Portfolio

Biotech minnows can be good medicine

Gabriella Hold

The lack of earnings from minnow biotechs means that many fund managers and longer-term investors tend to steer clear of the smaller end of the sector.

As many of these companies are also trialling drugs that can be years away from commercialisation, there's a fair bit of "blue sky" promise on the bottom line – earnings can be long-dated and may not even eventuate. As one analyst deftly put it: "We don't cover them because we like companies that make money."

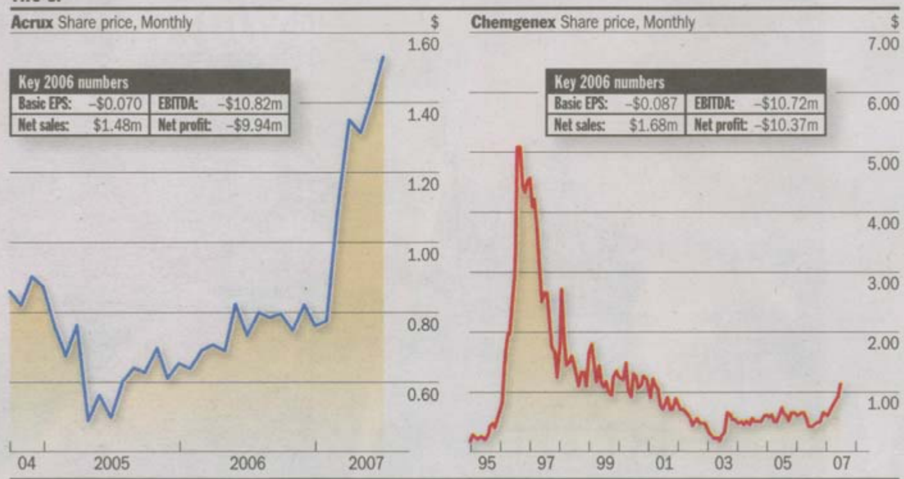
At the same time, a red flag to many managers out there is the high risk profile at the smaller end of town. When earnings eventuate, they can be great, but at the same time, a surprise on the downside in terms of trial success can't often be forecast.

Take the example of Metabolic Pharmaceuticals, whose shares plunged by 75 per cent in late February on news that its cornerstone obesity drug had failed its latest trials and the entire project was terminated. Meanwhile, shares in Avexa gained around 43 per cent about a month later when it announced it was raising $75 million to fund its HIV drug.

Craig Miller, a portfolio manager at Smallco who specialises in small cap investments, says his firm shies away from the biotech minnows because of their lack of a track record.

"You tend to find with the biotechs that they have no track record or cashflow," he says. "They're a bit of a concept stock until they actually deliver and in saying that, they then tend to go and look for 'the next big thing'. You tend to find that it is all or nothing with these guys – it's either downpour or drought."

TWO-UP



Source: Bloomberg

But ABN Amro Morgans analyst Tanya Solomon says value can be found in the sector if you look for those companies in the later stages of development that are well-funded, with outstanding management teams. They should also have a clear path to market with significant development opportunities, she says.

Another key point she raises is that investors should focus on these companies' potential future earnings and cash positions – not on their current lack of earnings capacity.

One of her top picks is **Chemgenex** – a company with projects in cancer, diabetes and obesity. She has a "buy" rating on the stock, with a $1.36 target price and considers it to be one of the Tier-1 players at the smaller end of the market. A key reason behind her positive view is the company's strong pipeline of cancer drugs, solid clinical trial record, as well as its good cash position, with the company having around $25 million to $30 million in cash after completing a $21 million capital raising earlier this year.

Also positive for the company is that it is in registration-directed trials for its lead cancer compound, Ceflatonin, to support its filing of a new drug application with the US Food and Drug Administration. Ceflatonin is used to treat chronic myeloid leukemia patients who have developed resistance to current leukaemia treatments.

Ms Solomon expects Chemgenex to file for FDA registration in the first half of calendar year 2008.

"That will be very positive news for the stock and will be a key milestone to focus on," she says.

EG Capital senior research analyst David Fox likes the look of **Acrux**, whose speciality is its technology to administer drugs through the skin, which it is applying to a number of existing treatments. He says although Acrux shares have appreciated strongly – hitting a record $1.74 earlier this month – this is warranted considering that within three to four years, the company will potentially have half a dozen products on the market.

And given that it is using its delivery technology on established drugs, the development time and cost is significantly less, he says.

One area of "very strong potential" for the group is EvaMist, an estrogen replacement for menopausal women, which the US Food and Drug Administration is reviewing for marketing approval. Fox says a positive is that Acrux already has a distributor in the US market – KV Pharmaceuticals – that will manufacture, market and sell EvaMist there.

"Which means that it will be a rare Australian biotech with a product on the market," he says. "We believe that because of Acrux's delivery technology, it has a very strong potential to capture a significant percentage of the market."

He believes the company will be cashflow-positive in the not too distant future, noting that it has been conservative with its expenditure and has a low-risk business development strategy: focusing on established drugs, it avoids "the major pitfalls of drug development: safety and efficacy".

"What they have to do is demonstrate that their delivery mechanism actually allows the drug to be delivered effectively and the payoffs can be significant," he says.