International Biotechnology Trust

International Biotechnology Trust plc

Key Information

INVESTMENT OBJECTIVE

To achieve long-term capital growth by investing in biotechnology and other life sciences companies.

FUND MANAGER/S	Carl Harald Janson, Ailsa Craig, Kate Bingham
Ticker:	IBT
Management Company:	SV Life Sciences
AIC Sector:	Sector Specialist: Biotechnology & Healthcare

Primary Prospectus Benchmark:	NASDAQ Biotechnology TR
Discount (Cum Fair) (%):	-11.14
Price:	534p
Market capitalisation:	£206,981,492
Latest Net Gearing (Cum Fair) (%):	0

Latest Ongoing Charge Ex Perf Fee (%):	1.48
Turnover Ratio (%):	137.3
Shares outstanding:	37,547,663
Net Assets (Cum Fair):	£235,487,000

Source: Morningstar

Trading on a broad discount, we think a resurgent healthcare sector could be good news for shareholders in this trust.

A highly experienced management team with a clear focus on avoiding 'key risk events' which has helped to bring volatility down since they were appointed.

A high quality portfolio, primarily focused on profitable businesses.

Tactical gearing adds the potential for boosted upside in a sector where positive periods are already punchy.

Summary

International Biotechnology Trust aims to deliver geared capital growth over the long term and – as of this year – income, from a diversified portfolio of small, medium and large biotech and life sciences companies, the vast majority of them based in the United States, with a smaller (22%) weighting in Europe.

The trust, with £240m under management as at Monday 14 November, invests primarily in quoted companies but holds around 10% to 15% of its portfolio in unquoted stocks, and is managed by an experienced team led by Carl Harald Janson, who took the reins in 2013.

Carl Harald runs the portfolio with co-managers Kate Bingham and Ailsa Craig. The managers pursue a benchmark aware – but not constrained – stockpicking approach, and place a high degree of emphasis on risk, avoiding 'key risk events' by selling companies as they approach clinical trial outcomes, even if they remain positive on the long term outlook.

As well as announcing plans to build up a stake in unquoted funds, gradually replacing the trust's direct exposure to unquoted companies without changing the overall weight toward unquoted, the trust announced in September that it would, for the first time, be offering a dividend, payable from capital twice a year, which amounts to 4% of NAV – or around 23.1p per share as at 31 August 2016 – the first instalment of which is due in Q1 2017.
Sentiment towards risk-on sectors including technology has been negative this year as investors, buffeted by Brexit and the undignified brawl and surprising result of the US election, have become increasingly nervous. Discounts across the board have widened as a result and biotechnology trusts in particular suffered amid fears of a clampdown on pricing in the event that Clinton won the Oval Office.

Trump's victory raises the possibility that Obamacare will be rolled back, which could have implications for biotech too, but the managers believe that these fears are overblown. Drugs make up a relatively small part of the overall spend in the US health budget, the largest part of which is sucked up by the cost of hospitals and the people who staff them.

All of this, in their view, means biotech stocks – with steady tailwinds from an older, chubbier population – are due for a re-rating upwards and, indeed, biotech trusts ticked sharply up in the immediate aftermath of the result. This demographic support combined with the move to begin paying a dividend which should attract some attention from new investors adds up to a gentle positive pressure on the discount, in our view, though we imagine short-term volatility here and everywhere else will remain a feature.

International Biotechnology currently trades on a discount of -10.4%, close to its average for the last twelve months (-12.5%).

Portfolio

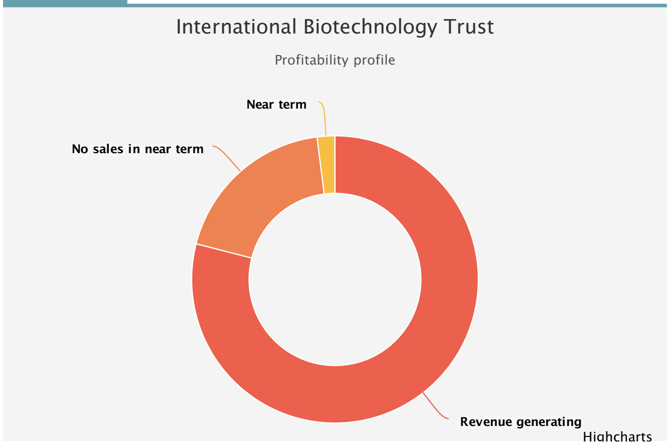
The managers pursue a benchmark aware – but not constrained – stockpicking approach, looking for companies which can generate strong top line growth which have limited competition, good pricing power, strong intellectual property and a clear medical need for their products.

The trust's benchmark, the Nasdaq Biotech index, is modified market cap weighted index. The five largest companies in the index are each weighted at a maxium of 8% of the total. If any other of the next four stocks in the index amount to more than 4% of the total, their index weighting is capped at 4%. All other stocks in the index are at their market cap weight.

The managers tend not to exceed the upper limits on the five largest company weightings, preferring to take their active bets either by underweighting them, or by overweighting smaller index constituents or non index stocks in a way which diversifies stock specific risk, which may see the trust underperform the index when large cap biotech stocks are outperforming mid and small cap stocks.

Nonetheless large caps, companies valued at more than $10bn, make up more than half of the trust's total net asset value (55%) with mid-caps valued at $1-10bn (25%) and small caps valued at less than $1bn (10%) taking progressively smaller weightings. Unquoted companies make up a further 10% of the portfolio via 17 holdings, 6 of which are partially exited. The trust previously invested directly in these unquoted stocks but has of late been harvesting this part of the portfolio. It ceased to make investments into new companies at the same time, and future unquoted investments will be made via funds. In October 2016 the trust made a commitment of $30m (US) to SV Life Sciences Fund VI which will be gradually drawn down over the life of the fund. The first drawdown was made in October 2016.

PROFITS



Source: Morningstar

In geographic terms the trust is heavily exposed to developed markets where the kind of technology it targets is most prevalent and in particular the US, where 78% of its investments are made, while Europe makes up the remaining 22%. An interesting feature of this is that the trust has virtually no sterling exposure (5%). Currencies are not hedged, so the fortunes of the dollar are important.
The majority of the companies in which the trust invests are already profitable (58%) however a significant portion of the portfolio is held in companies which are not yet making a profit (38%). A further 4% of companies in the portfolio will be profitable in the near term. A key aim of managers in this part of the portfolio is to harness capital growth as companies become more attractive to investors who believe their scientific research is going well, and to capture M&A activity, whilst avoiding the 'key risk events' which occur where clinical trials are to be announced on specific drugs with binary outcomes. As companies approach these events the managers may sell out, taking profit, and reinvesting if appropriate in the same firms afterwards on new terms, with new valuation targets. Portfolio turnover, as a result, is relatively high at around 150% per annum. The managers aim to be fully invested at all times but do hold cash where appropriate and gear up in a tactical fashion, with exposure tending to range between 10% cash and up to 15% gearing – valuations being the driving force behind this position.

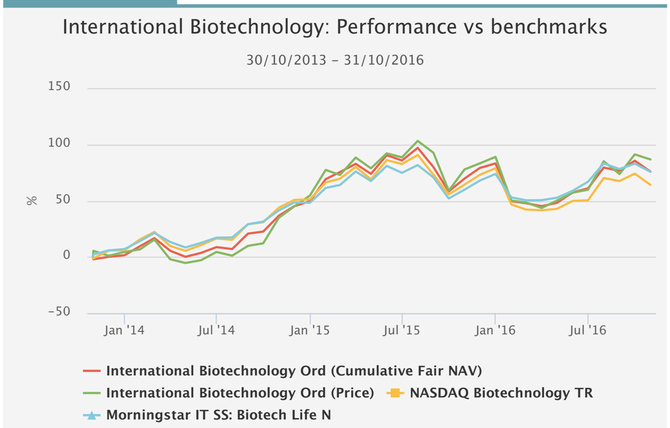
Performance

In performance terms the trust has done very well over the longer term, delivering NAV returns of 322% over ten years to the end of October, and performance has been strong under Carl Harald's stewardship – the trust is ranked second in our composite sector since the start of October 2013 with NAV returns of 85%, outperforming the benchmark Nasdaq Biotech index, which returned 69%, by a comfortable margin to the end of October.

In drawdown terms, the trust – alongside its biotech peers – is subject to sharp downturns and has, over one, three, five and ten years, seen periods when an investor could have lost as much as 26% had they bought and sold at the worst possible times.

However, over each of these periods the potential for upside is far greater – and offers an amplification not found in broader equity sectors. An investor who held on to their stake for ten years would've made around ten times the amount they would have lost had they chosen the worst possible moment to enter and exit the fund during that period.

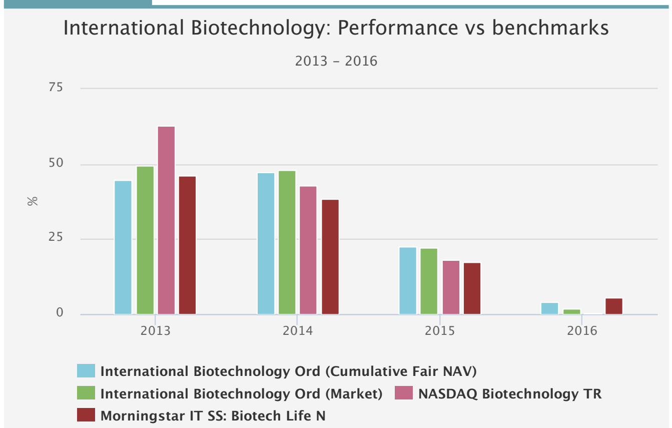
PERFORMANCE



Source: Morningstar

Looking at more recent performance, in discrete terms the management team's focus on avoiding 'risk events' appears to have paid off since Carl Harald was appointed – the trust outperformed in 2014 and 2015 when the Nasdaq was in positive territory whilst limiting downside this year when the index has lost 8%.

RETURNS



Source: Morningstar

Dividend

The board announced plans in September 2016 to pay a dividend equivalent to 4% of NAV from January 2017, payable in two equal instalments each year. The dividend will be drawn wholly from capital, and given its reflection of NAV may fluctuate from year to year. We understand that the board and the manager have no intention of building up reserves in order to smooth the dividend, relying instead on the long term trajectory of the trust's NAV to grow the dividend.
Management

Carl Harald, a medical doctor by training with seven years' medical industry experience, works alongside managers Kate Bingham and Ailsa Craig, who between them have more than thirty five years' experience in the sector. Kate runs the unquoted element of the portfolio, while Ailsa works with Carl Harald on the quoted portion. They are supported by a large team focused on biotech and medicine at US based SV Life Sciences, AIFM for the trust, which has raised assets of $2.4bn in the sector.

The team work in a collegiate fashion, with regular dialogue across the desks and between the offices in London, Boston and San Fransisco supported by more structured weekly team meetings.

The team place a high emphasis on direct contact with target companies and existing investments' management teams, and as a rule of thumb insist on seeing management face to face at least once a year, the majority of these meetings taking place in the US, Europe or UK.

Gearing

Gearing is used tactically and the trust tends to operate in a range between its most defensive position of around 10% cash to its most aggressive footing of around 15% geared. The managers employ gearing at times when valuations are at their lowest, deploying it to take advantage of anticipated uplift, and take money off the table during stronger times for the sector, when the risk is on the downside.

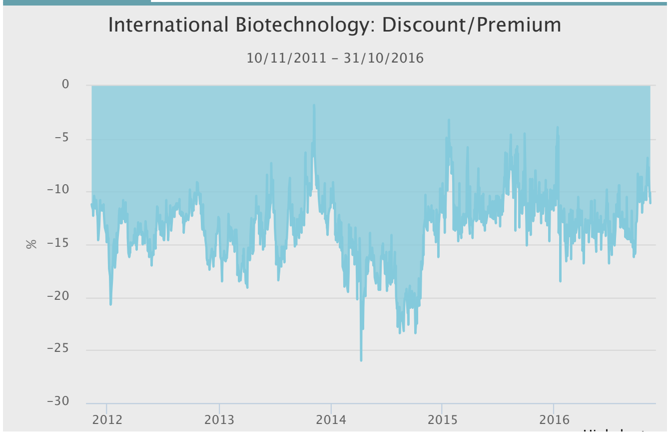
Gearing is available in the form of a £35m loan which tracks the Bank of England base rate +1.5%, and currently sits at 0% according to data from Morningstar.

Discount

The trust has historically traded at a discount in excess of 10%, sometimes reaching out beyond 15% and, while the board buys shares back on a regular basis, no formal discount floor is in place. Since the start of the year the trust has traded steadily at around 12.5%, narrowing to 6.8% at the end of October but losing ground since then.

The board has no plans to address the discount formally, but we would expect the introduction of a yield element to generate additional demand for the shares, particularly from retail investors, and as a result we expect to see this discount find a new floor long term, particularly if NAV performance leads to chunky payouts.

DISCOUNT



Source: Morningstar

Charges

The trust has an annual charge of 0.9% plus a performance fee, split between the quoted an unquoted elements of the portfolio. The fee on the quoted pool is 10% of relative outperformance above the Nasdaq Biotech index (sterling adjusted) plus a 0.5% hurdle. The fee on the unquoted pool is 20% of net realised gains, taking into account any unrealised losses but not unrealised gains.

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