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Time to buy biotech?

David Thornton asks if the recent divergence of biotech from the big-cap technology growth theme represents a buying opportunity

A surprising feature of this year's global equity market has been the exceptional rebound by Nasdaq. We have commented on this in recent Outlook articles, pointing out that the 30% rise has been very narrowly based on a handful of mega caps (eg Apple up 42%, Microsoft 39%, Meta 134%, Nvidia 195%, Tesla 111%). This is unusual in that technology and growth biased Nasdaq was in the vanguard of the bull market and it is usual for the old leaders to become laggards in the next up-cycle. The median US stock has barely moved in 2023; so it looks like there is ongoing enthusiasm for what are seen as secular growth stocks providing plays on the big themes of the day.

However, one major growth theme that has not participated in this rebound is biotech (Nasdaq Biotech index -1% YTD) – which might present investors with a buying opportunity. This month I interviewed Woody Stileman of RTW Biotech Opportunities to discuss the outlook for the sector and his fund in particular.

The biotech sector is experiencing an acceleration in innovation, resulting in an expanding set of opportunities. In the last decade several new, proven in-human, drug modalities (methods of therapeutic approach) have emerged; such as cell and gene therapies, mRNA, and protein degradation. These breakthroughs provide the industry a twenty-year runway for discovering new treatments. Much of the R&D driving this innovation is being carried out by smaller, focused biotech companies rather than 'big pharma'. This might be because talented scientists prefer working in a less bureaucratic environment where their work is directly related to the company's success. A biotech will also build a deep specialism in its particular technology, which is probably more conducive to success than big pharma advancing on a broad front.

Whatever the reason, there is a sense that big pharma has been 'outsourcing' discovery, development and early clinical work to biotechs in the knowledge that it can always use its financial muscle to acquire the de-risked technology – albeit at a premium.

Smaller biotechs are inherently speculative since they tend to be loss-making, at least in the development and pre-commercial phases. Valuations are derived from risk and time-based discounts applied to a guesstimate of

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the future revenues and profits that a successful drug might generate. As sentiment shifts, so does the discount rate. RTW regards the Russell 2000 Biotech index as its benchmark since they both focus on small caps, making it a better comparator for its portfolio than the Nasdaq Biotech index. Both indices paint the same picture of a sector where discount rates have shot up and, accordingly, stocks have fallen a long way.

Biotech has a history of volatility. Going back to the dotcom bubble, the Russell index rose four-fold in a year only to crash 85% from the peak in 2000 to the trough in late 2002. Then came plenty of trading opportunities in what was a protracted sideways move over the next ten years (which supports my contention that the leaders of the last bull market often become the laggards in the next upswing). Once risk appetite returned after the financial crisis the sector enjoyed a long bull run to the peak in February 2021, albeit punctuated by a couple of very significant corrections. The index then fell 70% to the May 2022 trough, which by any measure is a severe bear market (larger stocks represented by the Nasdaq Biotech index fell 38% peak to trough). We have since had a bounce followed by a sideways consolidation.

A potential opportunity

The recent divergence of biotech from the big-cap technology growth theme (Nasdaq Biotech flat so far this year, Nasdaq Composite up 30%) is interesting and presents a potential opportunity. In Woody Stileman's view: "Valuations are now reasonable again." For example, 30% of listed biotechs are valued at less than the cash on their balance sheets, which is an all-time-high. Larger, more mature biotechs are trading on 5x price:sales, which is similar to their global financial crisis low point. Poor sentiment is reflected in a sharp drop in IPOs, with 19 new listings last year compared with 100 in 2021.

The impression is of a secular growth sector bumping along the bottom while its peer IT sector is being rerated. If biotech appeals, then a portfolio approach makes sense. We might find the science fascinating but are not qualified to judge the likelihood of its success. This means using specialist fund managers, especially if we want to access the US market rather than restricting ourselves to AIM. Given the stock-specific risks it also makes sense to get a diversified exposure to the theme.

New York based RTW manages $6bn in the sector, with its London-listed fund having a NAV of $365m. This closed-end fund was launched in 2019 and has grown NAV 65% between inception and the end of May, compared to the Russell and Nasdaq Biotech index returns of -1% and 21% respectively. It adopts a full life-cycle approach: using its scientific expertise to invest at the early venture stage and staying with the company through funding rounds and IPO. For example, Immunocore (Nasdaq: IMCR) was supported in a series B round, IPO'd in 2021, and RTW today retains a 12% stake in the $2.8bn market cap company – which is based in Oxfordshire but chose to list in New York. Immunocore is developing immunotherapies for autoimmune diseases, which Stileman identifies as a key therapeutic focus for RTW.

Accordingly, RTW has 23% of its assets in private companies and 42% in its 'core' listed portfolio (mainly former private stocks that have IPO'd). It is worth noting that only 11% of the portfolio is in pre-clinical or phase I products; 45% is in phase II, 26% phase III, and 18% commercial – so the fund is much less speculative than implied by its former 'RTW Ventures' name (this was changed at the recent AGM). There is currently 5% in cash and 30% in 'other' listed biotech stocks, which is where cash is parked pending fresh commitments to core investments. Stileman believes publicly-listed stocks are relatively more attractive currently, having re-priced rapidly, while private valuations have yet to fully adjust.

Looking for evidence that a turn might be close, RTW has seen a couple of bids for portfolio companies this year. Immunology-focused Prometheus (RTW's largest holding) had been backed pre-IPO, listed at $25 two years ago, and has been acquired by Merck for $200 a share, a 75% premium to the prevailing market price. Which gives a flavour of the upside potential in the sector. So far this year there has been $100bn of bids, which is on track to repeat 2019's $200bn total. The message is that big pharma is keen to acquire innovative technology and valuations are attractive.

Follow-on financing might remain difficult for weaker businesses where the commercial phase is distant; but good quality companies are attracting funding. For example, RTW has seen successful IPOs for three portfolio companies so far in 2023, achieving good uplifts on the prior holding value.

The table below shows RTW alongside three UK-listed investment company peers. The stand-out number is its 29% discount compared to peers in the 8-10% region. Given the track record (NAV up 65% since launch in October 2019) that looks unwarranted and suggests an opportunity for investors anticipating better times ahead for biotech. ■

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	Ticker	Mkt cap £m	Price	Discount to NAV %	1yr share price return	3yr share price return
RTW Biotech Opps	RTW	205	123¢	28.9	17.2	-11.2
Intl. Biotech Trust	IBT	270	667p	8.3	6.9	-10.7
Biotech Growth Trust	BIOG	313	833p	8.8	2.2	-33.2
Syncona	SYNC	1,005	147p	9.7	-24.1	-32.0