Evaluate Vantage

November 12, 2014

# Debt-funded biotechs under the spotlight

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In the week that Dendreon was wheeled off into chapter 11 bankruptcy protection, equity investors will take a hard look at biotech stocks that have similarly been funded in large part through debt – a strategy that is not about to go out of fashion, as Isis Pharmaceuticals' $425m convertible raise showed yesterday.

An analysis by *EP Vantage* pinpoints 10 businesses with particularly disproportionate ratios of gross debt to market cap (see table below). There is no suggestion that these are about to go the way of Dendreon, and some boast healthy cash balances, but a sudden change of circumstances could put them into intensive care.

There are familiar names here: the capital structures of Amarin, Exelixis and Vivus, for instance, all rely heavily on debt. This the result of the attractiveness of cheap debt when moving from development to product launch – attractiveness that now seems misplaced given the setbacks that have seen the three stocks fall 58%, 71% and 64% respectively since January.

This is the problem with debt financing high-risk, lossmaking enterprises: what once seemed affordable and attractive starts to look increasingly like a burden that threatens equity holders, as Dendreon ably demonstrated (*Lessons from Dendreon's slow-motion car crash, November 10, 2014*).

That said, equity investors in Amarin, Exelixis or Vivus should not panic just yet: at the last count the three boasted cash of $135m, $192m and $307m respectively. But the risk is that the whittling away of cash combined with further share price drift could make the equity increasingly uninvestable and in time put the assets in debt holders' hands.

Retrophin is unusual in this list, being a company far from profitability that has nevertheless raised a lot of debt. Again, its cash balance is healthy, but the stock is up 62% this year, and an all-too-easy fall would paint a different picture. More typical is Aegerion, which secured a $325m convertible loan specifically to fund a questionable product acquisition.

| After Dendreon, 10 more heavily debt-funded biotechs | | | |
|---|---|---|---|
| **Company** | **Market cap ($m)** | **Gross debt ($m)** | **Debt as pct of market cap** |
| Alexza Pharmaceuticals | 31 | 64 | 203.6% |
| Emisphere Technologies | 20 | 35 | 174.8% |
| PhotoMedex | 51 | 81 | 158.4% |
| Amarin | 145 | 223 | 154.5% |
| Resverlogix | 45 | 63 | 141.0% |
| Exelixis | 345 | 355 | 103.1% |
| Vivus | 335 | 217 | 64.8% |
| Aegerion Pharmaceuticals | 640 | 330 | 51.5% |
| Aveo Oncology | 47 | 22 | 47.1% |
| Retrophin | 300 | 91 | 30.3% |
| *Notes: excludes companies worth under $15m; debt as at last financial report; companies on Western exchanges only.* | | | |

This analysis excludes medtech and speciality pharma companies, many of which – like Stada Arzneimittel and Alere – have been built on debt-funded acquisitions but are cash-generating and thus subject to different pressures. Excluding those with market caps below $15m weeds out businesses that are already seriously distressed.

But it does reveal some names clearly heading towards distressed territory, like PhotoMedex, a $52m business with $16m of cash and $80m of short-term debt on its balance sheet. PhotoMedex's stock has plummeted 80% this year, and the group has hired Canaccord to seek refinancing options; a secured creditor standstill agreement is in place.

Were this analysis to include medtech it would also have picked up another company on shaky ground: the $722m artificial limb maker Hanger. While Hanger appears to be profitable its cash flow looks lumpy, and at its half year it had just $5m of cash and $540m of debt.

The appointment of new chief financial and chief accounting officers in September gave hints that all was not well, and for the second time this year Hanger failed to announce its quarterly financials as scheduled, stalling for extra time to review the statements.

The stock lost 30% of its value in August, so the stage is set for the dreaded spiral whereby the problem will only be accentuated by panic and further selling. Investors of all heavily indebted companies must be well aware of such an outcome.