BB Biotech AG

Investment companies review

Edison investment research

Promising pipeline

Investment companies

BB Biotech AG (BION) is a Swiss-based investment company investing in mid- to large-capitalisation biotech companies. Over the past, year BION's net asset value beat comparable indices and was more than 10% ahead of its benchmark, the NASDAQ Biotechnology Index. In 2012, BION resisted an attempt to unitise the company and implemented a strategy to reduce its discount. The managers believe their stocks are attractively valued and see the prospect of M&A activity, driven by patent expirations in the pharmaceutical industry. BION's portfolio contains a number of drugs in the later stages of development and these could help drive further NAV growth.

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* (%)
01/03/10	13.5	11.6	30.0	31.3	29.1
01/03/11	(8.2)	(11.7)	(7.0)	(8.4)	(9.7)
01/03/12	20.7	13.5	24.8	8.4	9.1
01/03/13	40.8	46.4	30.7	28.0	30.9

Note: *Twelve-month rolling discrete performance.

Investment strategy: Profitable and late-stage biotech

BION aims to generate a total return of 15% pa over the long term by investing in a focused (20-35 stocks) global portfolio of biotech companies whose products address areas of significant unmet medical need and are capable of generating above-average sales and profit growth. These tend to be either already profitable or have drugs in the late stages of development.

Sector outlook: Positive on M&A and new developments

In 2012, 14 new drugs were approved by the FDA and the managers are optimistic that 2013 will be at least as good a year for product approvals. The managers believe regulators are taking less time to approve products. They see a number of promising therapies on the horizon, including oral treatments for Hepatitis C, drugs to tackle aggressive cancers and drugs aimed at rare diseases, and they are optimistic about new technology platforms based on RNA interference and antibody drug conjugates to tackle malignant cells.

Valuation: Unitisation rejected, capital return reinstated

At 21.8%, BION's discount is narrower than its three-year average of 22.1%, but wider than its UK-listed peer group. In November 2012, an unsolicited approach from Vontobel offering to unitise the fund (for a substantial fee) was withdrawn as it would have had adverse tax consequences for BION shareholders. BION's investment approach could also have been compromised in an open-ended structure. It would have hindered the managers' ability to take long-term views and might have necessitated the maintenance of large cash balances causing a cash drag on returns. In March 2013, BION will reinstate its programme of capital distributions, targeting 5% per annum, and aims to buy back an additional 5% of its share capital each year.

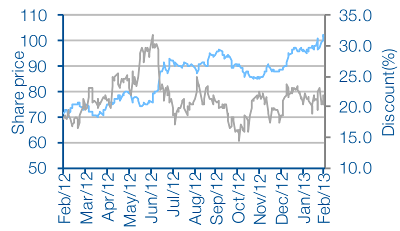
7 March 2013

Price	**CHF101.8**
Market cap*	**CHF1,146m**
AUM	**CHF1,601m**
NAV**	CHF130.25
Discount to NAV	21.8%
Yield	Nil

** Market cap. based on 13m shares in issue less estimated 1.8m shares in treasury (see page 7)*
** *Including income, as at 1 March 2013.*

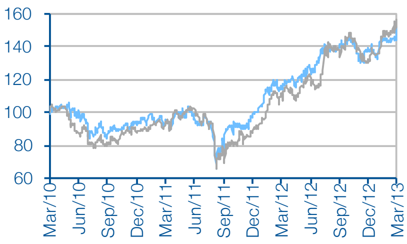
Ordinary shares in issue (*page 7*)	11.3m
Code	BION
Primary exchange	Zurich
AIC sector	SS: Biotech/Life Sciences

Share price/discount performance



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

Three-year cumulative perf. graph



52-week	High	Low
Price	102.1	70.0
NAV	130.25	87.05

** Figures in CHF, NAV Includes income.*

Gearing

Gross	9.6%
Net	8.3%

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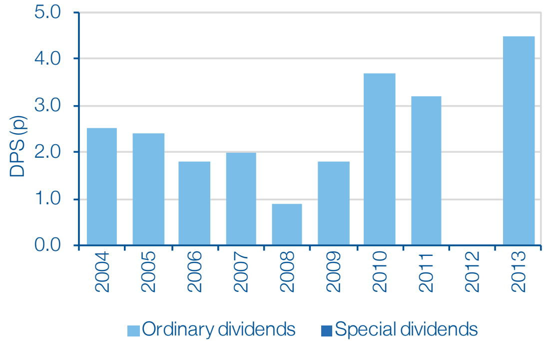
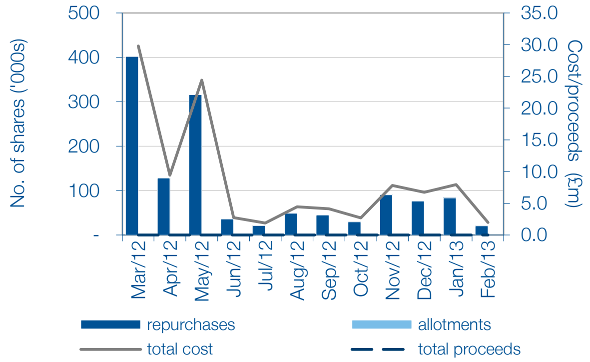
Exhibit 1: Trust at a glance

Investment objective and fund background	Recent Developments
BION is a Swiss-domiciled investment company, targeting attractive long-term returns from predominantly mid-/large-cap biotech companies with established product portfolios (sales and earnings) and promising pipeline candidates. It is benchmarked against the NASDAQ Biotech Index, but is managed bottom-up with a concentrated 20-35 stock portfolio.	21 February 2013: Annual Report published 16 January 2013: Preliminary results 20 November 2012: Vontobel unitisation proposal withdrawn

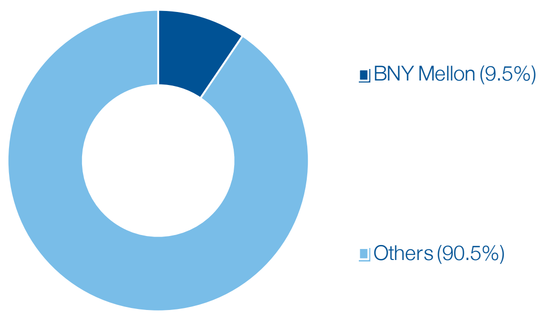
Forthcoming		Capital structure		Fund details	
AGM	March 2013	Ongoing charges	1.45%	Group	Bellevue Asset Management
Preliminary results	January 2014	Net gearing	8.3%	Manager	Self-managed by team
Year end	31 December	Annual mgmt fee	1.2% on market cap*	Address	Seestrasse 16, 8700 Kusnacht, Switzerland
Dividend paid	March (cap. return)	Performance fee	None		
Launch date	November 1993	Trust life	Indefinite	Phone	+41 (0)44 267 6709
Wind-up date	None	Loan facilities	See Page 7	Website	www.bbbiotech.com

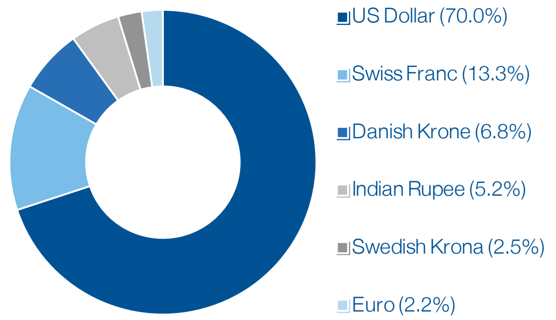
Dividend policy and history	Share buyback policy and history
BION focuses on capital appreciation. Dividends (part capital return) are paid as part of a broader discount management policy.	BION has authority, renewed annually, to repurchase up to 10% of its issued share capital as at March 2012. It is actively repurchasing shares with a view to managing the discount.



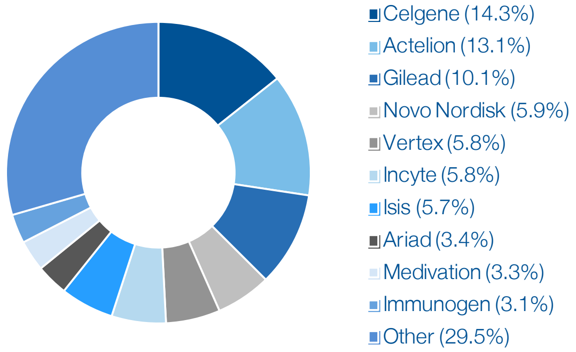


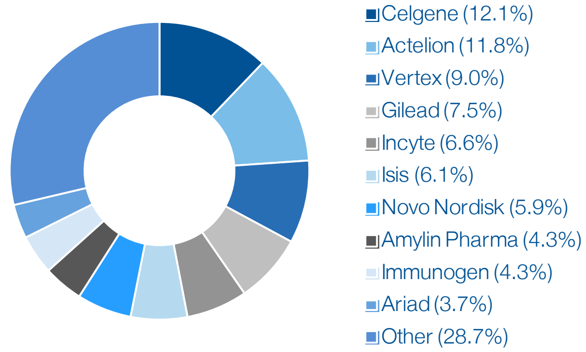
Shareholder base (as at 1 March 2013)	Currency exposure of portfolio (as at 31 December 2012)





Portfolio composition (as at 31 December 2012)	Portfolio composition (as at 30 June 2012)

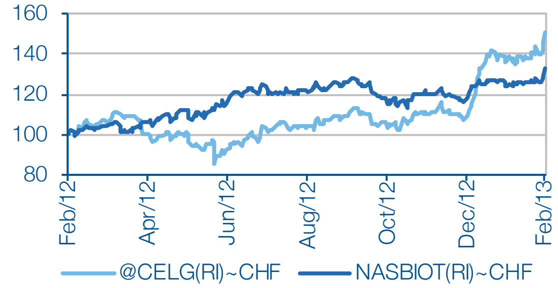




Source: BB Biotech, Edison Investment Research. Note:*Annual management fee capped at CHF12m.

Exhibit 2: Top five holdings at a glance

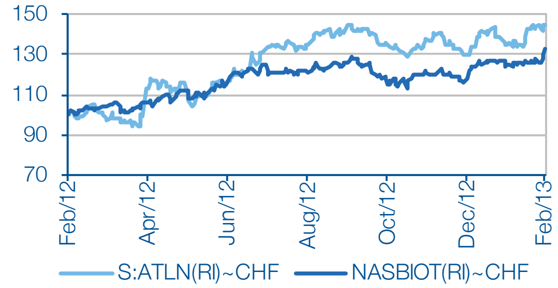
Celgene	Code: CELG US	Market cap: US$44,228m (£29,405m)



Div yield (trail. 12 months)	N/A
Sector focus	Cancer, Inflammatory diseases
Listing	NASDAQ
Website	www.celgene.com

Celgene has several potential positive items of newsflow this year. Pomalyst has been approved by the FDA as a bone marrow cancer therapy and is in Phase II trials for myleofibrosis, Celgene is working on an extension of cancer drug Revlimid's potential market; the managers believe its sales could exceed $5bn. Additionally, recent positive clinical results showed solid survival data for Abraxane in pancreatic cancer and strong results for Apremilast in two pivotal Phase III psoriasis trials.

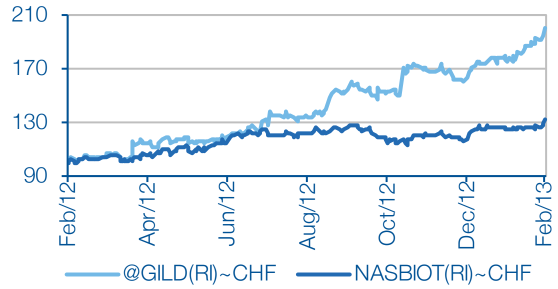
Actelion	Code: ATLN VX	Market cap: CHF6,080m (£4,287m)



Div yield (trail. 12 months)	2.09%
Sector focus	Pulmonary arterial hypertension
Listing	SIX – Swiss
Website	www1.actelion.com

Actelion's existing PAH treatment, Tracleer, has been coming under competitive pressure. Actelion has a similar new drug awaiting FDA approval, Opsumit (superior to Tracleer in that it has lower liver toxicity), which the managers think could help Actelion recover market share. Actelion also has a new class of drug, Selexipag, in Phase III, which can be used to treat more advanced PAH and should capture share from rivals because it is administered orally rather than intravenously.

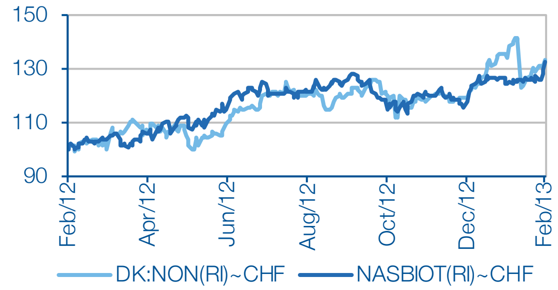
Gilead	Code: GILD US	Market cap: US$ 66,148m (£43,978m)



Div yield (trail. 12 months)	N/A
Sector focus	HIV, Hepatitis, Influenza, Pulmonary Disorders and Cystic Fibrosis
Listing	NASDAQ, Frankfurt
Website	www.gilead.com

Gilead receives a royalty on Roche's sales of Tamiflu, but it is better known for its HIV drugs, which have also proved useful in the treatment of Hep B. In 2012, Gilead acquired Pharmasset in part to give it exposure to Sofosbuvir, a drug in development to treat Hep C (filing on track). The managers are optimistic that it could take a leading share of this market. Gilead has settled a patent dispute with Teva over Viread

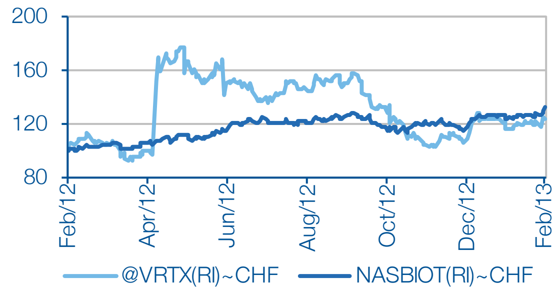
Novo Nordisk	Code: NOVOB DC	Market cap: DKK572,320m (£66,314m)



Div Yield (trail. 12 months)	1.76%
Sector focus	Diabetes, Haemophilia, Hormones
Listing	Copenhagen, Frankfurt
Website	www.novonordisk.com

Novo Nordisk is world's largest producer of insulin. It recently announced European approval of Tresiba (Degludec) – good news after the FDA rejected the drug – and Ryzodeg (Degludec plus), its new ultra-long acting insulins. The managers note approval comes with a positive label with superiority claims to Sanofi's Lantus. Novo Nordisk has other products in the pipeline for diabetes as well as NovoSeven (targeted at haemophilia) and hGH for human growth hormone deficiency.

Vertex	Code: VRTX US	Market cap: US$10,032m (£6,670m)



Div yield (trail. 12 months)	N/A
Sector focus	Hepatitis C, Cystic Fibrosis, Autoimmune disorders
Listing	NASDAQ
Website	www.vrtx.com

Vertex has sales of $1.5bn but is loss making. Incivek (its protease inhibitor for Hep C) sales fell in 2012, but the manager thinks sales could revive by combining it with VX-135 – trials are due to start shortly. Kalydeco (Cystic Fibrosis) launched in the US and Europe in 2012. It has a $1bn target market now (5% of cases), but this could expand if Vertex can successfully combine it with a new drug, VX-809, (to 70% of cases).

Source: BB Biotech, Datastream, Edison Investment Research

Fund profile

BION is a Swiss-domiciled investment company, listed in Zurich, Frankfurt and Milan. It was founded in November 1993 and now has AUM of c CHF1.6bn. BION is unlike most other investment companies in that the board has to approve all investment decisions. However, it is advised by Bellevue Investment Management, a biotech specialist (which also manages a fund of unlisted biotech investments). Members of the board and the management team are experts in the field.

The investment opportunity: Growing market

Healthcare spending is rising in response to a global population that is expanding, ageing, and in many developing countries, is more affluent. Although the pharmaceutical industry has made great strides, even in the recent past, there are still many diseases and conditions for which researchers have yet to identify a cure. Higher life expectancy, in part the consequence of therapeutic advances we now take for granted, is increasing the prevalence of age-related diseases and consequently the demand for new therapies. While 'big pharma' excels at sales and marketing it has often struggled in recent years to replace revenue as drugs went off-patent, despite spending large sums on R&D. Biotech companies are smaller, nimbler, more focused and more entrepreneurial, and consequently have attracted some of the best R&D talent. Although the rewards for discovering effective treatments are high, making the biotech sector an attractive place to invest, the associated risks are also high. It is expensive and time-consuming to bring a new treatment to market and products can fall at the final hurdle if they fail to pass the scrutiny of bodies such as the FDA or European Medicines Agency. Biotechs have often struggled to finance themselves through to profitability and while increasing numbers are reaching maturity, many fail to reach that point. The high risk and the need to understand the complex science that will often determine the success or failure of these companies are strong arguments for investing in the sector via a portfolio managed by an expert or experts.

The fund manager: Bellevue Asset Management

The management team, based primarily in Zurich, comprises Dr Daniel Koller (head), Dr Tazio Storni, Dallas Webb, Felicia Flanigan, Lydia Bänziger, Jan Bootsma, Hugo van Neutegem and Nathalie Isidora-Kwidama. Their average length of service with Bellevue is eight years. Each has their own area of expertise and many have previous experience of both managing healthcare investments and/or working in biotech research.

The manager's view: Exciting times ahead

2012 saw 14 new products approved by the FDA (eight of which were developed by stocks in BION's portfolio). The year was also characterised by relatively high levels of M&A, notably Glaxo's acquisition of Human Genome Sciences and Astra Zeneca's purchase of Amylin (both of which were held by BION). The managers foresee more of the same in 2013. They believe the portfolio is positioned for defensive growth. They have focused the portfolio principally on US-domiciled mid- and large-cap. companies, which they believe are addressing areas of unmet medical need, notably oncology and infectious diseases. There are a record number of products in clinical trials and they have identified 21 new products that could come to the market between now and 2015, which are being developed by the stocks BION holds. The managers believe this could drive an acceleration of portfolio average earnings growth from a mid-teens percentage today to over 20% in 2015 (around twice the average for the sector).

Asset allocation: Focused portfolio

Investment process: Blend of top-down and bottom-up

BION invests with the aim of generating 15%+ pa returns over the medium to long term (three to five years plus). BION operates with a concentrated portfolio of 20-35 holdings, five to eight of which are designated core holdings (stocks where their degree of conviction is such that they feel comfortable holding larger, typically 5%+ positions). BION's investment universe includes biotech companies (any company that applies technical advances in life sciences to develop commercial products) in all geographies and of all sizes, including some late-stage companies that have not listed yet – about 800 companies in all. The team talk to analysts, conduct interviews with doctors and specialists, attend medical conferences, review scientific literature and visit companies. BION also holds a bi-annual strategy meeting, where the board and the managers review strategic developments in the biotech industry and meet with the management of the portfolio holdings or of potential investments. The aim is to identify disease areas where major progress is being made. The managers then look for the individual companies and products best placed to exploit these areas, applying both quantitative and qualitative screens (including an assessment of the quality of management) and consulting doctors and specialists to learn more about different drug candidates. The managers want to understand not only why the product will work and its benefits for patients, but also to try and assess its economic impact. Ideally, BION targets products that are novel and reduce overall healthcare costs because of their higher efficiency or better safety.

The team maintain financial models on c 100 existing and potential investments. For the most promising ideas, an analyst prepares a detailed investment proposal (focusing on the potential downside as well as the upside), which is presented to the board in a monthly meeting. No new investment is made without board approval. Once the board has approved a proposal, the portfolio managers build the position in a relatively short time, provided price levels are within the approved range. Post-investment positions are monitored closely, with the validity of investment cases reassessed whenever new information becomes available. If a substantial change occurs, it triggers a proposal to the board to increase the position or to exit it, depending on the rationale. In between board meetings, the managers have the freedom to trim or add to existing holdings on valuation grounds. Natural turnover is relatively modest (10-15% per annum), but is heightened by M&A activity (all four companies exited in 2012 were taken over).

Overview

There were 32 holdings in the portfolio at the end of December 2012, nine of which were described by the manager as core holdings. The core holdings accounted for 65.9% of the portfolio. The managers estimated the sector distribution was oncology 36%, infectious diseases 18%, cardiovascular diseases 16%, metabolic diseases 12%, autoimmune diseases 3% and others 15%. The distribution by currency is shown in Exhibit 1.

Current portfolio positioning

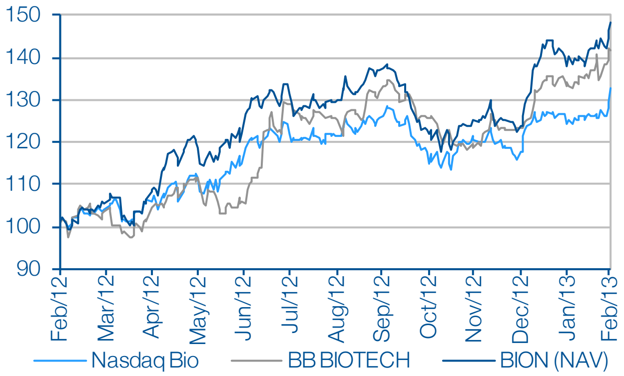
The managers made five additions to the portfolio in 2012: Medivation, Onyx, The Medicines Company (a company the board knows well, as one of BION's directors is its CEO), Intercell and IPCA, a fast-growing Indian company. These transactions were largely funded by takeovers of stocks in BION's portfolio. The managers see opportunity in the Indian market and BION now owns four Indian companies, which are mainly devoted to the manufacture and sale of generic products.

Recent performance

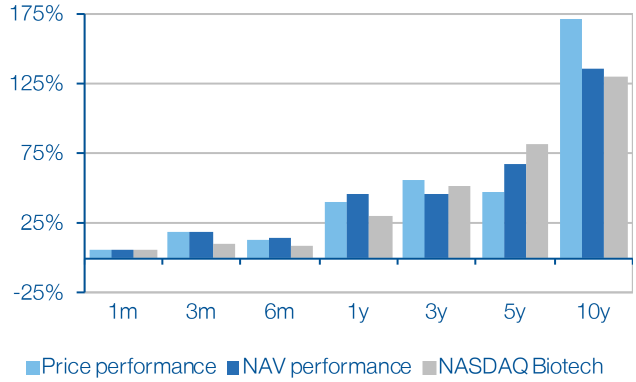
BION beat comparable indices comfortably in 2012. The performance was driven in part by M&A activity in the portfolio as Human Genome Sciences, Amylin, Pharmasset and Micromet (collectively c 9% of the portfolio at end-December 2011) were taken over (at an average premium of 81% to the share prices before the announcement of the deals), but also was assisted by strong performance from BION's core portfolio, excluding Vertex (as shown in Exhibit 2).

Exhibit 3: Investment trust performance

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



Price, NAV and benchmark total return performance (%)



Source: BB Biotech, Morningstar, Edison Investment Research

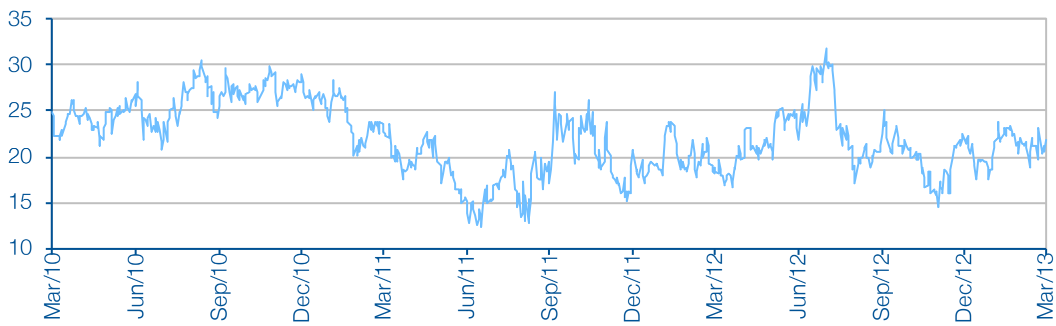
Exhibit 4: Share price and NAV total return performance (sterling adjusted), relative to benchmarks as at 1 March 2013

	1 month	3 months	6 months	1 year	3 years	5 years	10 years
Price relative to NASDAQ Biotech	0.3	9.4	4.1	10.1	4.3	(34.5)	42.0
NAV relative to NASDAQ Biotech	0.0	8.3	4.9	15.7	(4.9)	(14.6)	6.6
Price relative to MSCI World HealthCare	1.0	8.2	0.6	12.8	13.8	(4.7)	49.4
NAV relative to MSCI World HealthCare	0.7	7.2	1.4	18.4	8.3	16.9	29.4
Price relative to DS World Pharma & Biotech	0.8	8.0	0.2	9.9	11.9	(14.6)	37.4
NAV relative to DS World Pharma & Biotech	0.4	6.9	1.0	15.5	6.4	7.1	17.4

Source: BB Biotech, Morningstar, Edison Investment Research. Note: Figures are in Swiss francs.

Discount

Exhibit 5: Discount over three years



Source: Morningstar, Edison Investment Research

BION's discount has averaged c 22% over the past three years. It widened over the first half of 2012, while the board conducted a review of its discount management policy and suspended capital returns (see Dividend policy and record section below). In the summer of 2012, Vontobel approached the board offering to unitise BION but withdrew their offer in November 2012 as it would have had adverse tax consequences for BION's shareholders. Instead, the board committed to return at least 10% of capital each year, 5% through capital distribution and 5% through share buy-backs. BION's discount narrowed following the news and is now narrower than its three-year average at 21.8%.

Capital structure

BION has a conventional capital structure with one class of equity share of par value CHF1.0. Its share capital consists of fully paid standard registered shares. Registered shares are the same as ordinary UK equity shares, in that their owners' details are entered in a share registry. Owners may opt to remove their details from the register, but registration is necessary to vote and receive dividends. BION's shares are listed in Switzerland, Germany and Italy on the SIX, TecDAX and Star Segment respectively. All these exchanges are easily accessible to UK investors.

As part of its discount control programme, BION regularly repurchases shares into treasury and periodically cancels a proportion of these. It does resell stock from treasury when it can do so at a profit and these re-sales may be made at a discount to net asset value. Following the last AGM in March 2012, there were 13m authorised shares (including 649,106 shares held in treasury). BION took powers at the AGM to buy back 10% of its authorised share capital and by the end of December 2012, it had repurchased 992,247 shares as part of this programme, to leave 11,358,647 shares in issue and 1,641,353 shares in treasury. We estimate that following share repurchases made since 31 December, BION has 11,254,654 shares in issue and 1,754,306 shares in treasury. A proportion of the treasury shares will be cancelled at the AGM in March 2013. Note: for the avoidance of confusion, throughout this document we have treated the treasury shares as in issue but not outstanding, reducing the market cap accordingly, in line with standard UK practice. BION gives its issued capital as 13m shares.

BION can borrow up to CHF350m and at the end of December 2012 had gross borrowing of CHF135m, equivalent to 9.6% of net assets. This was offset by cash of CHF18.5m to give net gearing of 8.3% of net assets. All borrowings are short-term bank loans. The management fee, paid monthly, is 1.2% of the average market capitalisation up to CHF1.0bn. At CHF1.0bn, the management fee is fixed in nominal terms such that the fee rate falls if the market cap increases. There is no performance fee and the management contract may be terminated at each year end. Ongoing expenses last year were 1.45% (this excludes one-off legal and other expenses, mainly related to the Vontobel approach). This compares to 0.88% for 2011 (the basis of the calculation of the management fee changed last year resulting in an increase in fees). BION has an indefinite life and there is no specific mechanism to wind up the company.

Dividend policy and record

In contrast to the more mature pharmaceutical sector, the biotech sector has historically not generated much income for investors (as reflected in the yield statistics for the peer group shown in Exhibit 6 below). From 2003 to 2010, BION paid dividends, primarily from capital, as part of a discount management policy (according to a formula that linked distributions to the size of BION's discount – the larger the discount, the larger the dividend). No dividend was paid for 2011, while the board reviewed BION's discount management policy. However, for 2012 (ie to coincide with the next AGM in March 2013), the board has decided to make a distribution of CHF4.50 per share, approximately equivalent to 5% of BION's share price of CHF88.5 at 31 December 2012. The board has committed to paying out a 5% distribution in future years.

Peer group comparison

Although all five members of the peer group (shown in Exhibit 6 below) invest in biotech, their investment approaches are quite different from each another, some invest in early stage biotech, unquoted biotech or have a bias to large pharmaceutical companies. Within the peer group, BION's performance ranks second over one year and three years and third over five years. Its ongoing charges are close to the average of the peer group, but its discount is the widest. None of the funds is particularly geared at this point in time. Generally, these funds do not pay much by the way of dividend (BION's past payments, soon to be reintroduced, have been paid primarily from capital).

Exhibit 6: Biotech sector 1 March 2013

Company	Share price total return on £100			Ongoing charges (%)	(Disc)/ prem.	Net gearing (100=no gearing)	Five-year dividend growth (%)	Div. yield
	One year	Three years	Five years					
Average	**30.9**	**56.1**	**67.2**	**1.4**	**(5.7)**	**102**	**269.9**	**0.8**
BB Biotech AG	**40.8**	**56.0**	**47.6**	**1.4**	**(21.8)**	**108**	**(100.0)**	**0.0**
Biotech Growth	48.1	86.2	139.9	1.3	(0.8)	96	N/A	0.0
International Biotechnology	16.5	44.2	24.0	1.9	5.0	103	N/A	0.0
Polar Capital Glb Healthcare	20.9	N/A	N/A	1.1	(3.8)	99	N/A	2.5
Worldwide Healthcare	28.1	37.9	57.1	1.1	(7.1)	105	639.9	1.6

Source: Morningstar

The board: Executive board

The board members are advised by an external investment adviser, but sign off all major investment decisions. Therefore, none of the board should be considered as non-executive. The board consists of the chairman, Professor Dr Thomas D Szucs (appointed as a director in 2003 and as chairman in 2004. He is standing down as a director at the next AGM in March 2013) and two directors, Dr Clive Meanwell (appointed as a director in 2004) and Dr Erich Hunziker (the chairman designate, appointed as a director in 2011). In March 2013, Professor Dr Klaus Strein will be appointed to the board. Professor Szucs is director of the Institute for Pharmaceutical Medicine of the University of Basel and of the European Centre of Pharmaceutical Medicine. Dr Meanwell is executive chairman and CEO of The Medicines Company and was a founding partner and managing director of one of the world's largest dedicated investors in life sciences. Dr Hunziker was CFO of Roche. Professor Strein is a professor at the University of Heidelberg and has held top-level research positions at Boehringer Mannheim and Roche.

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