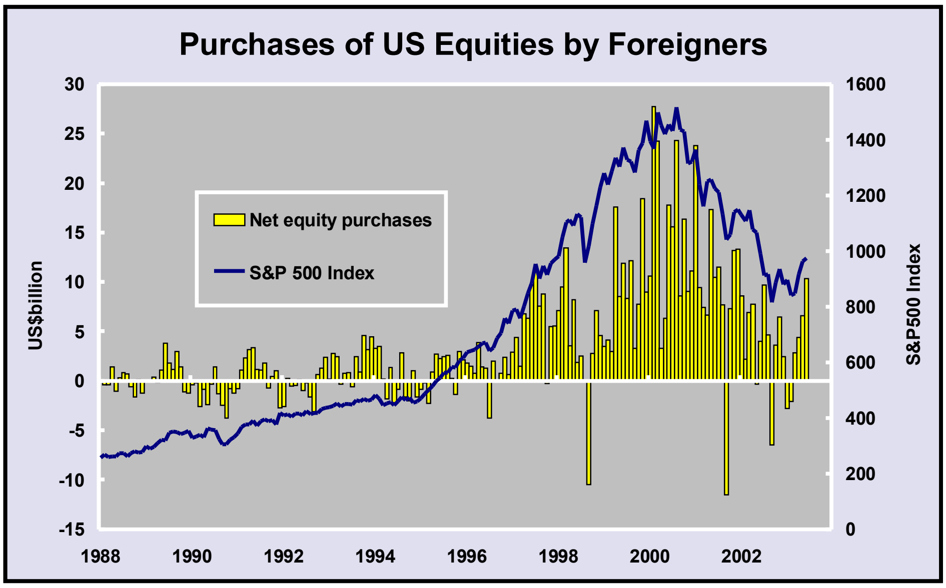
thebigpicture Economics
ABN 71 040 787 936
PO Box 333, Malvern
Vic 3144

The Weekly Chart Spot



Sources: US Department of the Treasury & Standard and Poors

A buoyant US equity market normally requires continuing support from foreign equity investors. Corporate profit growth and relatively attractive valuations are important fundamental underpinnings for a rising market but the upside pressure is usually sustained with the help of a strengthening flow of funds from overseas. A stronger market in turn will also attract additional capital to help sustain the momentum.

The strength of the market during the 1990s was greatly assisted by the interest in the US market from non-residents, as the chart helps to illustrate.

The most recent Treasury data (to June 2003) show a clear turn in demand for US equities from offshore through the second quarter of 2003 coinciding with firmer market conditions

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The aim of listing was to facilitate regular visits to the capital markets to ensure adequate funding. Listing is now a considerable burden for a company with little or no revenue and cash resources diminishing rapidly.

The Australian biotech predicament is being recognized more widely. There are investment funds now being gathered to take advantage of the malaise. They will seek to take listed companies off the public register or combine them into larger entities.

In this way, the financial burden of being a public company could be reduced. Larger combinations should also make it less costly to undertake market development activity in North America. There should be some economies of scale from reducing the duplication of activities among Australian companies seeking access to the relatively small number of channels to market in the USA.

This will be no windfall for existing investors. New investors will not always be looking for bargains but they will be seeking to pay prices realistically reflecting both the risks and the potential of what they are buying.

What value should be attributed today to a loss making company with funding for less than 12 months even if it might be able to demonstrate a cure for cancer in ten years if given the chance to survive? Arguably, there is a level of optimism already attached to many of these investments limiting further upside in the event that there is a takeover attempt. Alternatively, where new funding is provided based on more realistic valuations, existing shareholders will be diluted.

Like so many risky but grand investment plans, those first in are often the least likely to benefit. The second or third generation of investors are likely to be the ones to whom the greatest rewards accrue.

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any income might flow.

A company at the very earliest stages could easily have ten years ahead of it before it can take a product to market. Over such a period, an investor with $1000 could nearly triple his money investing in an industrial company fund with an annual yield of 4% and even a relatively modest (by historical standards) annual capital appreciation of 7%. That is the opportunity cost.

The alternative might be to put the $1000 into five biotech companies to spread the risk. At least four of these will probably fail. The single winner would have to show a fifteenfold increase in value simply to cover the opportunity cost of the industrial company investment.

For Australian companies, some of the challenges are especially daunting. Almost universally, the biotech must commercialize its products in the USA. This is the world's largest market. Despite attempts to dress itself up otherwise, Europe is still far too fragmented to be considered in the same category.

The USA is also the heart of the international pharmaceutical industry which can control access to the medical professionals who need to be persuaded to adopt an innovative technique or drug. The US regulatory environment sets the benchmark internationally.

Consequently, many Australian companies have decided to establish parallel business organizations in the USA. Some have also been tempted by the value attributed to US-based companies in similar sectors and have sought listings on foreign stock exchanges to achieve similar ratings. This has required additional overseas-based personnel and advisers.

For Australian companies this challenge has been made worse, until recently, by a depreciating currency. Even though the Australian dollar might have found new strength, the currency risk will remain significant for the foreseeable future.

Australian investors have been criticized for their indifference to the development of local early stage companies. This is only partly valid. Many smaller Australian companies have failed to get additional capital backing after an IPO and, in some cases, have gone to offshore investors for funding which was not available in Australia. However, the apparent lack of support has often reflected disappointment among local investors over companies failing to achieve their initial goals.

In fact, there is ample evidence that many Australian biotech companies came to the market too early and that Australian investors were too generous in their support, underestimating the risks and the lengthy periods involved before a return could be foreseen.

Consequently, Australian investors are confronted with an array of biotech companies at similar stages in their corporate life cycles making losses and having only limited financial capacity to carry on.

thebigpicture has identified 78 listed companies falling into the biotech category. Their average market capitalisation is $68 million. In the last full year for which they have reported, their average net loss before abnormal charges was $3.8 million and, on average, each had cash available to fund the business of $7.1 million.

Their financial capacity is illustrated in the chart on page one. Over one quarter had the financial resources to survive less than 12 months at this rate of loss. For this group, action was needed urgently to achieve some combination of:

- revenue from product sales;
- lower salary or development costs;
- up-front payments from a commercial partner;
- a new strategic equity investor; or,
- a capital raising from smaller investors.

Many would be working at all of these levels to stave off the prospect of an early demise. Another 40% would have been able to sustain this operating performance for up to 24 months. For them, the pressure was hardly less intense.

The costs of running a public company can be a considerable burden. At least $300,000 a year is needed to cope with the accounting and regulatory measures associated with a public listing. Increasingly strict governance requirements are adding costs and making life more difficult for the small listed company battling to conform.

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NO MORE EARNINGS SURPRISES?

Companies, not analysts, are now responsible for profit forecasts. This is one of the significant changes to occur as the reporting and disclosure regime has evolved in recent years. The change implies fewer surprises as companies release their profit reports.

Until very recently, analysts made forecasts of company profits a year or two ahead based on their views about the industry, the company's situation and broad guidance about objectives by management. Generally, management offered little comment on specific profit forecasts. Some companies offered no guidance on the likely profit outcomes while others confirmed only very general objectives for the immediate future.

A forecast was the responsibility of the analyst making it. There could be a wide range of forecasts in the market at any point in time. The reputations of the more highly skilled analysts would be made through their superior forecasting records.

More active policing of the continuous disclosure regime has meant a greater burden on company management. Where they have provided guidance, there is an ongoing obligation to keep it up to date. Where they have not provided earnings guidance and forecasts gain currency in the markets, they may be forced to comment if they have information which suggests that the forecasts are not likely to be realized.

These obligations are making the analyst's role as forecaster redundant and forcing companies to make ever greater efforts to keep the market informed about likely trends in profitability.

Ernst and Young, the international accounting firm, has recorded 117 profit warnings by companies in the six months to June 2003. This was 52% more than the 77 warnings which were made in the prior six months and 33% higher than the 88 warnings which were made in the second half of 2001/02.

Some of the warnings arose from changed conditions associated with the war in Iraq and the outbreak of SARS in Asia. However, business conditions over this last six month period were not so much weaker than they had been a year earlier. Also, given global uncertainties, most companies had been offering relatively sober and cautious assessments of their outlooks for at least the past year.

The upsurge in public comment reflects companies being engaged more actively in managing their profit expectations in line with evolving disclosure practices including the need to make any comment about profitability public. The closed conversation or confidential e-mail which might have once sufficed is no longer acceptable.

This more conservative approach ought to ensure fewer surprises when results are finally released.

Progressive release of profit outcomes through updates as information becomes available is likely to remove some of the significance of the formal profit release to the stock exchange. At the same time, the accompanying analysis and discussion from management is likely to assume greater importance.

The discussion of likely conditions in the period ahead should now be viewed by analysts and investors as one of the more important public statements by a company.

From a company's perspective more effort will have to go into crafting these words to ensure that they represent accurately how the company is likely to perform given all the available information.

From an investor's perspective, an explicit profit forecast range would signal management's own relative certainty about business conditions. The working assumption for investors will have to be that the blander and more generic the outlook statement, the greater the investment risk.

Investors should also look for a meaningful discussion of the risks to a forecast. An investor-friendly company will identify any key milestones (including required new business contracts) necessary for realization of the forecast.

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