BB Biotech

Vontobel offer

Edison investment research

Discount management tops agenda

Investment trusts

BB Biotech (BION) invests globally in companies active in the biotechnology sector. Biotech has been one of the best-performing elements within healthcare in recent months, supported by fundamental drivers and M&A interest from big pharma companies seeking to replenish their product pipelines. Within this, individual stock performance reflects the binary nature of biotech investing, and individual investors may benefit from the diversification offered by a collective fund managed by a sector specialist. The proposed tax-efficient distribution policy implies a yield of c 5%, with continuing share buybacks.

12 months ending	Total share price return* (%)	Total NAV return* (%)	Total return NASBIOT Index* (%)	Total return MSCI World H'Care* (%)	Total return DS Wld Phm & Bio* (%)
30/07/2009	(16.5)	(4.6)	(5.7)	(8.1)	(4.1)
30/07/2010	(19.3)	(17.0)	(4.0)	(0.6)	(0.4)
30/07/2011	10.8	(5.7)	(2.4)	(5.4)	(7.0)
30/07/2012	56.7	67.7	63.6	37.5	39.7

Note: Note: *Twelve-month rolling discrete performance in CHF terms.

The board reviews strategic direction

BION's board has rejected an informal proposal by Vontobel for a restructuring that would see BION shares exchanged for units in a new open-ended Luxembourg investment fund. The mooted proposal would see new fund units offered to BION shareholders at NAV less a 4.2% discount (retained by Vontobel for executing the transaction). BION shareholders would benefit from an immediate closing of the discount (c 27% before the announcement, though already close to c 22%) less 4.2%, and would be able to trade in the new fund at NAV. This may appeal to some investors in the short term but we think it very unlikely that BION could be managed with the same degree of stock conviction and would lose the benefits of a closed-ended structure, particularly the support for long-term decision making, free from redemptions, in volatile markets. BION is keen to find alternative ways to narrow the discount to NAV and the newly proposed tax efficient distributions (free from local withholding tax), equivalent to a c 5% yield should broaden investor interest.

Positive fundamentals

The healthcare sector is supported by favourable global trends with biotech further supported by big pharma companies looking to replenish their product pipelines, which is driving M&A. Our healthcare team believes collective investment vehicles such as BION are for many investors the most appropriate way to access these favourable fundamentals given the complexity of the sector and stock-specific risk.

Valuation: Discount opportunity

The current 21% discount is attractive and although similar to the three- and five-year averages of 22% and 19% respectively, is much higher than peers and the level that the board aspires to (between 10% and 15%). BION continues to repurchase shares and proposed tax efficient cash distributions should attract investor interest.

BB Biotech is a research client of Edison Investment Research Limited

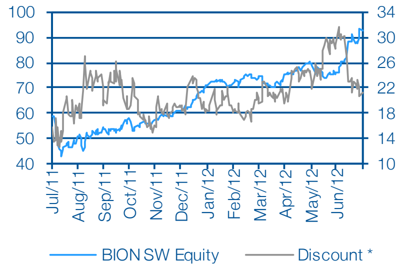
31 July 2012

Price	CHF92.45
Market cap	CHF1,371m
AUM	CHF1,742m
NAV*	CHF 117.45
Discount to NAV	21.3%
Yield	0.0%

** Including income, as at 30 July 2012.*

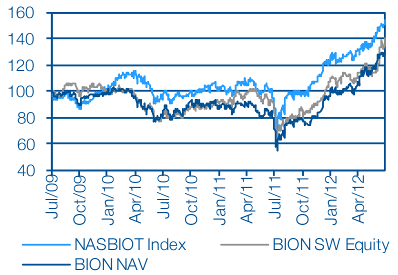
Ordinary shares in issue	13.0m
Code	BION
Primary exchange	Six Swiss
Sector	Investment Companies

Share price performance



** Positive values indicate a discount; negative values indicate a premium.*

Share price performance



52-week high/low	CHF93.00	CHF43.15
NAV* high/low	CHF117.45	CHF49.85

** Including income.*

Business description

BB Biotech is a Swiss-domiciled biotech investment company, targeting attractive long-term returns from predominantly mid-/large-cap companies with established product portfolios (sales and earnings) and promising pipeline candidates.

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Investment summary: Discount management tops agenda

Vontobel suggests reorganisation

On 13 July 2012 Vontobel made public its willingness to propose a restructuring of BION to the board that would see BION's shares exchanged for units in a new open-ended Luxembourg investment fund (it has not formally made the proposal yet). Vontobel's announcement suggested the new fund units could be offered to BION shareholders at NAV less a fairly substantial 4.2% discount (compared with typical new issue charges of c 2%), charged by Vontobel for executing the transaction. BION shareholders would thus be able to benefit from an immediate closing of the discount (c 27% before the announcement, though already closed to c 22%) less 4.2%, and would be able to trade in the new fund at NAV. BION's board made clear that it had been aware of the possibility of such a proposal since January and that an examination of the possibility had formed part of a detailed strategic review for the company, aimed at reducing the discount to NAV, further details of which have subsequently been released. We discuss the company's new distribution policy below.

If a proposal from Vontobel emerged, its structure would resemble the July 2009 public exchange offer to shareholders in the BB Medtech closed-ended fund, which went ahead and concluded in October of that year. BB Medtech had traded at an average 18.5% discount over the previous 12 months and Vontobel proposed the an exchange into units of a new open-ended fund at net asset value less a fee of 3.9% payable to Vontobel for executing the transaction. The offer was subject to a minimum acceptance threshold by BB Medtech shareholders of 90%. Subsequent to the exchange the annual management fee increased from 0.4% pa to 1.2%. Including performance fees payable by BB Medtech to the manager and other company expenses, the total expense ratio averaged 2.21% pa in the five years 2005 to 2009, so the flat 1.2% fee post-exchange (no performance fee) represented a reduction in expenses. The manager, Bellevue Asset Management, has not benefited from the management fee increase as subsequent redemptions mean the fund is now considerably smaller than it was in 2009.

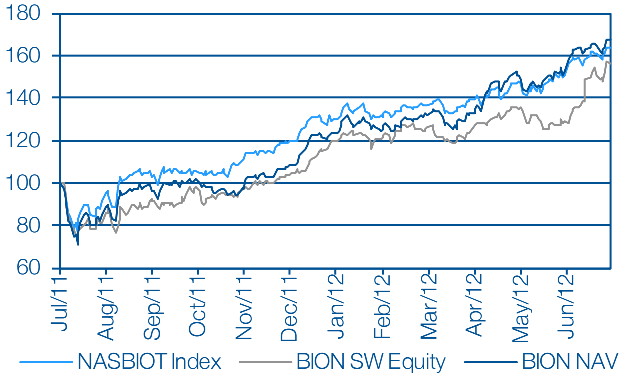
The issue: Discount not performance

The board has concluded that while an exchange would have a short-term benefit to shareholders (in terms of closing the discount to NAV less the transactions fees of 4.2%) there are enough negative aspects to the transaction for it to be rejected. The board has subsequently proposed a new distribution policy that we believe is attractive to shareholders.

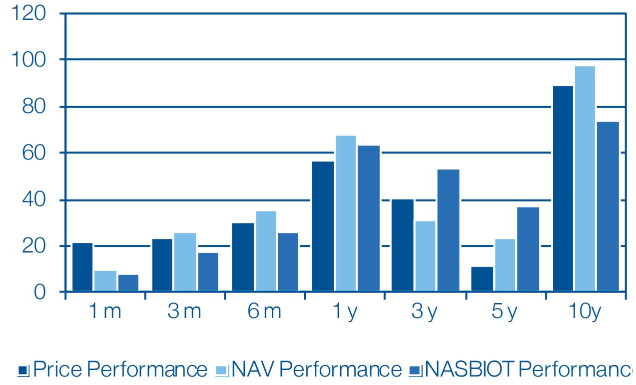
In our view, the crucial issue that BION has been trying to address is the persistent material discount of share price to NAV. Its official benchmark is the NASBIOT, although portfolio construction does not track the index closely over the short term. Over 10 years NAV total return has outperformed the NASBIOT by c 20%. More recently performance has suffered from some stock-specific disappointments, for example Actelion's performance suffered during 2011 after the loss of the Asahi Kasei legal case over a licensing and development dispute, and being underweight certain M&A candidates, for example BION's portfolio had an allocation half that of the benchmark for Pharmasset when it was acquired at a 90% premium by Gilead. Actelion's fortunes have since improved with the successful conclusion of a long-term study into its potential blockbuster drug, Macitentan. Year to date, BION's NAV in US$ terms is up around 45% and its share price around 38%. Relative to the broader market, investors have seen a positive outcome over most periods.

Exhibit 1: Investment company performance

Price, NAV and benchmark total return perf., one year rebased



Price, NAV and benchmark total return performance (%)



Source: BB Biotech, Bloomberg, Thomson Datastream, Edison Investment Research

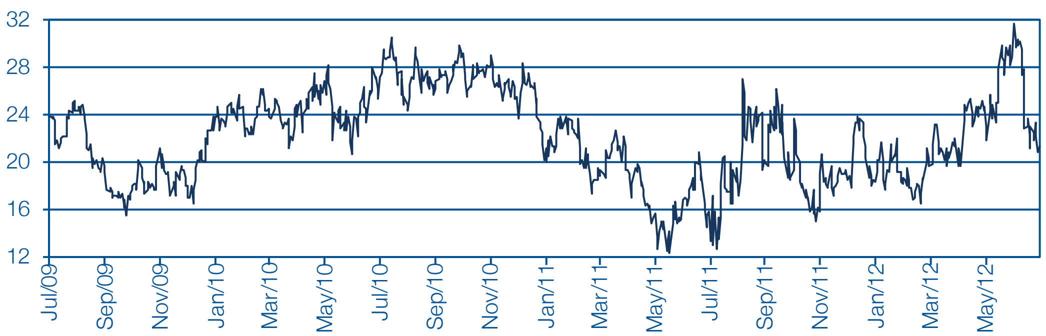
Exhibit 2: Share price and NAV total return performance (Swiss franc adjusted), relative to benchmarks

	1 month	3 months	6 months	1 year	3 years	5 years	10 years
Price relative to NASBIOT Index	13.0	5.9	4.5	(6.9)	(13.2)	(25.9)	15.5
NAV relative to NASBIOT Index	1.4	8.5	9.4	4.0	(22.1)	(13.4)	24.0
Price relative to MSCI World Healthcare	15.2	11.6	13.6	19.2	11.0	9.7	59.6
NAV relative to MSCI World Healthcare	3.6	14.2	18.5	30.2	2.1	22.2	68.1
Price relative to DS Pharma & Biotech	13.7	9.8	12.1	17.0	10.7	2.7	50.0
NAV relative to DS Pharma & Biotech	2.1	12.4	16.9	27.9	1.8	15.2	58.6
Price rel. to FTSE All-Share	15.2	18.8	20.2	36.1	21.4	41.3	51.7
NAV rel. to FTSE All-Share	3.6	21.4	25.1	47.0	12.5	53.8	60.3

Source: BB Biotech, Bloomberg, Thomson Datastream, Edison Investment Research

Despite its performance record, BION has persistently traded at a discount to NAV, as shown in Exhibit 3. The current c 21% discount is similar to the average for the last three years but clearly larger than AIC peers Biotechnology Growth Trust (BIOG) c 1% and International Biotechnology Growth Trust (IBT) c 12%. BION has been seeking to reduce the discount to less than 15% in the short term (by the end of 2012) and then to consolidate it between 10% and 15%, stepping up its buy-back programme and putting additional resources behind its sales and marketing programme.

Exhibit 3: Discount over three years



Source: Bloomberg, Thomson Datastream, Edison Investment Research

Is reorganisation the answer?

While we can understand the frustration of BION's board and its current shareholders at the persistent discount to NAV, we are more inclined to look at the company's performance record and consider whether the discount is better seen as an opportunity for new investors.

The biotech sector as a whole has performed well compared with broader markets and is supported by a number of continuing factors, including an ageing population and improving wealth across the globe. Large pharma companies have also been acquiring biotech companies in an effort to replace their depleting patented drug portfolios.

Within the biotech sector, it has historically targeted mid-/large-cap companies that already have an established product portfolio (sales and earnings) with promising pipeline candidates, although it has recently been shifting down the market-cap scale, towards the mid-caps, in search of companies with superior risk-return profiles. This is less risky than investing in earlier-stage companies where the risk and returns are generally higher. A direct comparison of the performance of BION with say, the Biotech Growth Trust or International Biotechnology Growth Trust, which both focus on earlier-stage investments, is not entirely valid.

We doubt that BION as an open-ended fund could be managed in the same way as it has been as a closed-ended fund. In fact we see some advantages for closed-ended funds that can be of particular value in volatile markets or in volatile asset classes. BION has typically been managed with a small number of high conviction core holdings (five to eight stocks within a 30-35 stock portfolio) that have usually attained their share of the portfolio by outperforming over time (eg Celgene, c 15% of the portfolio). As an open-ended fund, holding sizes would be subject to tighter restriction. Closed-ended funds do not face pressure to liquidate assets in volatile markets to meet redemption demands from investors, a very useful foundation for long-term decision making.

BION has been actively repurchasing shares in an effort to manage the discount but has been hampered from making income distributions by tax regulations that impose withholding tax on dividends payments that are difficult or impossible for investors not paying Swiss tax to reclaim. While we would expect many BION investors to be more interested in capital growth than income distribution, we believe its intention to include tax efficient distributions (ie without withholding tax) from c CHF400m of available capital reserves may well encourage additional investor interest from those whose investments are required to offer a yield or those who seek additional measures to boost cash income while interest rates remain low, The reserves are sufficient to support the proposed CHF4.5 per share annual payment for a very satisfactory c seven years. With continuing share repurchases, BION seeks to distribute c 10% of market capitalisation annually.

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