

The Biotech Growth Trust

Valuations starting to improve with more to come

The Biotech Growth Trust (BIOG) has two experienced managers, Geoff Hsu and Josh Golomb, at leading global healthcare specialist OrbiMed. They remain very positive on the outlook for the biotech sector, believing that industry valuations became disconnected from positive industry fundamentals during a period of elevated interest rates. BIOG's strategy favours emerging (smaller-cap) over large-cap biotech companies, as, while aggregate risks are higher, they can be more than outweighed by superior returns. This strategy has proved successful over the longer term, but was detrimental to the trust's performance between Q121 and Q323. Investor focus is starting to return to company fundamentals but Hsu and Golomb also believe that when the US Federal Reserve starts to cut interest rates, it should be a positive catalyst for small-cap stocks, including those of emerging biotech companies.

BIOG AGM presentation with Geoff Hsu (July 2024)



Source: BIOG

Why consider BIOG?

'A golden era of innovation' is how the managers describe the positive fundamentals within the biotech sector, with 65% of the US drug industry pipeline coming from smaller-cap biotech companies across all therapeutic areas. There is a range of novel/next-generation technologies including antibody-drug conjugates, cell therapy and gene editing/therapy, to which BIOG has exposure.

Last year saw a record number of new drug approvals by the US Food and Drug Administration (FDA) and the momentum has continued. M&A is an important feature of the biotech sector as pharma companies are taking advantage of attractive valuations to bolster their product pipelines ahead of an upcoming patent cliff. OrbiMed estimates that around \$270bn in branded sales are at risk between 2024 and 2030. In July 2024, BIOG's holding in Morphic Holding was bid for by Eli Lilly in a cash deal at a c 80% premium to Morphic's pre-bid share price.

In an environment of heightened investor risk aversion, BIOG's current discount is wider than its historical averages, which may offer an opportune time for investors seeking exposure to a sector with long-term growth potential.

Investment trusts Biotech equities

20 August 2024

Price 993.0p
Market cap £322m
Total assets £372m

NAV* 1,072.8p
 Discount to NAV 7.4%

*Including income. At 16 August 2024.

Yield 0.0%

Ordinary shares in issue 32.4m

Code/ISIN BIOG/GB0000385517

Primary exchange LSE

AIC sector Biotechnology & Healthcare

Financial year end 31 March

52-week high/low 1,062.0p 718.0p

NAV* high/low 1,156.3p 777.2p

*Including income.

Net gearing* 6.8%

*At 31 July 2024.

Fund objective

The Biotech Growth Trust seeks capital appreciation through investing in the worldwide biotechnology industry. Performance is measured against its benchmark index, the NASDAQ Biotechnology Index (sterling adjusted).

Bull points

- The biotech sector has delivered above-average returns for shareholders over the long term.
- Positive industry fundamentals and valuations, but the sector has been out of favour with investors.
- OrbiMed is a global leader in healthcare research and investment, with more than \$17bn of assets under management.

Bear points

- The focus on emerging biotech stocks was detrimental to the trust's performance during the latest sector drawdown.
- Biotech stocks can be volatile.
- Periodic political pressure.

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The Biotech Growth Trust is a research client of Edison Investment Research Limited

BIOG: Better performance from emerging biotech

BIOG has a structural bias towards emerging (smaller-cap) biotech stocks, as the managers consider these stocks offer a better risk/reward profile than large-cap biotech stocks.

Recent development – change in benchmark

Following shareholder approval in July 2024, BIOG will change its benchmark from the NASDAQ Biotechnology Index (sterling adjusted) to the NASDAQ Biotechnology Index Total Return (net of withholding tax and sterling adjusted). This change becomes effective from 30 September 2024 and reflects the maturation of the biotech index, as some of the larger companies in the industry now pay a dividend. Although BIOG's income is currently insufficient to require a dividend to be paid under investment trust taxation rules, the board believes the dividend income will become an increasingly larger percentage of the benchmark's total return. Hence, a total return index is deemed a more appropriate comparator to assess BIOG's performance.

Exhibit 1: Index and BIOG's NAV returns to 31 March 2024

(%)	1 year	3 years	5 years
NASDAQ Biotechnology Index (capital return)	5.0	2.5	29.8
NASDAQ Biotechnology Index (net, total return)	5.6	4.2	33.1
BIOG NAV total return	26.5	(25.4)	37.1

Source: BIOG

Performance of the biotech sector in FY24

Exhibit 2 shows BIOG's overweight exposure to emerging biotech stocks. Following an extended drawdown during a period of higher interest rates, smaller-cap biotech stocks are starting to perform relatively better.

Exhibit 2: BIOG's breakdown by market cap and NBI performance in FY24

(%)	31 March 2023			31 March 2024			NBI perf, 12m to 31 March 2024
	BIOG*	NBI	Delta	BIOG*	NBI	Delta	
Large cap (>\$10bn)	37	70	(33)	32	64	(32)	(6.9)
Mid cap (\$2-10bn)	14	18	(4)	33	24	9	20.1
Small cap (>\$2bn)	53	12	41	42	12	30	28.1

Source: BIOG. Note: NBI, NASDAQ Biotech Index. *Percentage of BIOG's NAV excluding unlisted holdings.

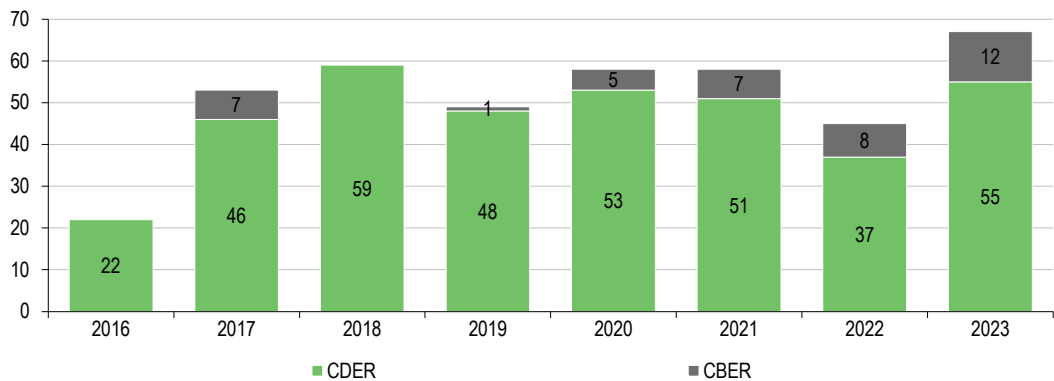
Hsu expects the performance gap to completely close but there is still a way to go. Between the end of March 2021 and the end of June 2024, the performance of biotech stocks by market cap was large cap -0.9%, mid-cap -29.3% and small cap -30.3%. It should be remembered that it is not just in the biotech sector that small-cap companies have underperformed. Between the end of March 2021 and the end of June 2024, the US 1000 large-cap index rallied by c 30% compared with a c 10% decline in the US 2000 SMID-cap index.

History supports Hsu's view that smaller-cap biotech stocks will make up lost ground versus the broader US market as after each period of significant underperformance, smaller-cap biotech stocks have subsequently hit a relative high point. In addition, absolute valuations were at an unprecedented low based on median market cap versus net cash on the balance sheet. More than 25% (> 150 of biotech companies) were trading below net cash. While valuations have started to recover, the manager suggests a reduction in interest rates could be a catalyst for biotech stocks to move substantially higher.

Favourable biotech industry fundamentals

Hsu explains that biotech valuations have become disconnected to favourable industry fundamentals. There has been a stream of breakthroughs across a wide range of products and indications. The regulatory environment remains favourable, as shown in Exhibit 3; there were a record number of new molecular entity approvals in 2023 and the momentum has continued into 2024 (the 2022 dip is likely due to a COVID-related backlog). Within the US FDA there are different departments for drug and biologics approvals – the Center for Drug Evaluation and Research and the Center for Biologics Evaluation and Research.

Exhibit 3: FDA new molecular entity approvals



Source: BIOG, Edison Investment Research

Oncology is the largest biotech drug development area, given the unmet need. There are multiple innovative approaches across tumour types, giving physicians more options to extend the lives of cancer patients including cellular therapies, antibody-drug conjugates, bispecific antibodies, targeted therapies, radiopharmaceuticals and cancer vaccines.

Obesity treatment is a high-profile and potentially very large market. The current market leaders are US-listed Eli Lilly and Denmark-listed Novo Nordisk, whose products lead to 12–15% weight loss in 12 months (next-generation products could see 25% annual weight loss). Current drugs are weekly injectable products offering ancillary health benefits including lower heart attacks and strokes, but with weight loss comes undesirable muscle loss. Other companies are developing oral obesity products with novel mechanisms of action or combination therapies that have better side-effect profiles, but the market is considered to be large enough to support a range of players.

M&A activity within the biotech industry remains robust and Hsu expects this to continue. Major pharma companies have been highlighting their acquisition strategies as they seek to bolster their pipelines ahead of a major 2025–30 patent cliff. As an example, Merck’s \$25bn sales of Keytruda are at risk of generic competition.

Biotech financing volume has picked up in 2024, although the number of IPOs has remained muted. There is robust demand for follow-on financings in strong companies, but weaker companies face financing challenges.

The managers’ playbook

Hsu reiterated his and Golomb’s playbook. They will continue to favour emerging over large-cap biotech stocks, aiming to capture their full rebound from a significant period of underperformance. The managers believe that emerging biotech stocks are coming off unprecedented low valuations, which are lower than during the bursting of the dot.com bubble or the global financial crisis. Hsu and Golomb believe that biotech valuations are disconnected from favourable industry fundamentals, which offers significant share price upside from current levels. In addition, ongoing robust levels of M&A should continue as pharma companies seek new products ahead of a major

patent cliff. The managers consider the political risk is low as healthcare is not a subject high on the presidential election agendas. Hence, they consider now is a very good time to invest in biotech innovation at low valuations.

Portfolio breakdown

At the end of June 2024, BIOG's top 10 holdings made up 41.9% of the portfolio. This was a lower concentration compared with 46.9% a year earlier and six names were common to both periods. The portfolio had 65 positions, which was six higher year-on-year, while the active share declined to 66.6% from 73.0% (this is a measure of how the fund compares with its benchmark, with 0% representing full index replication and 100% no commonality).

Exhibit 4: Top 10 holdings (at 31 July 2024)

Company	Country	Sector	Portfolio weight %	
			31 July 2024	31 July 2023*
Amgen	US	Major biotech	8.5	6.8
Argenx	Europe	Emerging biotech	4.8	5.0
Biogen	US	Major biotech	4.4	6.3
Sarepta Therapeutics	US	Emerging biotech	4.3	N/A
Gilead Sciences	US	Major biotech	4.0	N/A
Ionis Pharmaceuticals	US	Emerging biotech	3.8	4.4
XtalPi	China	Emerging biotech	3.2	3.8
Regeneron Pharmaceuticals	US	Major biotech	3.1	N/A
Acadia Pharmaceuticals	US	Emerging biotech	2.9	N/A
Syndax Pharmaceuticals	US	Emerging biotech	2.9	4.7
Top 10 (% of portfolio)			41.9	46.9

Source: BIOG, Edison Investment Research. Note *N/A where not in end-July 2023 top 10.

Looking at BIOG's portfolio breakdown in Exhibit 5, the notable change is a marked reduction in the trust's exposure to unquoted companies (-4.4pp) as some of the former private Chinese companies listed. The proportion of the portfolio invested in the dominant US increased by 6.1pp to more than 85% of the fund.

Exhibit 5: Portfolio geographic breakdown (%)

Sector	End-July 2024	End-July 2023	Change (pp)
North America	85.5	79.4	6.1
Continental Europe	7.6	10.0	(2.4)
China (quoted)	6.5	5.8	0.7
Unquoted*	0.4	4.8	(4.4)
Total	100.0	100.0	

Source: BIOG, Edison Investment Research. Note: Adjusted for gearing. *Of the 0.4% unquoted investments at end-July 2024, 0.1% was in China and 0.3% was in Asia.

Performance: Turned the corner, but more to do

Exhibit 6: NAV performance versus benchmark over 10 years



Source: LSEG Data and Analytics, Edison Investment Research

Over the long term, from BIOG's inception in May 2005 to the end of June 2024, the trust's NAV total return of +968.3% compared with the NASDAQ Biotech Index's +866.0% and the UK market's +257.1% total return. The trust's performance has turned a corner after a prolonged period of underperformance between Q121 and Q323, when emerging biotech stocks significantly lagged their larger-cap peers (Exhibit 6).

Exhibit 7: AIC biotechnology and healthcare sector at 16 August 2024*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Discount (cum-fair)	Ongoing charge	Perf. fee	Net gearing	Dividend yield
Biotech Growth Trust	321.6	28.7	(14.7)	28.7	92.3	(7.2)	1.2	Yes	107	0.0
Bellevue Healthcare Trust	706.2	8.7	(1.3)	58.9		(6.4)	1.0	No	100	3.9
International Biotechnology Trust	249.2	16.2	16.3	48.7	185.4	(12.1)	1.4	Yes	102	4.2
Polar Capital Global Healthcare Trust	474.2	18.7	35.2	75.4	192.5	(5.3)	0.9	Yes	100	0.6
RTW Biotech Opportunities	398.4	21.0	24.1			(25.4)	2.0	Yes	100	0.0
Syncona	769.1	(2.8)	0.3	(10.9)	69.9	(33.2)	1.9	No	100	0.0
Worldwide Healthcare Trust	1,923.4	20.2	13.1	53.0	203.0	(9.0)	0.9	Yes	104	0.8
Average (7 funds)	691.7	15.8	10.4	42.3	148.6	(14.1)	1.3		102	1.3
BIOG rank in peer group	6	1	7	5	4	3	4		1	5=

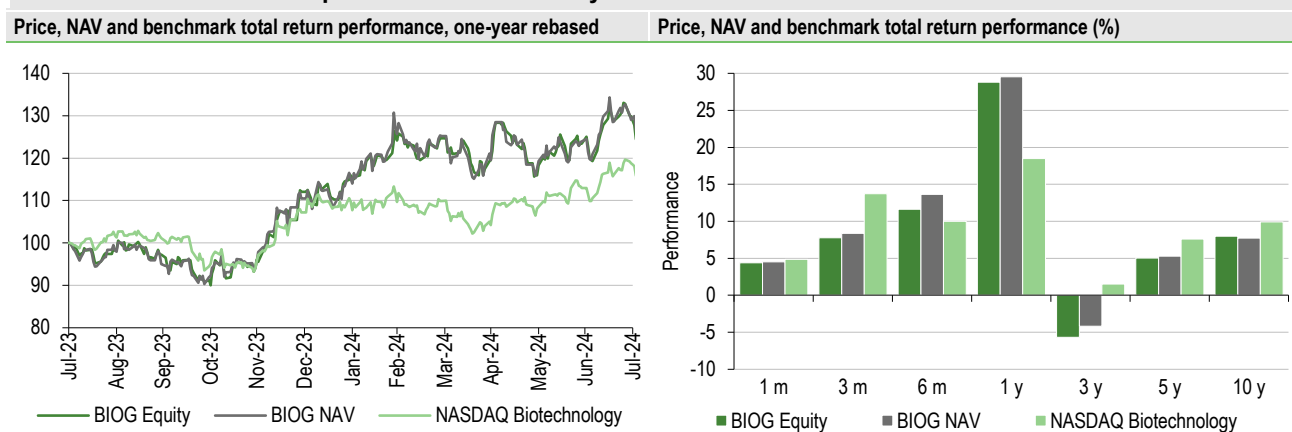
Source: Morningstar, Edison Investment Research. Note: *Performance data to 15 August 2024 based on ex-par NAV. TR, total return. Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

There are seven funds in the AIC biotechnology and healthcare sector. Comparing BIOG with its biotech peers International Biotechnology Trust (IBT) and RTW Biotech Opportunities (RTW), BIOG's NAV total returns rank first over the last 12 months and third over the last three years. BIOG ranks second out of two funds over the last five and 10 years.

Three of BIOG's other peers invest more broadly in the healthcare sector, Bellevue Healthcare Trust (BBH), Polar Capita Global Healthcare Trust (PCGH) and stablemate Worldwide Healthcare Trust (WWH), while Syncona is an early-stage healthcare investor. Looking at BIOG's NAV total returns compared with all of its peers, it ranks first over one year, seventh over three years, fifth out of six funds over the last five years and fourth out of five funds over the last decade.

BIOG currently has the third-widest discount in the sector (no funds are trading at a premium), the fourth-highest ongoing charge and the largest level of gearing. The trust does not receive sufficient income to require a dividend payment; biotech peer IBT makes a distribution out of capital.

Exhibit 8: Investment trust performance to end-July 2024



Source: LSEG Data and Analytics, Edison Investment Research. Note: Three-, five- and 10-year performance figures annualised.

Since the publication of our March 2024 [update](#), BIOG has released its FY24 results. Its NAV and share price total returns of +26.5% and +27.1% respectively were considerably ahead of the benchmark's +5.0% total return. The three largest contributors to the trust's performance were Vera Therapeutics, which had positive trial data for a key immunotherapy product; Scholar Rock Holding, which announced it would advance programmes in obesity, whereby its products would help patients on GLP-1 weight-loss therapies retain their muscle mass; and Janux Therapeutics, which had positive Phase I data for its medicine used for prostate cancer and may prove successful for

the treatment of other tumours. On the other side of the ledger, the three largest detractors were Travers Therapeutics, which had a disappointing launch for Filspari, a treatment for a kidney disease; uniQure, whose Phase I/II trial for a gene therapy used in the treatment for Huntington's disease did not meet expectations; and Biogen, which had a slower-than-expected launch of Leqembi, its first-in-class treatment for Alzheimer's disease.

Exhibit 9: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to NASDAQ Biotechnology	(0.5)	(5.2)	1.5	8.7	(19.8)	(11.3)	(16.0)
NAV relative to NASDAQ Biotechnology	(0.3)	(4.7)	3.3	9.3	(15.9)	(10.3)	(18.0)
Price relative to World-DS Pharm & Bio	3.1	0.6	1.1	8.1	(35.6)	(22.4)	(26.1)
NAV relative to World-DS Pharm & Bio	3.3	1.1	2.9	8.7	(32.5)	(21.5)	(27.8)
Price relative to MSCI World	4.2	1.8	(0.1)	8.2	(37.4)	(25.9)	(37.2)
NAV relative to MSCI World	4.3	2.4	1.7	8.8	(34.4)	(25.1)	(38.7)
Price relative to CBOE UK All Companies	1.2	3.5	(0.2)	13.7	(34.5)	(3.1)	17.6
NAV relative to CBOE UK All Companies	1.4	4.1	1.6	14.3	(31.3)	(2.0)	14.8

Source: LSEG Data and Analytics, Edison Investment Research. Note: Data to end-July 2024. Geometric calculation.

BIOG has started to recover some relative underperformance as it is now ahead of the benchmark over the last six and 12 months.

Exhibit 10: Five-year discrete performance data

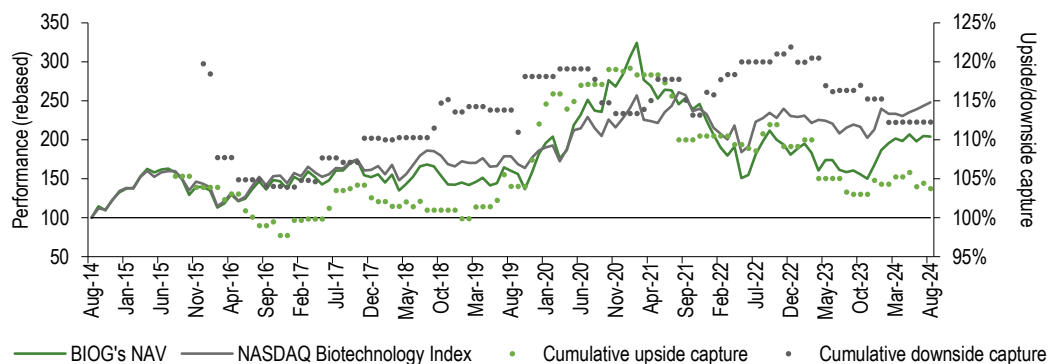
12 months ending	Share price (%)	NAV (%)	NASDAQ Biotech (%)	World-DS Pharm & Bio (%)	MSCI World (%)
31/07/20	51.5	40.4	19.3	14.4	0.6
31/07/21	0.7	4.7	15.5	10.6	28.1
31/07/22	(30.7)	(26.9)	(12.5)	9.1	4.3
31/07/23	(6.1)	(7.2)	0.9	0.2	7.9
31/07/24	28.8	29.5	18.5	19.1	19.1

Source: LSEG Data & Analytics. Note: All % on a total return basis in pounds sterling.

BIOG's upside/downside analysis

In Exhibit 11, we highlight BIOG's performance versus its NASDAQ Biotechnology Index benchmark over the last 10 years. The trust's upside capture rate is 104%, suggesting that in months when biotech shares are rising, BIOG will outperform by a very modest amount. It has a larger downside capture rate of 112%, which implies that in months when biotech shares are falling, the trust will likely underperform by more than 10%. This analysis is not surprising given BIOG's bias to emerging biotech stocks, which are inherently more risky than large-cap biotech stocks.

Exhibit 11: BIOG's upside/downside capture

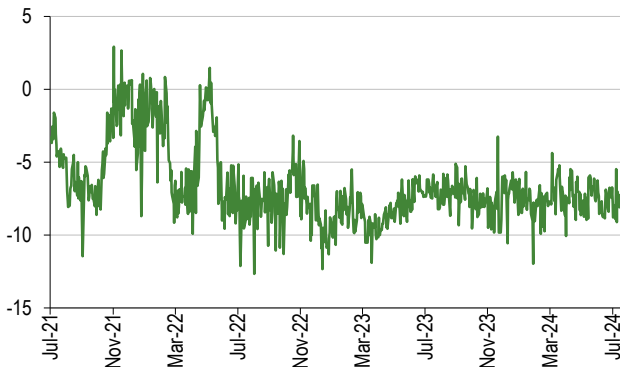


Source: LSEG Data and Analytics, Edison Investment Research. Note: Cumulative upside/downside capture calculated as the geometric average NAV total return (TR) of the fund during months with positive/negative reference index TRs, divided by the geometric average reference index TR during these months. A 100% upside/downside indicates that the fund's TR was in line with the reference index's during months with positive/negative returns. Data points for the initial 12 months have been omitted in the exhibit due to the limited number of observations used to calculate the cumulative upside/downside capture ratios.

Valuation: Discount remains wider than average

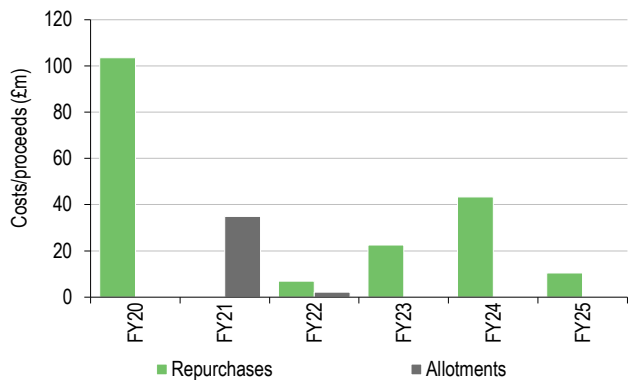
BIOG, in keeping with many other investment trusts is trading at a wider-than-average discount during a period of elevated investor risk aversion. The current 7.4% share price discount to cum-income NAV is wider than its average discounts of 6.6%, 5.5% and 5.7% over the last three, five and 10 years, respectively. Looking at Exhibit 12, over the last three years, BIOG traded in a range of a 2.9% premium to a 12.7% discount. One may argue that the trust deserves to trade on a higher valuation now that its performance is getting back on track.

Exhibit 12: Discount over three years (%)



Source: LSEG Data and Analytics, Edison Investment Research

Exhibit 13: Buybacks and issuance



Source: Morningstar, Edison Investment Research

Renewed annually, the board has the authority to purchase up to 14.99% and allot up to 10% of BIOG's issued share capital. It remains committed to limiting the discount to 6% over the long term, in normal market conditions. During FY24, c 5.3m shares were repurchased (c 13.6% of the share base) at a cost of c £43.6m and an average 7.3% discount to cum-income NAV, which added 0.9% to BIOG's NAV. Share buybacks are continuing in FY25.

Fund profile: All-cap, global biotech exposure

BIOG was launched in June 1997 and is listed on the Main Market of the London Stock Exchange. The trust is managed by Geoff Hsu and Josh Golomb at OrbiMed Capital, which is a global healthcare specialist investor with more than \$17bn of assets under management. OrbiMed operates from three continents with offices in New York, San Francisco, London, Herzliya (Israel), Hong Kong, Shanghai and Mumbai. It has a team of around 140 people, of whom more than 35 hold PhD or MD qualifications and around 15 are former CEOs or company founders.

Hsu and Golomb aim to generate long-term capital growth from a diversified portfolio of global biotech equities and related securities. The trust's performance is measured against the NASDAQ Biotechnology Index (sterling adjusted) and its currency exposure is unhedged. BIOG's investment guidelines state that at the time of investment, a maximum of 15% of gross assets may be held in a single stock; up to 10% may be in unquoted securities (including any private equity funds managed by OrbiMed and its affiliates); and swaps exposure is permitted up to 5% of gross assets at the time of entering into the contract. The managers may employ gearing up to 20% of net assets.

Investment process: Bottom-up stock selection

Hsu and Golomb aim to generate long-term capital growth from a globally diversified portfolio of biotech companies across the market cap spectrum. They can draw on the broad resources of OrbiMed's experienced investment team; their scientific expertise is deemed critical in terms of evaluating potential investments. Stocks are selected on a bottom-up basis following thorough in-depth fundamental research, which includes financial modelling, an assessment of research pipelines and identification of potential catalysts; company meetings are a very important element of the research process. Reasons to initiate a new position include whether an early-stage company is approaching profitability, ahead of anticipated positive clinical data, or if a business is considered a potential takeover target.

While the managers seek the best potential opportunities across the globe, most of the portfolio is held in US companies, reflecting its dominance in the biotech industry; however, BIOG has a notable exposure to China. The trust's holdings are regularly reviewed to ensure the original investment theses are still valid and positions are sized correctly. The managers note that BIOG's portfolio turnover is relatively high because of its large emerging biotech exposure, where stocks can be volatile around news about clinical results.

BIOG's approach to ESG

OrbiMed believes that there is a high congruence between companies seeking to act responsibly and those that succeed in building long-term shareholder value. To the extent that it is practicable and reasonable, OrbiMed takes applicable environmental, social and corporate governance factors into account when evaluating a prospective or existing investment via a five-step process:

- Negative screening – OrbiMed does not invest in businesses that lead to negative effects on public health or wellbeing, such as banned or illegally marketed pharmaceuticals or tobacco.
- Due diligence – fundamental analysis to review material ESG factors.
- Monitoring – performance of portfolio companies is regularly monitored on multiple factors.
- Engagement – occurs with portfolio companies on a regular basis including meetings with management, voting by proxy and ESG conferences.
- Reporting – OrbiMed has introduced a quarterly ESG update covering sector and portfolio highlights, along with engagements on material issues.

OrbiMed may seek to engage with portfolio companies to promote changes in their conduct or policies and could ultimately decide to sell the investment in these firms. In some cases, it may adopt an 'activist' approach to encourage change at investee companies, which may include a proxy campaign or seeking representation on their boards of directors. The managers seek to invest in reputable management teams and are especially aware of corporate governance in emerging markets, as company credentials in these regions may not be as high as those of firms in developed regions.

Gearing

Gearing of up to 20% of NAV is permitted and is employed via a loan facility with JP Morgan Securities, priced at 45bp above the US Federal Funds rate. At the end of July 2024, the trust's net gearing was 6.8%, which compares with its typical range of 5–10%.

Fees and charges

OrbiMed is paid an annual management fee of 0.65% of BIOG's NAV. It is also entitled to a performance fee of 15.0% of outperformance versus the benchmark if the cumulative outperformance since the start of the arrangement on 30 June 2005 gives rise to a total fee greater than the total of all performance fees paid to date.

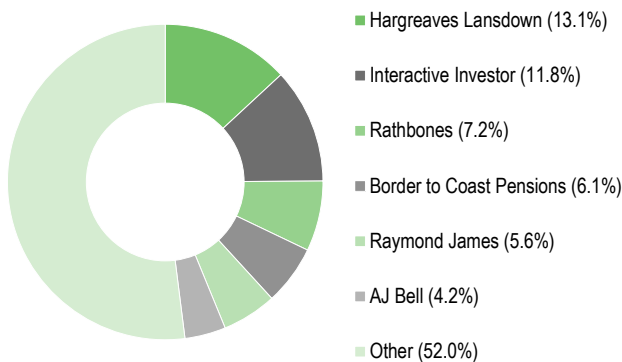
Frostrow Capital is the trust's alternative investment fund manager, providing company management, secretarial, administrative and marketing services. It receives a tiered annual fee of 0.3% of BIOG's market cap up to £500m, 0.2% between £500m and £1bn and 0.1% above £1bn.

In FY24, the trust's ongoing charges were 1.2%, which were 10bp higher than 1.1% in FY23; no performance fees were payable.

Capital structure

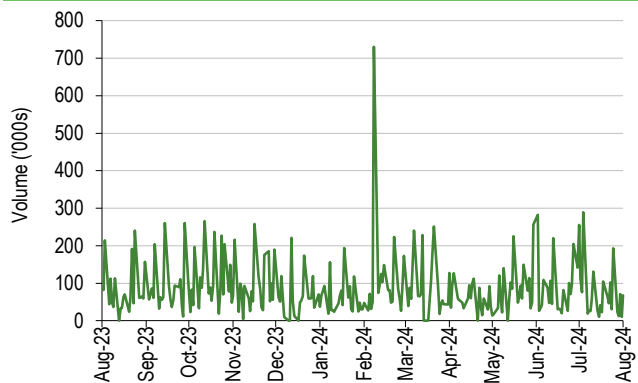
BIOG is a conventional investment trust with one class of share. There are currently 32.4m ordinary shares in issue and the average daily trading volume over the last 12 months was c 87k shares.

Exhibit 14: Major shareholders



Source: BIOG. Note: At 31 July 2024

Exhibit 15: Average daily volume



Source: LSEG Data and Analytics. Note: 12 months to 16 August 2024.

The trust has a five-year continuation vote; the last was held at the July 2020 AGM where the resolution was passed by a significant majority (99.9% of votes were in favour).

The board

Exhibit 16: BIOG's board of directors at end-FY24

Board member	Date of appointment	Remuneration in FY24	Shareholdings at end-FY24
Roger Yates (chairman since July 2022)	1 December 2021	£42,000	15,000
Steve Bates	8 July 2015	£31,500	10,000
Rt Hon Lord Willetts	11 November 2015	£28,875	Nil
Julia le Blan	12 July 2016	£33,600	7,000
Geoff Hsu	16 May 2018	Nil	Nil
Dr Nicola Shepherd	18 January 2021	£28,875	2,000
Hamish Baillie	1 November 2023	£12,031	3,000

Source: BIOG

As Geoff Hsu is a partner at OrbiMed, he is considered to be a non-independent director, and his fees are waived.

On 9 October 2023, BIOG's board announced the appointment of Hamish Baillie as an independent, non-executive director, with effect from 1 November 2023. He is a non-executive

director of Mid Wynd International Investment Trust, and his 20-year executive career was spent at Ruffer, until his retirement in October 2022.

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