EDISON

BB Biotech AG

Double-digit returns with a double-digit discount

Investment companies

BB Biotech AG (BION) is a Swiss-based investment company specialising in the biotechnology sector, with a focus on mid-sized and larger companies that are already generating revenues. Exposure to success stories such as Gilead, whose hepatitis C treatment Sovaldi became a record seller on its introduction earlier this year, has seen the portfolio achieve annualised gains of more than 20% over five years, yet the discount to NAV remains wide, at 20% (double the peer group average excluding BION). A 5% annual distribution policy means BION is the only biotech specialist trust with a yield, equivalent to 4.5% at 16 July.

12 months ending	Share price (%)	NAV return (%)	NASBIOT Index (%)	MSCI World HealthCare (%)	FTSE All-Share index (%)
30/06/11	15.0	6.8	8.4	0.5	5.3
30/06/12	19.0	41.5	37.5	19.3	6.4
30/06/13	55.2	42.5	34.4	27.5	14.0
30/06/14	44.8	37.1	39.2	21.2	19.5

Source: Thomson Datastream, Morningstar. Note: CHF total returns.

Investment strategy: Growth through innovation

BION aims to achieve average annual double-digit returns over the longer term by investing in fast-growing biotech companies that are developing and marketing innovative drugs and treatments. Headquartered in Zurich, the company's investment management team comprises six biotech specialists with an average tenure of seven years. There is an executive board whose three members approve all new investments and complete exits. The managers seek to invest in companies that can double their asset value on a four-year view, and BION's concentrated portfolio is heavily weighted to the US (77% at 30 June).

Outlook: Strong rebound from spring sell-off

The biotech sector has bounced back from a sharp sell-off in March and April, with the benchmark NASDAQ Biotech index up 15.8% year to date at the start of July, and only 3.7% below the all-time high achieved in late February. Fundamentals remain supportive for the sector, with ageing populations around the world providing a growing market for new treatments, and scientific advances meaning quality of life can be dramatically improved for many patients with long-term conditions. Valuations are favourable compared with 'big pharma' but investors should be mindful of the extra risk inherent in biotech because of the binary nature of drug development, compared with the more diversified pharmaceutical firms.

Valuation: Wide discount relative to peers

At 16 July BION was trading on a cum-fair discount to net asset value of 20.0%, broadly in line with its own average over one, three and five years, but significantly wider than its peers, where biotech specialists in the AIC peer group traded on an average discount of 8.1% excluding BION. The board hopes to address the discount through its recently adopted distribution policy, whereby it seeks to return 10% of capital to shareholders each year, half through a dividend-style distribution (making BION the only biotech trust with a yield) and half through share buybacks.

21 July 2014

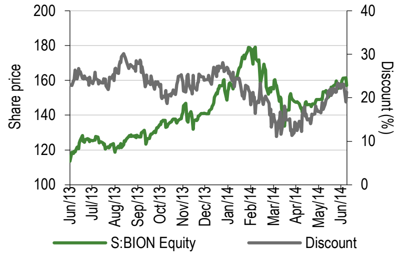
Price	**CHF155**
Market cap	**CHF1,839m**
AUM	**CHF2,300m**

NAV*	CHF194.00
Discount to NAV	20.0%

*Including income. Data at 16 July 2014.

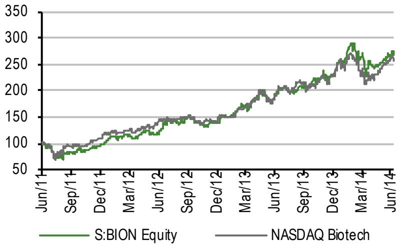
Yield	4.5%
Ordinary shares in issue	11.85m
Code	BION
Primary exchange	Zurich
AIC sector	N/A

Share price/discount performance



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

Three-year cumulative perf. graph



52-week high/low	CHF179.1	CHF118.7
NAV* high/low	CHF229.1	CHF156.0

*Includes income.

Gearing

Gross	6.8%
Net	6.7%

Analysts

Sarah Godfrey +44 (0)20 3681 2519

Andrew Mitchell +44 (0)20 3681 2500

investmenttrusts@edisongroup.com

Edison profile page

BB Biotech AG is a research client of Edison Investment Research Limited

Exhibit 1: Trust at a glance

Investment objective and fund background

BB Biotech (BION) is a Swiss-domiciled investment company, targeting long-term capital growth from biotechnology companies that are developing and marketing innovative drugs. At least 90% of the portfolio is invested in listed companies, primarily large and mid-cap names that are already profitable. It is benchmarked against the NASDAQ Biotech Index, but is managed bottom-up with a concentrated 20-35 stock portfolio.

Recent developments

31 March 2014: Release of results for the first quarter. NAV increased by 2.8% in CHF (3.6% in €; 3.8% in US$) and the share price increased 15.0% in CHF (15.5% in €) compared with 4.3% for the benchmark NASDAQ Biotech index (in US$).

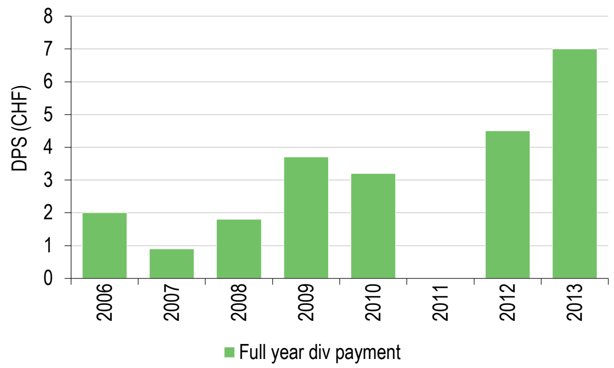
Forthcoming		Capital structure		Fund details	
AGM	March 2015	Ongoing charges	1.1%	Group	Bellevue Asset Management
Quarterly results	17 July 2014	Net gearing	6.7%	Manager	Team-managed
Year end	31 December	Annual mgmt fee	1.1% on market cap	Address	Seestrasse 16, 8700 Kusnacht, Switzerland
Dividend paid	March (part capital return)	Performance fee	None		
Launch date	November 1993	Trust life	Indefinite	Phone	+41 (0)44 267 6700
Continuation Vote	None	Loan facilities	See page 7	Website	www.bbbiotech.com

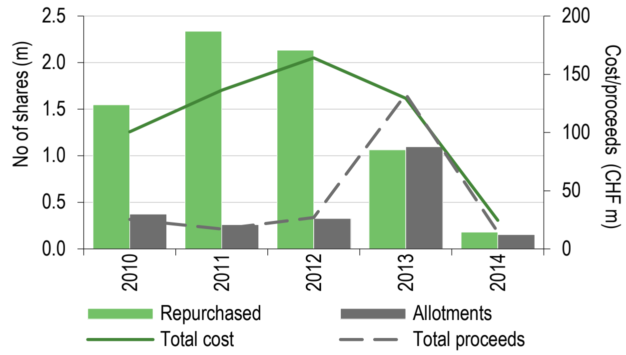
Dividend policy and history

A new distribution policy was put in place from the year ended 31 December 2012, whereby BION makes a cash distribution equivalent to approximately 5% of its share price at the year end.

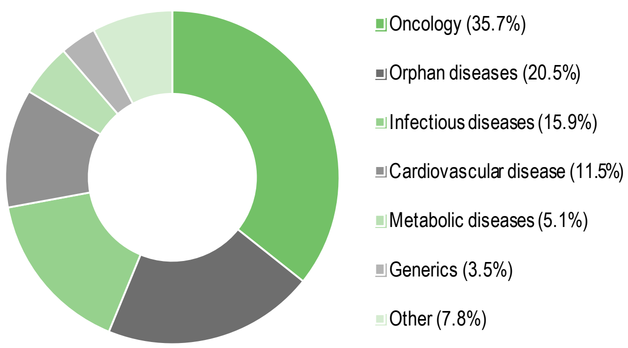
Share buyback policy and history

BION has authority, renewed annually, to repurchase up to 10% of its issued share capital. As part of the new distribution policy announced from the year ended 31 December 2012, BION has also committed to returning 5% of its share price, at the year end, via the share buyback programme during the year.

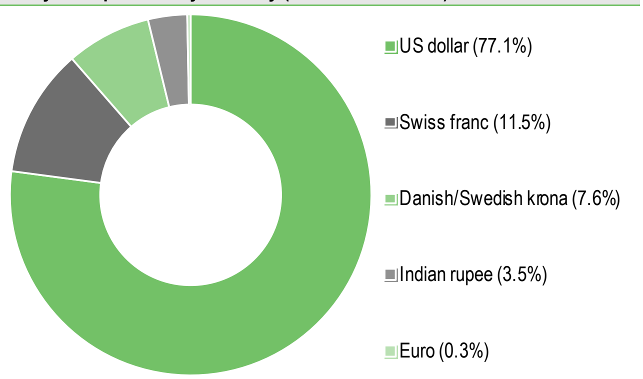




Breakdown by primary area (as at 30 June 2014)



Analysis of portfolio by currency (as at 30 June 2014)



Top 10 holdings (as at 30 June 2014)

			Portfolio weight %	
Company	**Country**	**Primary area**	**30 June 2014**	**30 June 2013**
Celgene	US	Oncology/inflammatory diseases	13.2	13.5
Actelion	Switzerland	Cardiovascular	11.5	11.6
Gilead	US	Infectious diseases	10.5	10.2
Incyte	US	Orphan diseases/cancer	8.6	6.3
Isis Pharmaceuticals	US	RNA interference	8.4	11.2
Vertex Pharmaceuticals	US	Orphan diseases	4.8	6.1
Medivation	US	Oncology	4.2	3.8
Alexion Pharmaceuticals	US	Orphan diseases	4.1	3.9
Novo Nordisk	Denmark	Diabetes	3.8	4.3
Synageva BioPharma	US	Orphan diseases	3.4	0.1
Top 10			**72.5**	**71.0**

Source: BB Biotech AG, Bloomberg, Morningstar, Edison Investment Research.

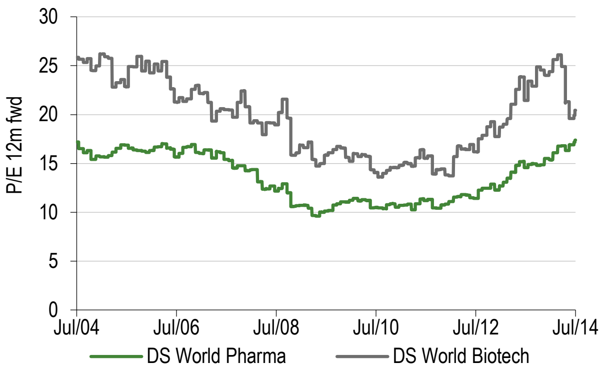
Outlook: Better value after correction, but risks remain

The biotech sector had enjoyed a long bull run beginning in 2011, and as the US stock market hit multiple all-time highs in early 2014, fears began to emerge that biotech was entering bubble territory. A letter from three congressmen (the 'Waxman letter') on 20 March asking Gilead to justify the US$84,000 price tag for a course of its hepatitis C treatment Sovaldi brought wider concerns over drug pricing to a head. The NASDAQ Biotech index (which was already down 6% from its 25 February peak) sold off sharply, falling 4.4% in a day and 14.2% over the following month (19.4% from peak to trough).

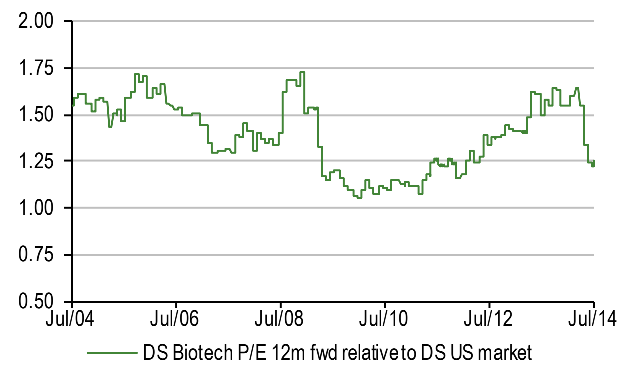
Biotech and the wider healthcare sector benefit from ageing populations around the world and growth in emerging markets, while advances in the understanding of disease mechanisms mean that quality of life and survival rates may be improved for many patients with previously untreatable conditions. Biotech is a higher-risk but higher-growth area of medicine than 'big pharma', and company valuations tend to be higher as a result. However, as can be seen in Exhibit 2, the P/E premium for biotech versus the wider healthcare sector has declined following the correction earlier this year, and managers now see considerable value among many biotech stocks. The 12-month forward P/E for the Datastream World Biotech index at 1 July was in line with its 10-year average (20.4x vs 19.7x over 10 years), while the Datastream World Pharma index forward P/E was 28% above its 10-year average (17.4x vs 13.6x). Compared with the wider US market, biotech stocks currently trade at a lower premium in P/E terms than the average over 10 years (1.25x the US market P/E compared with a 10-year average of 1.39x); the 12-month forward P/E for biotech stocks was 104% of its 10-year average at 1 July, compared with 116% of the average for the US market P/E as a whole. Investors should be mindful of the historically high levels and valuations of the US stock market, given the concentration of biotech stocks in the US.

Exhibit 2: Healthcare sector valuations

World-DS Pharma and World-DS biotech P/Es over 10 years



World-DS Biotechnology P/E relative to US-DS Market P/E over 10 years



Source: Thomson Datastream, Edison Investment Research

Fund profile: Biotech specialist with panel of experts

BB Biotech is a Swiss-domiciled investment company set up in 1993 to invest in high-growth biotechnology companies, with a bias towards those that are already generating revenue and profits as a result of their innovations. Its shares are listed on the Swiss SIX exchange in Zurich (in Swiss francs) and it also has listings in Frankfurt and Milan (euro-denominated).

The company has a three-strong executive board (see page 8) and employs Bellevue Asset Management as its investment manager. All the board members and fund managers are life sciences specialists. The investment team comprises Dr Daniel Koller (biotechnologist), Felicia Flanigan (economist; expert in oncology/infectious disease), Dallas Webb (microbiologist), Dr Tazio Storni (biotechnologist), Dr Stephen Taubenfeld (neurologist) and Lydia Bänziger (biochemist).

The fund manager: Bellevue Asset Management

Managers' view: Innovation underpins continued pricing power

After a significant run-up in recent years, the biotech sector corrected sharply in March/April 2014. BION's managers say one factor behind the sell-off was political and regulatory concern over the pricing of Gilead's mega-blockbuster hepatitis C drug Sovaldi, which broke prescription records on its introduction and is now expected to achieve sales of US$5-10bn in its first year.

Many generalist investors had ventured into the biotech sector on the back of strong performance, and BION's managers believe the Waxman letter gave them the trigger they needed to take profits. Smaller stocks, which had reached more extended valuations, were hit hardest, particularly those new to the market, as some of the 2013 IPOs had more than doubled from their flotation price. Manager Dallas Webb says investors "needed to get their feet back on the ground", and the correction caused stocks in the mid-cap space in particular to move to more attractive valuations.

With some of the 'hot money' having exited the sector, Webb says the fundamentals remain sound, with launches, drug approvals and late-stage trials progressing at good rates. Valuations on a 2016 forward P/E basis are now on a par with large-cap pharmaceutical firms, in spite of biotech's multi-year record of double-digit sales growth, compared with 2-3% a year for big pharma. The managers believe pricing power will be maintained despite political scrutiny, with the healthcare system increasingly looking at drugs in terms of the magnitude of benefits rather than simply the price tag. In its valuation work, the team considers what a drug will bring not just to the patient, but to the doctor and the healthcare system as a whole. Webb points to the increased use of companion diagnostics and genetic testing in the development of new cancer drugs as having potentially huge benefits in areas of unmet need; as well as more personalised medicine, he says several companies in the portfolio also have 'blockbuster potential' for larger disease populations.

While the managers acknowledge the growing importance of emerging markets – particularly given the increased levels of diseases such as diabetes in India and China – Webb says they will not be a major sales driver for the sector in the next five or six years, although he does expect significant progress in awareness and understanding.

Asset allocation

Investment process: Focus on science and financials

The executive board and investment managers all have expertise across a variety of life science areas, and the investment process is underpinned by continuing industry analysis, looking at drugs under development across the disease spectrum, meeting company management, attending industry conferences, interviewing physicians and specialists and monitoring scientific literature. Financial models are built for all candidate companies – c 150 out of a universe of 800. The managers will generally seek to invest in companies where they see potential for asset value to double in around four years. There is a bias towards revenue-generating companies or those in the later stages of drug development.

All new investments must be proposed to the board, who will examine the data and models before approving or rejecting an idea. The managers propose an initial position size based on upside and downside potential and the risk profile relative to other stocks in the portfolio. Most new stocks enter the portfolio at 2-3% of NAV. Once in the portfolio, the managers may trade stocks quite actively, adding on weakness or taking profits when they have done well. All positions are actively monitored against price targets and there is ongoing research and dialogue with company management.

The majority of the portfolio is in US-listed stocks and BION does not hedge currency exposure. It has done so in the past and would not rule out doing so again in future, however.

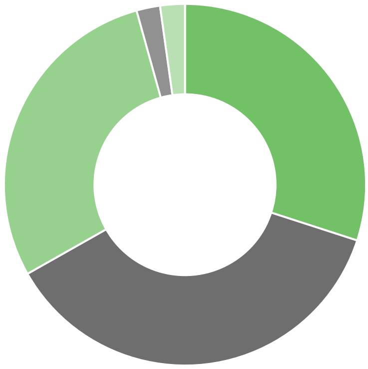
Current portfolio positioning

BION has a concentrated portfolio of 20-35 stocks (33 at 30 June 2014). Of these, five to eight (currently five) are designated 'core' holdings, representing those companies in which the managers have greatest conviction. At 30 June, the five core holdings represented 52.2% of the portfolio, with the top 10 stocks accounting for 72.5%. The portfolio is heavily weighted to the US (24 stocks), with four holdings in India, two in Denmark and one each in Switzerland, Sweden and Germany.

Exhibit 3: Portfolio distribution by stage of profitability and market capitalisation

Portfolio distribution by stage of profitability	
Companies generating revenues	c 95%
Profitable companies	c 50%
Platform companies	c 15%
Pre-phase III companies	<15%

Portfolio distribution by market capitalisation (US$)



Source: BB Biotech AG, Edison Investment Research. Note: Data at 30 June 2014.

Actelion, a Swiss company and the only non-US stock among the core holdings, recently reported positive data on its pulmonary arterial hypertension drug selexipag, leading to a c 20% rise in the share price. Vertex, the sixth-largest holding at 30 June, moved up the rankings (from eighth at 31 March) following a 40% increase in its share price on good data for its cystic fibrosis combination, which Webb describes as "probably the most binary data event this year". Gilead was punished in the sell-off but is still up c 16% year-to-date, and should receive a further boost if its one-pill combination version of Sovaldi is approved as expected later this year. A more favourable regulatory environment in the US, with the FDA continuing its 'breakthrough' designation for drugs addressing unmet needs, is expected to continue to be supportive of stocks in the portfolio.

Biotech investment can be risky owing to the binary nature of developing new drugs. An example is Endocyte (2.3% of the portfolio on 31 March; 0.6% on 30 June), which has not recovered after poor Phase III data for its vintafolide cancer treatment caused a one-day fall of 62% in early May.

The managers continue to see value in the mid-cap sector and expect M&A activity to be supportive now that the froth has come off the IPO market. They presently favour quoted over unquoted investments, where they may hold up to 10% of the portfolio but have only 1% exposure.

Performance: Strong returns despite correction

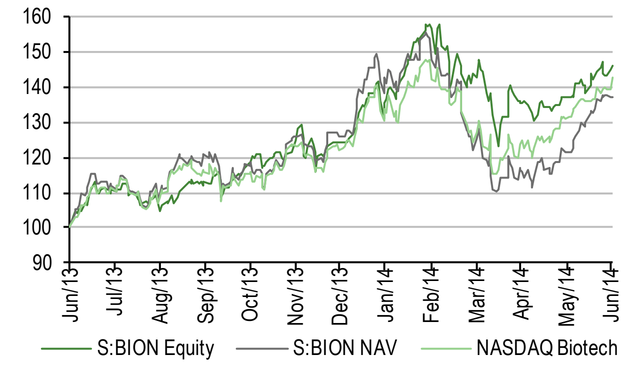
In spite of the market correction earlier this year, returns from biotech have been strong, with BION and the NASDAQ Biotechnology Index producing total CHF returns of c 10% a year over 10 years and c 20% a year over five years. However, much of this longer-term performance can be attributed to more recent periods, with annualised gains of close to 40% over three years for BION's NAV and share price, and for the benchmark (Exhibit 4, right-hand chart).

BION has outperformed the benchmark over one year on a share price basis; its NAV fell by more than the index during the correction but it also recovered more strongly, and stood only just behind the benchmark total return at 30 June (Exhibit 4, left-hand chart).

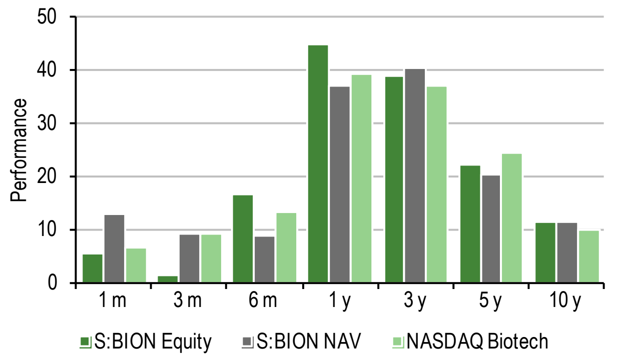
Exhibit 5 shows a general trend of NAV outperformance over the longer term, although BION has tended to underperform somewhat in falling markets. As shown in Exhibit 6, it has also outperformed the wider healthcare sector over most periods on both a share price and NAV basis, as well as the broad UK equity market, included for reference rather than relevance.

Exhibit 4: Investment trust performance to 30 June 2014

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

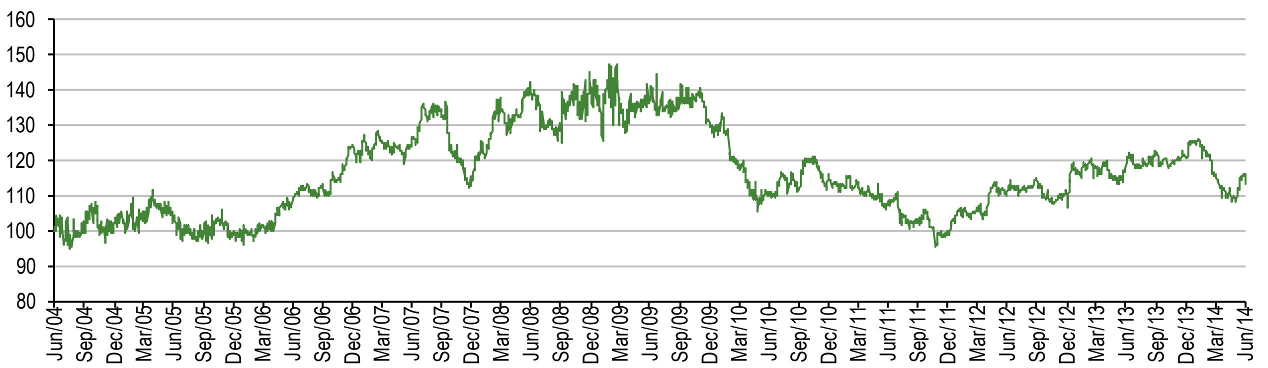


Price, NAV and benchmark total return performance (%)*



Source: BB Biotech AG, Thomson Datastream, Morningstar, Edison Investment Research. Note: *Three, five and 10 years annualised. All performances calculated in CHF.

Exhibit 5: BION NAV total return vs NASBIOT total return, over 10 years, rebased to 100



Source: BB Biotech AG, Thomson Datastream, Morningstar, Edison Investment Research. Note: Performance calculated in CHF.

Exhibit 6: Share price and NAV total return performance, relative to benchmarks (%), to 30 June 2014

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to NASDAQ Biotech	(0.8)	(7.2)	3.1	4.0	3.9	(7.7)	16.6
NAV relative to NASDAQ Biotech	6.0	(0.0)	(3.8)	(1.5)	7.5	(14.8)	16.2
Price relative to MSCI World Health Care Index	4.0	(3.7)	5.3	19.4	44.9	35.1	65.0
NAV relative to MSCI World Health Care Index	11.1	3.8	(1.8)	13.1	49.9	24.8	64.4
Price relative to FTSE All-Share Index	5.8	(3.7)	11.6	21.2	84.4	63.8	94.2
NAV relative to FTSE All-Share Index	13.1	3.8	4.1	14.7	90.8	51.3	93.5

Source: BB Biotech AG, Thomson Datastream, Morningstar, Edison Investment Research. Note: Performance calculated in CHF.

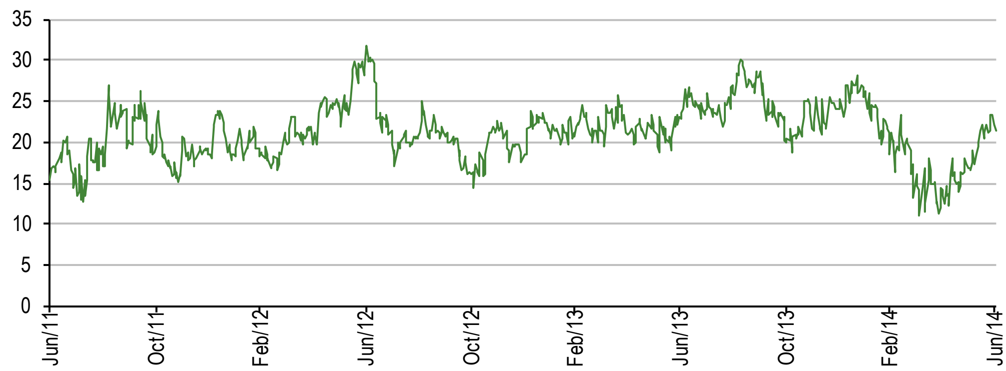
Discount: In line with history but still wider than peers

BION's 20.0% cum-fair discount to NAV at 16 July is broadly in line with its average over one, three and five years. However, as seen in Exhibit 7, in recent months the discount narrowed, reaching a five-year low of 11.1% in mid-April 2014 before widening again.

The company's current discount management/distribution programme, adopted at the end of 2012, is to return 10% of capital to shareholders each year, with half being through a capital distribution (see dividend section below) and half through share buybacks. In 2013, 415,000 shares were bought back under this policy, with 91,925 bought back in the first half of 2014.

While discount volatility seems to have reduced somewhat for the majority of the period since the new policy was adopted, the sharp correction in biotech stocks in March and April – which had the perverse effect of narrowing BION's discount as the NAV fell by more than the share price – means it is hard yet to form a clear picture of the success of the new discount management policy. BION's discount is wider than those of its peers: looking only at the biotech specialists in the AIC sector (see Exhibit 8), the weighted average discount excluding BION is 8.1% (17.9% including BION), while for the sector as a whole it is 5.6% (13.7% including BION). With buybacks at a fixed rate of 5% a year, all of BION's shares would be bought back in 20 years, so the policy may need to be reconsidered at some point.

Exhibit 7: Discount over three years, including income



Source: Thomson, Morningstar, Edison Investment Research. Note: Positive values indicate a discount.

Capital structure and fees

BION has one class of share with a par value of CHF1.0. It is listed on the Swiss SIX exchange and also has euro-denominated listings in Germany (Frankfurt Stock Exchange: ticker BBZA) and the Italian Star segment (BB). All the exchanges are accessible to UK investors and all are classed as 'recognised exchanges' by HM Revenue & Customs for the purposes of ISA investment. There are 11.85m shares in issue as at July 2014. The company may borrow up to CHF350m and at 30 June had borrowings of CHF175m, translating to gross gearing of 6.8%. Allowing for CHF31m of cash at 30 June, the net gearing figure was 6.7%.

Bellevue Asset Management receives an all-in fee of 1.1% of market capitalisation, reduced as of 1 January 2014 from the previous level of 1.2%. At the time the management fee was reduced, a fee cap on the average market capitalisation of CHF1bn was also removed, which, as things stand, will result in the fees payable to the manager being higher than they were, as the current market capitalisation is CHF1.8bn.[1] There is no performance fee as the board feels the current remuneration structure already aligns the interests of management with shareholders by rewarding increased average market capitalisation. At 30 June 2014 BION's total expense ratio was 1.18%.

Dividend policy and record

Prior to 2011, BION paid dividends (mainly out of capital) as a way of managing the discount. No dividend was paid for the year ended 31 December 2011 while the policy was reviewed. Since the 2012 financial year BION has adopted a new policy whereby it pays a capital distribution of 5% of the volume-weighted average share price for December. This translated to a distribution of CHF7.00 per share for the year ended 31 December 2013 (2012: CHF4.50), paid in March and representing a yield of 4.5% on the 8 July share price of CHF157. In addition, the company uses share buybacks to achieve a return of capital to shareholders of 10% a year. While past performance is no guarantee of future returns, the fact BION has achieved annualised total returns of 10%+ over 10 years and 20%+ over five years suggests a 5% annual distribution is sustainable.

[1] 1.2% of CHF1bn = CHF12m; 1.1% of CHF1.8bn = CHF19.8m.

Peer group comparison

While it is Swiss-listed and not a member of the Association of Investment Companies, the AIC Biotech & Healthcare sector is probably the most appropriate peer group for BB Biotech. Within the sector there are two biotech specialists and two more general healthcare funds. Exhibit 8 below shows all data in sterling terms. BION is the largest fund in the group by a considerable margin. Its NAV total return ranks it third over one year, second over three years and second over five years. Its discount is wider than the weighted average for the sector and its ongoing charges are lower than average; it is also the only fund in the group not to have a performance fee structure. Although it is the result of a capital distribution rather than a dividend, the 4.5% yield (based on the 8 July share price) is the highest in the sector. Neither of the other two biotech trusts has a yield. In terms of risk-adjusted performance (Sharpe ratio) BION is ranked fifth of five over one and three years.

Exhibit 8: Biotech and healthcare investment trusts

Percentage unless stated	Market cap £m	TR one year	TR three years	TR five years	Ongoing charges	Perf. fee	Discount (-) /premium	Net gearing	Yield	Sharpe NAV 1 year	Sharpe NAV 3 years
BB Biotech AG	**1351.7**	**17.1**	**135.5**	**195.2**	**1.5**	**No**	**-21.6**	**106.0**	**4.5***	**0.7**	**1.2**
Biotech Growth Trust	345.4	27.3	141.0	292.4	1.2	Yes	-4.5	111.0	0.0	1.0	1.6
International Biotechnology Trust	158.1	15.9	92.0	157.2	1.7	Yes	-16.0	109.0	0.0	0.7	1.4
Polar Capital Glbl Healthcare	183.8	10.4	57.5		1.2	Yes	-4.0	100.0	2.3	1.4	1.7
Worldwide Healthcare	615.9	21.9	73.4	161.7	2.8	Yes	-4.0	112.0	1.1	1.3	1.5
Sector weighted average		**19.0**	**113.8**	**198.0**	**1.7**		**-13.7**	**107.8**	**3.3**	**0.9**	**1.4**
BION rank in sector	**1**	**3**	**2**	**2**	**3**		**5**	**5**	**1**	**5**	**5**

Source: Morningstar, 8 July 2014, Edison Investment Research. Notes: TR = NAV total return. The Sharpe ratio is a measure of risk-adjusted return. The ratios we show are calculated by Morningstar for the past 12- and 36-month periods by dividing a fund's annualised excess returns over the risk-free rate by its annualised standard deviation. Net gearing is shown here as total assets less cash/cash equivalents as a percentage of shareholders' funds (100 = ungeared). BB Biotech is not part of the AIC peer group. All data is in sterling terms. *BB Biotech's yield is a function of its 5% capital distribution policy. Few biotech stocks pay dividends.

The board

BION has three executive directors. All major investment decisions are signed off by the board, who are highly qualified industry experts, although idea-generation and day-to-day portfolio management reside with the fund managers. Chairman Dr Erich Hunziker has been on the board since 2011 and became chairman in 2013. He is a former CFO of Roche. Dr Clive Meanwell has been a director since 2003 and is executive chairman and CEO of The Medicines Company, which he founded in 1996. Professor Dr Klaus Strein joined the board in 2013. He previously held various lead R&D roles at Roche and Boehringer Mannheim.

Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
245 Park Avenue, 39th Floor
10167, New York
US

Sydney +61 (0)2 9258 1161
Level 25, Aurora Place
88 Phillip Street, Sydney
NSW 2000, Australia

Wellington +64 (0)4 8948 555
Level 15, 171 Featherston St
Wellington 6011
New Zealand