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This Week's Top Articles

- **Dick Smith prospectus failed to disclose** *Roger Montgomery*
- **Australian shares OK if you avoided banks and miners** *Ashley Owen*
- **Global credit valuations: are we there yet?** *Tony Adams*
- **Value in Australian hybrids: are we there yet?** *Jonathan Rochford*
- **Oh dear, not another glitch with borrowing in SMSFs** *Stephen Lawrence*
- **Trends and themes in global pharmaceuticals stocks** *Justin Braitling*

Dick Smith prospectus failed to disclose

Roger Montgomery

We have watched from the sidelines, with interest, the commentary surrounding the collapse of Dick Smith (ASX:DSH).

Having eschewed the float for our investors we refrained from commenting before and immediately after the company's very public downfall.

More recently, a public spat emerged between two commentators, both of whom we respect enormously. While it's never a great idea to have an argument with someone who buys their ink in bulk, our friends Steve Johnson at Forager Funds and Tony Boyd at *The Australian Financial Review* (AFR) locked horns over who might have been at fault for the demise of Dick Smith.

And since, according to Tony, the collapse of Dick Smith will now be the subject of a Senate Inquiry, it is worth highlighting what we currently believe to be the three major issues that Dick Smith's collapse raises for investors.

Pierpont, in the AFR on 5 February 2016 wrote: *"The DSH accounts showed inventory at November 25, 2012 at $370 million. On the following day, November 26, the inventory was written down $58 million to $312 million.*

The writedown would have written down any premium on consolidation by the same amount, but on the flip side it gave Anchorage a $58 million start on the next profit and loss account. That write-down was not mentioned in the DSH prospectus although Pierpont would have thought it material information.

It was not even mentioned in the meagre report by Deloitte as investigating accountants. All Deloitte said was that they had read the previous annual reports of DSH and they seemed to have complied with the law."

We believe Pierpont has a point. Deloitte fulfilled its obligations under the law, the prospectus fulfilled its obligations and Anchorage complied too. But what if complying with the law was not enough to properly inform investors? Could it be that the law is deficient?

The role of disclosure

The Australian Corporations Act contains a general disclosure test for prospectuses. It requires that a prospectus must contain all the information that investors and their professional advisers would reasonably require to make an informed assessment about the prospects of the share issuer.

Therefore, protection for investors is offered under the regime of disclosure. If everyone is fulfilling their obligations under the law and the law enshrines a regime of general disclosure, then clearly it is the regime that is the source of investor pain.

Fund managers frequently explain to their investors, sometimes in jest, that it is productive to read prospectuses from back to front. Any distasteful elements are obfuscated at the back. That professional fund managers must do this in order to properly assess a prospectus suggests the current regime of disclosure has been corrupted.

But because there are conflicts, it might be argued that change won't happen for two reasons:

a) our government is sympathetic to big business and their role in employment generation, and

b) companies need a well lubricated, liquid and efficient market through which to raise capital.

I forecast little tangible benefit for investors will come from a Senate Inquiry that does not examine the regime itself.

The role of the auditors

Retail investors believe that what they read in a prospectus is sacrosanct. Perhaps more shocking is that less sophisticated investors believe the mere issue of a prospectus renders the offer as 'investment grade'.

I suspect few retail investors read the auditor's opinion that accompanies the financial information included in a prospectus.

A hypothetical auditor is only required to state that the hypothetical prospectus complies with the law. However, this may be at a time (such as during the fund-raising period, when not all information about the historical performance of the 'business' is always available) coinciding with the omission or obfuscation of meaningful financial information. When this happens, both the auditor and the law are rendered useless by the regime itself.

The role of timing of information release

The final point that the DSH collapse raises for this investor is the timing of the release of historical information. Prospectuses are relatively selective about the information that is revealed about a company's historical trading performance and balance sheet changes. It's particularly irksome that historical revenue and EBITDA numbers are often provided in the table of historical financial performance but not the more granular numbers. If they are, they are heavily-modified, normalised and adjusted so as to bear no resemblance to the tax returns the then owner of the business (as opposed to the listing company) sent off to the Tax Office.

At the time investors were asked to invest in DSH, it is not clear it was possible to reach the conclusions about the company that other commentators and fund managers have subsequently made about the reasons for the company's collapse. The balance sheet data in the prospectus dated November 2013 only related to June 2013. It is important to note that this is all the disclosure required by ASIC in their regulatory guidance '*Effective disclosure for retail investors'.* Senate Inquiry anyone?

What did the prospectus really say about inventories?

Dick Smith's $149 million inventory valuation as at June 2012, the subsequent jump to $370 million on 25 November 2012, the fall to $312 million on 26 November 2012, and the $168.5 million at June 30, 2013 (this latter figure was reported in historicals provided only on the day of the float, as is required) were not numbers disclosed obviously in the prospectus.

Although Dick Smith was founded in 1968, the prospectus states Dick Smith Holdings was incorporated on 25 October 2013. Changes to ownership and structure, in the few short years prior to listing, will always complicate disclosure, giving the issuers valid reasons for being unable to provide investors with the meaningful information they might argue they require, while simultaneously providing another reason any Senate Inquiry will probably fail in improving the lot of retail investors.

Note No.4 to Table 5.7.1.1 'FY2013 Pro Forma and Statutory Reconciliation' on page 62 of the prospectus, under the heading 'Acquisition and Restructuring Costs' stated (in arguably microscopic font); "… and $2.5 million in costs related to achieving a significant reduction in the inventory balance".

However, there was precious little evidence of the extent of the changes in inventory that have subsequently been cited by other commentators.

And page 53 of Prospectus also stated; "The unaudited income statements for the period from 1 July 2010 to 26 November 2012, which were derived from the unaudited accounting records of DSE, <u>exclude certain items, such as inventory impairment</u> … as these adjustments were not recorded in the DSE unaudited income statements. These items were charged to either the acquisition balance sheet or the impairment loss and restructuring provisions recorded by the previous owner."

Importantly, it could be argued the information pertinent to inventory has now been 'disclosed', even though it is equally arguable that very little was really disclosed.

Disclosure regime needs overhaul

While the furore surrounding DSH's demise may focus on inventory changes and private equity's role, we believe any Senate Inquiry should broaden its scope to include the disclosure regime upon which all laws and regulatory guidances - designed to protect retail investors - are based.

Of course, we don't expect anything will change.

In the meantime, for investors worried they might be duped when examining a prospectus in the future, simply take a look at the Statutory and Pro-Forma Historical Consolidated Balance Sheet. There you will find a business that would list with $33.5 million less cash than the $46 million it started with, $26.5 million of borrowings (where previously there were none), and $40 million less equity than the $156 million it had prior to the float. And all this despite investors 'contributing' equity of $337 million.

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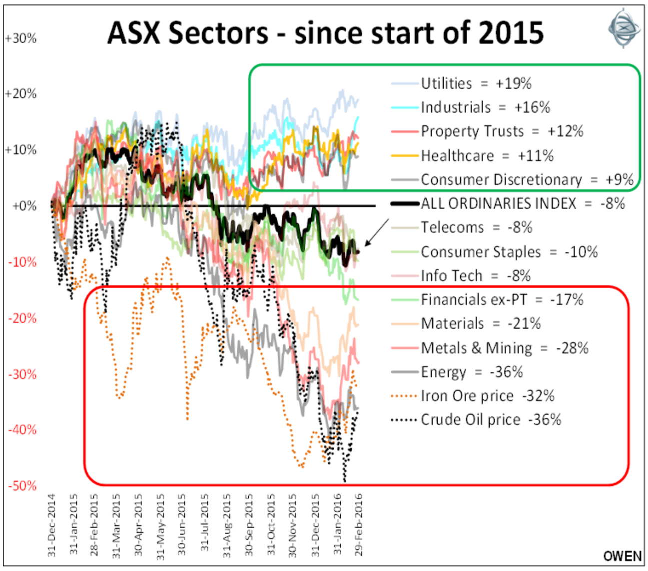
Australian shares OK if you avoided banks and miners

Ashley Owen

Many people see the Australian stock market as little more than banks and miners. They certainly dominated the market index before both sectors were sold off over the past year. The chart shows ASX share price indexes by sector since the start of 2015 (excluding dividends). The overall market has been dragged down by mining/energy sectors and banks ('financials ex-property trusts') languishing at the bottom of the chart but several other sectors are doing well at the top.



Mining and energy stocks have been hit heavily by the collapse in commodities prices. The problem is not lack of demand - the world economy and demand for energy and resources are still growing. The problem is over-supply and excess production from all of the new mines developed during the mining boom. Many are now being closed or written off.

Banks have been hit by rising funding costs as investors demand higher risk premiums when lending to banks. There are fears of a blow-out in bad debts from bank exposures to mining and energy companies as they contract, and also bad debts from a possible bursting of the local housing bubble which is inflated by bank debt. Higher equity capital requirements also reduce future returns on equity from banks.

But outside the two problem sectors other stocks are doing rather well. Traditional 'defensive' sectors of utilities and healthcare are up strongly. Industrials and consumer discretionary stocks are benefiting from lower energy and input prices and the lower dollar, and consumers are spending more as fuel prices fall.

Ashley Owen (BA, LLB, LLM, Grad. Dip. App. Fin, CFA) has been an active investor since the mid-1980s, a senior executive of major global banking & finance groups, and currently advises and UHNW investors and advisory groups in Australia and Asia.

Global credit valuations: are we there yet?

Tony Adams

The credit spreads between government bonds and investment grade bonds have widened significantly since mid-2014, from 1.04% to 1.88% (over 80%), and from 3.42% to 7.26% on high yield credits. The main drivers of spread widening in high yield markets are the impacts of falling oil and commodity prices affecting the energy and mining sectors.

However, for investment grade it is less clear, particularly since fundamentals remain solid overall. The main cause appears to be technical factors and in particular a rising liquidity premium as well as the impact of recent market volatility. Taking all factors together it seems that a reasonable buying opportunity is starting to present itself.

Breakeven and fair value levels attractive

Each of the two main measures of credit valuation we use indicate credit valuations are attractive. We estimate appropriate fair value compensation, the spreads required to compensate for default, volatility and liquidity risk, to be 1.64%. This compares to current spreads on investment grade credit of 1.88%, with the key source of the fair value premium being the reward for current levels of volatility.

Economic conditions are supportive

Global economic growth is moderate and well-balanced: Europe is commencing recovery (from a low base), China is slowing down and the US is growing fairly well. Low or falling growth is negative, but rapid globally synchronised growth is not necessarily altogether positive since synchronised booms are often followed by synchronised busts, and blue sky environments often encourage companies to take unnecessary risks.

While there are increasing risks around a slowdown in emerging markets (especially as the US Federal Reserve starts withdrawing some of the surplus global liquidity), we see little risk of another global recession.

US interest rates on an upward path

The Fed's move in December 2015 confirmed that interest rates are on an upward trajectory, and while further increases depend on economic data remaining positive, it is an indication of improving economic conditions in the US. It is unclear which of the forces will prevail in the short term – the 'tourist money' leaving credit or the 'value money' buying credit – but there is always a risk that spreads could continue to widen further.

Furthermore, while rising interest rates have historically been positive for credit market performance, there is a risk of an increase in the correlation between the two if investors sell all fixed income exposure simultaneously.

Although this has happened to some extent during recent bouts of rising bond yields, on balance we think a measured normalisation of cash rates globally as economic activity improves is positive for credit markets albeit with some pick-up in volatility.

Corporate fundamentals and increasing downgrades

While default risk comprises only a small element of the risk for investment grade companies and this remains very low, the current projection from Standard and Poor's indicates that potential downgrades are rising while potential upgrade rates remain broadly constant. Despite some deterioration over the last quarter, the median default probability is around the same as it was a year ago. Leverage is increasing slightly, but one could argue that this is reasonable at current once-in-a-lifetime low debt costs. Increasing and lengthening debt when rates are this low could be seen as a stabiliser for credit quality going forward, while interest coverage ratios remain healthy.

Liquidity risk presenting opportunities to capture premium

The recent widening in credit spreads is also being driven by investors increasing their desired liquidity compensation. As such, there is an opportunity for investors to capture additional liquidity premium.

Over the last year issuance has outstripped demand as companies have issued a record amount of corporate bonds looking to fund at, what appear to be, very attractive yields.

The reduced liquidity in global credit markets is well-documented. The withdrawal of QE and rising interest rates in the US may precipitate a further liquidity squeeze, increased market volatility and spreads gapping wider as carry trades are unwound. In credit, any such move could be exaggerated as retail investors, who still view fixed income as a low risk asset class, may get shocked by negative absolute returns as interest rates rise and spreads widen. This fear has been reflected in the growing divergence between 'liquid' credit derivatives indexes and the less liquid physical credit indexes, the spread having widened from approximately 0.20% in the middle of 2014 to approximately 0.73% today.

Conclusion

So are we there yet? Credit fundamentals remain fairly strong though we have seen some broad weakening, which, given how far spreads have already widened, suggests that this is already 'in the price'. Economic fundamentals are supportive but not spectacular and valuations look cheap albeit by no means remarkably so – especially with 2009 levels still in our frame of reference – and US rates are rising for essentially the right reasons (lower unemployment and improving growth and economic activity).

Credit is rarely traded purely on technicals. However, at present the market is trending aggressively wider for which reason prudence might argue against fully backing any valuation models while such an aggressive up trend is in place.

The backup in spreads since mid-2014 is now presenting interesting opportunities for investors to start gradually and carefully rebuilding their credit positions, especially for longer-term, patient investors who are looking to capture some liquidity premium in their bond positions

Tony Adams is Head of Global Fixed Income and Credit at [Colonial First State Global Asset Management]. This article is for general education purposes and does not consider the circumstances of any individual investor.

Value in Australian hybrids: are we there yet?

Jonathan Rochford

After the rapid increase in margins on Australian listed hybrids over the last 18 months, many are now asking "are we there yet"? Have we reached a level where there is sufficient return for risk to justify investing? Those who have followed my comments on this area will know that I've consistently recommended selling long maturity debt securities and preference shares in the last two years. The July 2014 article [The Perils of Hybrids] was written at the time of peak pricing levels (ie lowest margins). The average margin over bank bills is now nearly double what it was then. For those tempted to dip into listed hybrids, here are some key points.

Credit is about avoiding losers

One of the mistakes that equity investors often make when thinking about credit investing is forgetting that credit is all about avoiding losers. It's nice for a borrower to have solid growth prospects, but it's not essential. What it must have is a very low probability of deteriorating. Picking seven out of ten winners makes an equity manager successful, but is a huge failure for a credit manager.

For those who have seen the movie *Moneyball*, recall the scene where Brad Pitt is teaching the talent scouts how the new selection process works. He throws out a bunch of names the scouts don't like. The scouts keep asking why he wants these unfashionable players and the answer keeps coming back "because he gets on base". Credit is the same – investors should like credits because they will get their money back under all reasonable scenarios. Simply substitute the baseball statistics of on base percentage and slugging percentage for the key credit statistics of probability of default and loss given default.

Don't ignore the fine details

Whilst many deals can be grouped together as the same security type, there can be subtle but significant differences. For instance, the hybrid, ANZPC, has a maximum exchange percentage (into the ordinary equity of ANZ) of 50% if a regulatory trigger occurs whereas other similar securities have this set at 20%. This means that if APRA orders that ANZ preference shares be converted to ordinary equity, ANZPC holders will get fewer ordinary shares than other ANZ preference shareholders. Conversely, ANZPC has the lowest Volume Weighted Average Price (VWAP) of the ANZ preference shares. This means that if ANZ's share price halved from current levels, all other ANZ preference shares would be blocked from mandatory conversion and would miss their first call dates. ANZPC investors would have a realisation event, when others are stuck without one for an indeterminate period.

Bank capital levels have finally improved

Until last year, many investors mistakenly thought Australian banks were much better capitalised since the financial crisis. Whilst the tier one equity ratios had increased, this was primarily as the equity required to support residential mortgages had decreased. When comparing the amount of tangible equity with the asset base, there was little improvement. This finally changed in 2015, eight years after the credit crisis began.

For Australian major banks, APRA changed two key components on equity levels last year. Firstly, APRA flagged that banks will need to hold higher amounts of capital against their residential property loans. Westpac will be most impacted by this change and recently noted that its tier one capital ratio would drop from 10.2% to 9.1% as a result of this change. Secondly, APRA agreed with the Financial System Inquiry that banks should be in the top 25% globally by capital ratios. This saw a wave of equity raisings last year, with the likelihood that another round may be needed this year. Put together, by 2017, preference shareholders will have a significantly larger slice of equity below them, decreasing both the probability of default and the loss given default.

But the risk of home loans is higher

The [60 Minutes story about Australian residential property] in February 2016 was exaggerated but still a helpful reminder that residential property in Australia is very expensive. Both major political parties are talking about restricting negative gearing and there's even mentions of broad-based land tax and removing some of the discount on capital gains tax. None of this is good news for residential property investors or the banks that have made highly-leveraged, often interest only loans, using foolishly low assumptions of living expenses and interest rates.

The fact that banks were using the Henderson Poverty Index as a cost of living indicator for middle and high income households was completely nuts. Marginal borrowers have received loans higher than they can comfortably support. Stress tests typically assume that lenders mortgage insurance will cover most or all of the losses if unemployment increases and house prices fall. However, if we do have a property bubble then the insurance providers are unlikely to be able to pay all claims.

Listed note holders are usually passengers

Preference shares and long dated debt securities give rights to the Board of the issuing company on whether their payments will be made on time or at all, and when their principal will be repaid. The history of listed notes is that Boards prioritise ordinary shareholders over preference shareholders. Paperlinx and Elders preference shareholders haven't been paid for years, and there's eight other securities that have gone past their call dates. Standard debt securities have the threat of insolvency as the stick to see that their interest and principal is paid on time, whereas most listed notes leave their holders as passengers subject to the discretion of the Board.

Noteholders of Crown have learnt this lesson in the last six months, as James Packer has worked away on a potential 'take-private' transaction. There has been limited disclosure from the Board about whether a deal could happen and what action they might take in regards to the long dated securities if a deal was done. The notes have accordingly traded down, as noteholders have to consider the possibility that they might become a very cheap form of mezzanine debt in a company that could be more highly leveraged that it is now.

Lower margin doesn't mean lower risk

Long term holders of the old style income securities, notably BENHB, MBLHB, NABHA and SBKHB, know the dangers of buying into a security with a low margin. Even if the securities no longer qualify for tier one or tier two capital calculations, they are a cheap form of perpetual debt for the banks. The best outcome could be that that the issuer offers to buy back the securities at premium to the current price but less than the face value or allows for conversion into a new security with better terms. While PCAPA was recently repaid even though their margin was low, there is a small possibility that WCTPA isn't called or that holders need to switch into a new security to get their principal back.

Holders of CBAPD find themselves with an interesting decision. Should they sell out at a loss and buy into the new CBAPE security or stick with what they have? Assuming a clean switch could be completed at a similar margin to call, CBAPE is a superior security. It has a shorter period to the first mandatory conversion date and is likely to have a lower VWAP price. The higher margin received (as opposed to margin to call) means that CBAPE holders will be in a better position if the CBA share price falls and mandatory conversion conditions can't be satisfied.

Summing up

With current average margins of bank bill rate plus 5.0%, close to double the cycle lows of 2014, value is certainly better than it was. Some listed notes I've ignored in the past are now at or close to levels where they could be considered as acceptable additions to a portfolio. However, relative value hasn't improved as much as it might first appear, and I prefer pure debt securities and others with a clear exit mechanism.

Jonathan Rochford is Portfolio Manager at [Narrow Road Capital] and this article expresses the views of the author at a point in time. It is for educational purposes and is not a substitute for professional and tailored financial advice. Narrow Road Capital advises on and invests in a wide range of securities.

Editor's comment on specific hybrids

There are dozens of hybrids listed on the ASX, each with different terms and conditions. For independent ratings on specific hybrids, see updated reports under Ratings & Reports > ASX Debt & Hybrid Research Scheme section on www.australiaratings.com. This website requires registration but no payment.

Oh dear, not another glitch with borrowing in SMSFs

Stephen Lawrence

Could SMSFs lose imputation credits on 100% leveraged share portfolios? Well, it pretty much looks like that is the case.

Before getting into the detail about the most recent issue with Limited Recourse Borrowing Arrangements (LRBAs) and SMSFs, it's worthwhile putting the issue in context.

Borrowing and unintended consequences

LRBAs allow an SMSF to leverage an investment portfolio, real property or listed shares say, which may be acquired using a LRBA. They were permitted to enable superannuation funds to participate in the Telstra sell down because it was structured as an instalment warrant. In other words, investors were loaned part of the purchase price, hence superannuation funds had to be permitted to borrow for them to participate in that sell down, and consequently, LRBAs started.

An unintended consequence of allowing funds to leverage with LRBAs has been that wealthy SMSF members are using LRBAs to get significant amounts of their wealth into their SMSF by simply lending money to their fund for it to acquire assets. That, of course, defeats the purpose of the contribution limits because there is no limit to the amount that can be lent to an SMSF. In effect then, this form of leveraging drives a Mack truck through the contribution rules.

However, that unintended consequence is currently being addressed by the ATO through application of the non-arms-length income rules (NALI), which makes that strategy less appealing because, in order to avoid those provisions, these transactions have to be completed on arm's length terms.

Consequences of '45-day rule'

Nevertheless, another issue with LRBAs has arisen and that is the '45-day rule', which means that in certain circumstances where an SMSF leverages Australian shares it can lose its rights to imputation credits attaching to the dividends received.

The 45-day rule says, in effect, that to be eligible to claim imputation credits, an SMSF trustee must be at least 30% 'at risk' for at least 45 days, where risk is measured using the financial concept of 'delta', which is the percentage change in the price of one security relative to the percentage change in the price of another or to the market as a whole.

However, here is the problem: buying shares under a LRBA necessarily reduces the risk of an SMSF trustee holding those shares. This is because the LRBAs regulations are, in effect, a risk transfer mechanism as they include an effective put option to the lender, limiting the risk of loss to the borrower to the value of the shares on default.

In other words, there is 'limited recourse' to the other assets of the SMSF. The lender only has recourse to the asset against which the loan is made.

The ATO seems to be of the view that where more than 30% of the risk is transferred away from an SMSF trustee, the 45-day rule will not be satisfied and so the SMSF trustee is not entitled to imputation credits. That is, if the borrowed funds under the LRBA represent more than 70% of the purchase of the shares, the trustee does not get the imputation credits.

Yet in ATOID 2015/27 the ATO has said that the loan funds can represent 100% of the purchase price of the shares.

What should be done?

It looks like the ATO is entitled to amend prior year returns of SMSFs who claimed franking credits where the LRBA is more than 70% of the value of the shares, and penalties and interest could apply.

However, it is super fund regulation that forced SMSFs to use a borrowing structure (LRBA) that can, in these circumstances, deny the tax benefit of imputation credits.

It seems reasonable that, because this problem was caused by government regulation, the ATO should cut affected SMSFs some slack. Perhaps they could be given time to restructure the arrangements so that they are not booby trapped in future?

Stephen Lawrence, sessional associate lecturer, with Gordon Mackenzie, Senior Lecturer, [Taxation and Business Law School UNSW](). These views are considered an accurate interpretation of regulations at the time of writing but are not made in the context of any investor's personal circumstances. Readers should obtain professional advice before acting.

Trends and themes in global pharmaceuticals stocks

Justin Braitling

Following a significant re-rating post the GFC, global healthcare shares entered a period of increased volatility in the latter half of 2015. Biotechnology and specialty pharmaceutical shares were key drivers of the post-GFC recovery, but their stellar run came to an end in September when drug pricing and affordability were thrust into the spotlight.

Stock shocks in global healthcare

Hillary Clinton famously accused Turing Pharmaceuticals on Twitter of 'outrageous' price gouging following its decision to raise prices of a 62-year-old drug (Daraprim) to $750 per tablet from $13.50. Her comments sparked a sell-off in biotechnology and specialty pharmaceutical shares. Drug pricing is now an election campaign issue in the US, with some candidates talking of price regulation.

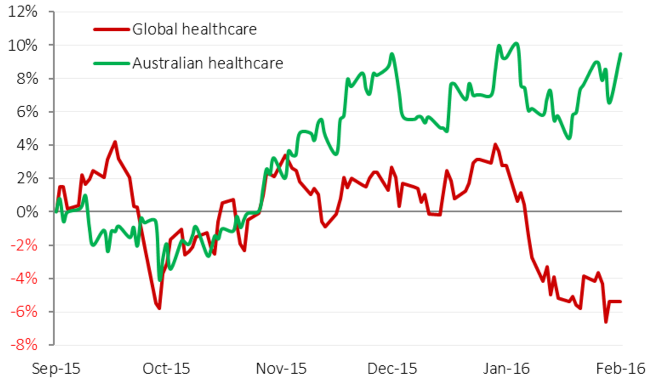
During the same period, the dubious business practices of specialty drug-maker Valeant Pharmaceuticals came under intense public scrutiny, leading to a congressional investigation; Valeant shares have more than halved since. In response, pharmaceutical executives argue that price hikes are rarely realised in full by the manufacturer (with the majority given away through rebates) and reflect the high risk, high costs and long timeframes associated with developing new drugs.

Australian stocks have done better

Interestingly Australian healthcare shares did not react to the same issues (as seen in the chart below), and were driven by more stock-specific factors.

With a large proportion of their earnings derived offshore, the weaker AUD has benefitted domestic healthcare companies. In addition, more money has flowed into the domestic sector, given it is one of the few remaining pockets of growth in our share market. As a result, the domestic sector currently trades at historically high valuations versus offshore peers. However, given Australian healthcare companies face many of the same risks as their international peers, there are arguably better opportunities to invest offshore.

Australian healthcare stocks outperformed global peers



Source: Bloomberg

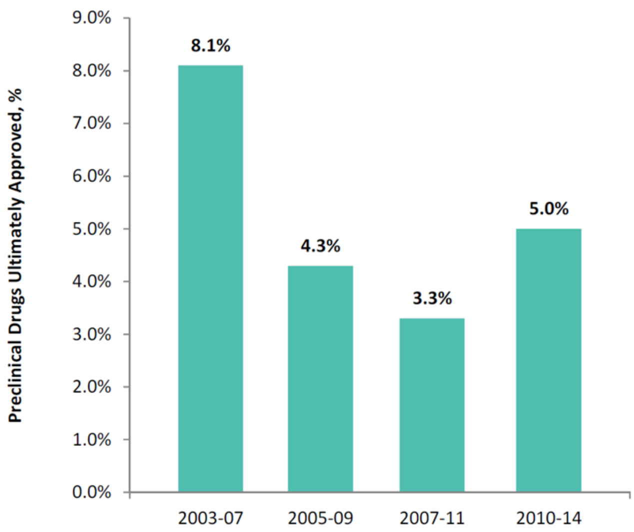
Falling off the patent cliff?

The 'patent cliff' refers to a period between 2003 and 2013, when drug patents that protected many of the highest selling drugs in history from competition expired. The industry reacted by undertaking a wave of M&A deals while also increasing investment in lower risk drug development (such as 'biologics', see below) to diversify their earnings. A period of recovery and improved R&D productivity ensued.

A more subtle driver of the previous cycle was a decline in R&D productivity, which has improved since then through higher investments in lower-risk drug development. The chart below shows that the probability of success in developing new 'small molecule' drugs was in clear decline between 2003 and 2011, meaning companies had to conduct more trials with more drug candidates to gain approval. Recent data shows a reversal of this trend from

2010 to 2014, coinciding with a recovery in pharmaceutical valuations.

Percent of preclinical drugs ultimately approved



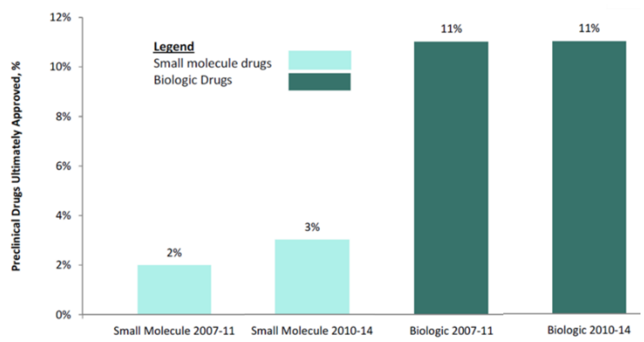
Source: KMR, Bernstein

Why is 'biologics' more promising?

In our view, the more relevant and striking driver of productivity improvement has been the development of a new drug class called biologics. Biologics are commercial products derived from biotechnology, manufactured in a living system such as a microorganism, a plant or an animal.

Data on approval rates shows that biologics carry a dramatically higher likelihood of success in being developed compared to small molecule drugs, and so those companies developing more biologic drugs are more likely to have a greater number of successful products. Small molecule drugs are synthetically produced chemicals where the drug chemistry and structure is known, but often carry less favourable side effects. Biologics on the other hand are treatments made by manipulating naturally occurring systems. Because they mimic naturally occurring pathways in the body and are typically composed of either sugars, proteins, DNA or living tissues, they tend to have less off-target effects with outcomes that are more predictable.

Approval rate for small molecule vs. biologic drugs (%)



Source: KMR, Bernstein

Our focus in looking for suitable investments is on diversified pharmaceutical shares with breadth in treatments for more favourable diseases and weighted to biologics – such as Merck & Co. We will avoid shares that have exposure to the pricing issues highlighted earlier including generic competition – diabetes as an example strikes us as a market that will come under intense pricing and competitive pressures from generics.

Justin Braitling is a portfolio manager at Watermark Funds Management. This article is for educational purposes only and does not consider the circumstances of any investor. For more detail on the global healthcare sector, see the latest edition of The Leading Edge at www.wfunds.com.au