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When Did Biotech Investors Get So Sophisticated?

How Hedge Funds and New Research Models Are Changing the Rules

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On a recent earnings call, the CEO of a mid-size pharmaceutical company was fielding all the usual questions about the firm: earnings projections, R&D spending, sales efforts, etc. Then came a question about an experimental drug that was moving through the FDA approval process. The question was based on one of the more esoteric assumptions about the new drug's efficacy. The CEO was stumped. He had heard some murmurings about recent research on the topic, but he hadn't prepared for the question and was clearly rattled.

It's easy to understand how this happened. CEOs are paid to handle such matters without flinching, but this CEO had never – in years of investor calls – gotten a question like this. In the past, a quick briefing with his direct reports was more than enough preparation for an investor call.

There's a fundamental shift underway in the biotechnology investment world, particularly for highly specialized fields such as pharmaceuticals and genetic research. The MDs and PhDs who run biotech companies are no longer de facto more informed than their investors, nor do they have a monopoly on access to information. Investors, it seems, are getting educated.

Why Is This Shift Taking Place Now?

There are several factors prompting these changes, but overall it's about a fairly simple idea: As competition increases among investors to discover and invest in high-potential companies and sectors, those investors respond by getting smarter. This is the classic story of investors searching for an edge. In this case, hedge funds are changing the game by tapping directly into the industry's experts, either by hiring them outright to join their investment teams or — more cost-effectively — by using primary

research firms to assemble expert panels.

To better understand this shift, it's helpful to consider how hedge funds are changing the biotech investment landscape. Looking back just 10 or 15 years, most holders of large-cap biotech companies were mutual funds – relatively passive investment vehicles that buy and hold stocks over a long time horizon and typically track to an index. Mutual funds are usually characterized by low fee structures and modestly paid investment managers (relatively speaking) who work within fairly narrow investment parameters.

Over the past several years, however, hedge funds have become more and more of a force in biotech, as well as in several other sectors. McKinsey estimated in October 2007 that total hedge fund assets under management are around \$17 trillion, more than triple the total in 2000 1. (Although not a perfect apples-to-apples comparison, the Investment Company Institute estimated net assets in stock-based mutual funds to be about \$6.7 trillion as of the beginning of 2007 2.) Unlike mutual funds, hedge funds aggressively reward their managers for outperformance. Hedge funds typically use some permutation of the "2 and 20" formula in which the fund pockets 2 percent of all assets under management, then an additional 20 percent of any profits.

To get a sense of how this plays out, consider the case of a mutual fund and a hedge fund that each take a \$100 million stake in a biotech company. The mutual fund might book fees of 1 percent of total assets under management, or \$1 million; if the stock price appreciates by 5 percent, investors do not owe a cut of their earnings back to the fund. The hedge fund, on the other hand, with a "2 and 20" structure, would get a \$2 million management fee as well as another \$1 million for the 5 percent appreciation. Both funds made the same bet, but the hedge fund manager gets three times the take. Investors are willing to pay that premium with the assumption that the hedge fund will consistently make better investments.

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Hedge Funds' Competitive Edge

Hedge funds, in turn, use that extra fee income to maintain a competitive edge over the competition. These days they're accomplishing that primarily in two ways, both of which directly tap the expertise of the biotech industry.

First, no longer content with having the best MBAs money can buy, hedge funds are filling out their research teams with PhDs and MDs from leading schools and medical institutions. As a result, the analysts covering biotech companies now often have the same level of understanding and sophistication as the scientists at the companies, raising the bar of investor understanding. In fact, hedge funds and biotech companies now compete for talent.

Second, hedge funds are investing in expert-panel primary research as a more efficient means of getting direct access to top opinion leaders. As an example, consider a hedge fund that is analyzing a pharmaceutical company with a drug in FDA testing; the hedge fund would need a great deal of diverse expert information to make a true evaluation of whether the company's shares are underpriced, overpriced or properly valued. The investor would need the insight of a research scientist capable of interpreting the test results, a regulator who understands the hurdles the treatment might face, an investment analyst who understands the sector and perhaps an economist to give insight into the near- and mid-term outlook for companies that require continuous cash infusions for R&D. It's very rare that any individual would be able to provide that level of perspective, and most investors would not have the necessary contacts to assemble this knowledge. With primary research, hedge funds are assembling these types of panels and getting deeper insights through multiple expert perspectives.

The drive for an edge in research is ultimately about hedge funds' fiduciary responsibilities to their limited partners. It's an arms race of sorts among biotech investors: If a hedge fund is losing money to other funds that are quicker to the punch because they understand the science better, then it is incumbent on that hedge fund to step up its own level of expertise by hiring more industry-savvy people and using better tools.

How Should Biotech Companies React to These Changes?

Biotech executives who want to stay in step with their investors need to rethink how to monitor and then effectively communicate with the investment community. Those who are able to do both will be best able to understand

what information investors are looking for and then answer that call.

The first part of this equation, monitoring the investment community, is a classic exercise in gathering strategic intelligence, and it forms the foundation of any good investor relations program. All firms participate in this exercise, with varying levels of formality – sometimes the executive team just knows the investment community; other times it hires outside firms to help it understand what investors are looking for. Nowadays, as institutional investors are turning the due-diligence process on its head by using biotech tools to research biotech companies, those same companies should consider similar moves. A panel of experts can provide invaluable information to an investor, and – similarly – an expert panel can help companies understand where they meet, and where they fall short on, investor expectations.

Once these firms understand how their investors perceive them, they can then start working to fill in gaps, recast messages, better explain strategy, and so forth. The process could even result in changing business practices, as expert panels can bring a fresh perspective to companies that aren't realizing their full potential.

On top of this, basic investor relations assumptions need to be reconsidered. As the knowledge gap between investors and biotech firms continues to narrow, companies need to begin stepping up their level of discourse. This doesn't involve scrapping current IR approaches and starting fresh. Indeed, many non-science-trained analysts will still be out there reviewing companies, and thus will still want the science simplified. But, alongside of those analysts are new investors with a more sophisticated understanding of the science. Any information that is pushed out to investors will need to accommodate both audiences, and any forum in which company executives interact with the investment community will also be reshaped.

These changes, considered all at once, are likely fear-inducing for biotech executives and their IR officers, but they are ultimately positive developments for the industry. As the knowledge gap between investor and executive narrows, strong companies with complex products and services will be better understood, valued and funded.

Notes:

- 1 McKinsey Global Institute. *The New Power Brokers: How Oil, Asia, Hedge Funds, and Private Equity Are Shaping Global Capital Markets*. October 2007.
2. Investment Company Institute. *Trends in Mutual Fund Investing*.