

thebigpicture

guideposts for the private investor

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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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MARKET TITILLATION OR PROPER DISCLOSURE?

Stricter reporting standards should apply to announcements from early stage technology companies. For disclosure rules to be effective, firmer guidelines about what constitutes sound market communication need to be in place.

The recent share price fluctuations of Biota Limited displayed starkly the risks for investors trying to make judgements about the direction and performance of technology companies when the information flow is incomplete or hard to assess.

During the late 1990s, many companies were listed on the ASX whose core businesses were dependent on little known emerging technologies. Some were concerned with developing and selling information technologies. Others were involved in the emerging biotechnology fields.

These companies faced the same risks, including securing adequate funding, as any early stage business. They were also at risk because they were engaged with unproven products sometimes barely past advanced research, having to develop international markets from the inception of the business and gain regulatory approvals overseas.

Often, too, the people managing the companies had little experience at these tasks. Nonetheless, they were backed because, if successful, the rewards might be financially staggering. That was the hope.

For the investor, technology stocks hold two further risks, whatever their financial performance. Firstly, how to react to a piece of information is often unclear. The nature of the information disclosed can be so obscure that there is no basis for deciding without an appropriate doctoral degree what might be a nugget and what might be dross.

The second is that company executives are often working very hard to get their businesses noticed by the broader market. Confronted with an opportunity to highlight progress prematurely they are loath to let it pass lest they are criticised by their shareholders or fail to get another chance at publicity.

Among *thebigpicture*'s guideposts to companies communicating badly is a failure to:

- quantify the impact of discoveries or regulatory approvals when announcing them
- distinguish the exact nature of an approval, including qualifications and necessary next steps in commercialisation
- clarify timing for products to reach market
- identify capital requirements consistent with the business plan
- advise the market *in an equally prominent fashion* of tactical or strategic changes to the business plan which have been the subject of previous announcements
- co-ordinate announcements with government and research centres having a commercial interest in the technology to ensure that they conform to acceptable market standards

Some of these failures arise from neglect and executive inexperience, some from excessive executive enthusiasm and some might be deliberate decisions to titillate. All, however,

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THE WEEKLY CHART SPOT



Sources: US Department of Labor, International Monetary Fund and *thebigpicture* Economics

The gold price has been poor protection against inflation during most of the past 20 years. After an inflation induced frenzy in the 1970s, inflation adjusted gold prices have been trending down toward the values which prevailed in the 1960s. Since the beginning of 2002, the inflation adjusted price has been rising again but not by so much to make the chart suggest a permanent change in direction.

“Establishing guidelines for everyone to follow would go some way to preventing poorly informed markets. As in the case of the mining industry, standardised reporting would allow more ready comparison with peers and perhaps allow relative valuations by analysts based on progress toward meeting approval criteria.”

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ever, disadvantage investors.

The Biota experience has elements of all of these. It is a well-known company which could not deliver on its initial promise of a treatment for influenza. Many of its shareholders had become disaffected and the company had to adjust its business focus, change its management and, more recently, adapt to criticisms about its cash holdings by seeking to participate in merger activity with many of the small biotechnology companies struggling for funding. Consequently, it is unusually prone to speculative interest.

The Biota share price had traded between 51 and 59 cents during the first part of February, a fraction of its \$9 peak price in February 1999.

On 20 February, the CSIRO issued a statement saying that anti-flu products based on its research would be effective against the H5N1 avian influenza strain in the event that it was transferred to humans. This was topical after outbreaks had been reported in several Asian countries, mass slaughtering of birds and, after the SARS experience, anxiety about a global epi-

demic if the spreading incidence of the flu caused it to cross from birds to people.

The CSIRO referred to Relenza as one specific brand which could be used. Biota has the commercial rights to Relenza.

In the immediate aftermath of the announcement, the Biota share price rose by 149%. The stock turnover was equivalent to an extraordinary 122 per cent of the company's outstanding shares in the 11 days after the announcement was made.

Interestingly, the company itself simply drew the attention of the market to the CSIRO statement without comment although a spokesperson was reported in the press as saying that the connection with avian influenza had been made public nearly a year before. The motivation for the repetition was, therefore, unclear.

At the time of writing, the Biota share price had returned to within 35 per cent of where it had been prior to the CSIRO intervention. The shares purchased at the peak of the market had lost half of their value.

thebigpicture hastens to point out that this

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is not a criticism of Biota's management. It is probably a victim whose already scarred credibility would have been done no good. The announcement promoting the frenzy was apparently initiated by a government body and not by the company.

The Biota predicament was further complicated by it not having marketing control of Relenza which had been ceded to a multinational pharmaceutical company as part of a commercial agreement. Whether or not the CSIRO discovery could be applied in the way it was advertising seemed to be entirely in the hands of a third party, not an uncommon situation where companies use international marketing partners.

The Biota experience is an egregious example of information coming to the market without adequate quantification of the impact on the company. Nor was there any description of what would be required before the company might be able to realise the potential which was being highlighted. It is also an example of how non-company interests can become involved in communications with the market.

At the other end of the reporting spectrum in Australia is the mining industry. Strange as it may sound today, this was once the speculative and highly risky end of the Australian stock market. Since they accounted for over a third of the market's capitalisation, mining companies were required to adopt a more rigorous reporting regime than industrial companies in the interests of investors and the reputation of the overall Australian market.

One difference with the miners is that Australian technology stocks are of little interest to international investors. When resource stocks were the principal reason overseas investors were interested in the Australian market the imperative to act to protect the integrity of the market was greater than it is today.

Nonetheless, the reporting regime for the miners might be the model for early stage technology companies. Quarterly production reports, exploration statements and strict guidelines for reporting resource positions have all helped to give resource investors an abundance of timely information and a base from which analysts can make judgements about performance and value.

Different indicators will be required but similarly prescriptive reporting might be necessary to ensure sound information flows into the market about early stage technology stocks.

In this context, the quality of the information disclosed and the way it is presented is just as important in terms of its market impact as the information itself. As anyone associated with the Biota episode could attest, the market was being informed.

thebigpicture has found without searching too hard some further illustrations of market titillation and cites them without any judgement as to whether they are deliberately misleading or made simply because companies lack the resources to craft their written announcements more carefully.

One example in the past month was from Senetas Limited, a company providing IT services and products to business and government. Senetas announced that one of its subsidiaries had entered an agreement to sell an undisclosed quantity of an innovative leading edge security product to an unidentified customer.

The statement was replete with characteristically arcane technical language. The tenor of the statement was that the agreement would have a transforming effect on its financial performance.

When it came to saying by how much, however, the most we were told was that the initial Australian sale was "the start of substantial international Sales". Investors were left to guess the meaning of the word substantial for a company claiming to have annual revenues of \$20 million.

Another area of sloppy information quality control is often found in references to capital raisings particularly where shareholder purchase plans are involved. The latter are uncertain in their capital raising effects because the decision to subscribe can depend on share price movements during the offer period.

For example, if the offer price has been set before the offer period and the share price rises strongly, the take-up is likely to be high. There are cases, however, where the share price has fallen during the offer period and the take-up rate has been very low.

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Virax Limited, an early stage biotech company, announced in February 2002, for example, that "anticipated revenue from the SPP is \$2.4 million" from an issue of shares at 60 cents. There was no hint of a risk of a shortfall.

Taken at face value, the capital raising would have provided significant additional security for the company. Its most recent balance sheet had shown only \$2.2 million in cash available to fund its activities and it had used \$1.5 million in the prior half year. Access to such funds at a difficult time for the market would have been a positive influence.

For companies of this size, a share purchase plan can be far more strategic than for a large company simply using it as an investor relations tool for its small private investors. And yet the rules for both are the same.

There was no equivalently prominent announcement of the results of the Virax raising which was scheduled to close on 5 March 2002 except that deep in the notes to its half year accounts released on 8 March was the information that "the offer closed on 05/03/2002 and raised \$413,000".

There was no mention of any 80% shortfall. Nor was there any mention of the implications for business performance of falling so far short.

Another example of market titillation is the use of the foreign listing to support interest in a stock. Occasionally, a company will announce that Australian investors have failed to understand or take an interest in what it is doing and that it will seek to list its shares on an offshore exchange to attract a broader spread of (presumably more astute) investors. The US NASDAQ market has been a favourite but the occasional European listing has also been foreshadowed.

This sort of statement hints at the company being undervalued, without saying by how much, and implies a remedy once the offshore listing is in place. The announcement effect is designed to be a positive influence on the share price.

There is no evidence of companies being better off with an offshore listing. There is, however, ample evidence of Australian companies being neglected because of inferior financial performance. Moreover, companies that have foreshadowed an offshore listing have often failed to follow through within a reasonable time period (or ever). More importantly, in these cases, there has usually been no statement as to why a previously significant step is no longer thought necessary.

Another form of market titillation is to announce an ambitious market development programme for which there are insufficient financial resources within the company at the time and no investor commitments to provide the funding.

One company admitted to shareholders at its annual general meeting in December 2002 that it would need to raise the equivalent of 25% of its then market capitalisation to be able to put its plans into action but made no separate announcement to this effect to the market.

It did, however, make six separate announcements about patent approvals subsequently and four about offshore listing of its shares.

The ASX is reported to be studying ways biotechnology companies should report the progress of their drug approvals especially within the US staged-approval system.

Establishing guidelines for everyone to follow would go some way to preventing poorly informed markets. As in the case of the mining industry, standardised reporting would allow more ready comparison with peers and perhaps allow relative valuations by analysts based on progress toward meeting approval criteria.

However, the propensity for market titillation extends beyond early stage drug developers. Certainly, there are rules about disclosure but the culture and resources are so different between a top 10 company and a company capitalised at \$50 million, for example, that the nature of the communications with the market are also very different. And yet investors can lose their money on either.

"Another form of market titillation is to announce an ambitious development programme for which there are insufficient financial resources within the company at the time and no investor commitments to provide the funding."