EDISON

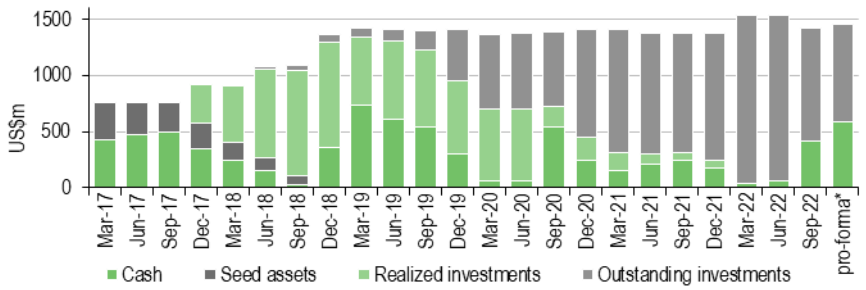
BioPharma Credit

A quality dividend play with FY22 yield of 12%

Investment trusts
Debt: Direct lending

BioPharma Credit (BPCR) is on track to deliver a strong (possibly record-high) annual NAV total return (TR) in FY22 on the back of a high investment level in H122, rising interest rates benefiting its floating rate loans, as well as healthy prepayment and make-whole fees from the early loan repayments in recent months. This has allowed BPCR to announce a US$0.045 special dividend, which implies a 12.0% dividend yield for FY22 on the current share price. The above-mentioned fees also provide BPCR with a good income runway for the re-deployment of prepayment proceeds. Since being fully invested in August 2018, BPCR achieved a net NAV TR of c 8% per year.

BPCR's strong track record of capital re-deployment since IPO



Source: BPCR, Edison Investment Research. Note: *Including post-balance sheet prepayment of GBT loan.

Why invest in BioPharma Credit now?

BPCR's returns are largely based on recurring income from a portfolio of senior loans secured by revenues from approved life sciences products (drugs, devices or diagnostics). As the latter are mostly dependent on the adoption curve among patients (and largely uncorrelated with the broad economy), this makes BPCR an attractive portfolio addition in all phases of the economic cycle. The credit quality of BPCR's loans is underpinned by the sector expertise and strong track record of Pharmakon Advisors (BPCR's investment manager), which so far has avoided any defaults. Since being fully invested, BPCR has consistently delivered an attractive regular dividend per share of 7c pa, often with special dividends on top of it.

The analyst's view

We estimate BPCR's cash position post recent prepayments at c 40% of NAV. BPCR has proved in the past that it is able to redeploy such a cash pile and the current market environment (lower valuations and fewer public equity raises) is supportive for BPCR. However, we note that its new investment activity will, in the short term, be limited by the requirement to hold cash for the purpose of its discount control mechanism. We calculate that post prepayments, c 70% of BPCR's senior loan portfolio (or c one-third of its NAV) will be floating rate and BPCR's preference for new investments is also likely to be floating rate (or high fixed rate). We thus believe that the significant increase in three-month Libor (now at c 4.46% vs 0.20% at end-2021), together with wider high-yield spreads, should support BPCR's targeted net NAV TR of 8–9% pa upon cash recycling.

3 November 2022

Price	**US$0.96**
Market cap	**US$1,285.4m**
NAV*	**US$1,395.2m**

NAV per share*		US$1.02
Premium/(discount) to		(5.9%)
* At end-August 2022		
Yield		7.3%
Shares in issue (excl. treasury shares)		1,339.0m
Code US$/£		BPCR/BPCP
Primary exchange		LSE
AIC sector		Debt – Direct Lending
52-week high/low	US$1.04	US$0.90
NAV* high/low	US$1.02	US$0.99
*Including income		
Gross gearing*		0.0%
Net cash*		29.9%
* At end-September 2022		

Fund objective

BioPharma Credit was incorporated in the UK in October 2016 and aims to generate predictable income for shareholders over the long term through a diversified portfolio of loans and other instruments backed by royalties or other cash flows derived from sales of approved life sciences products. This includes senior secured notes, royalty debt instruments and priority royalty tranches.

Bull points

- Strong and predictable income generation.
- Loans backed by approved and marketed products.
- High dividend yield.

Bear points

- Highly concentrated portfolio.
- Loans are often prepaid, creating a temporary cash drag (though normally offset by prepayment and make-whole fees).
- A sharp increase in US Libor increases the default risk across the floating rate part of the portfolio.

Analysts

Milosz Papst +44 (0)20 3077 5720
Michal Mordel +44 (0)20 3077 5720
investmenttrusts@edisongroup.com
Edison profile page

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The fund manager: Pharmakon Advisors

Pharmakon Advisors was established in 2009 and is a New York-based team of 10 professionals that manages BPCR. Pharmakon Advisors is run by Pedro Gonzalez de Cosio (co-founder and principal), Martin Friedman (principal) and Pablo Legorreta (co-founder and principal).

Exhibit 1: The manager's view: Rich pipeline of opportunities

Source: Edison Investment Research

Strong track record of delivering a healthy IRR with no defaults

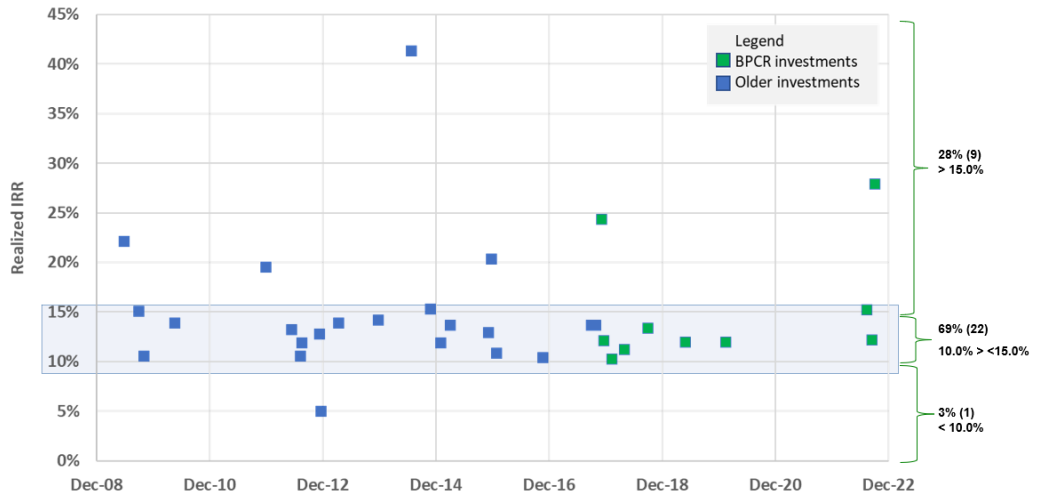
Since inception, funds managed by Pharmakon have committed c $6.5bn across 46 investments in the life sciences sector, mostly through debt investments. All structures managed by Pharmakon have been focused on debt and royalty investments.

Exhibit 2: Pharmakon Advisors' track record (private funds' performance at March 2021)

	BioPharma I	BioPharma II	BioPharma III	BioPharma IV
Launch date	June 2009	March 2011	February 2013	December 2015
End of investment period	May 2010	March 2013	August 2015	December 2017
Raised amount ($m)	268.9	363.1	500.0	512.9
Invested amount ($m)	263.7	343.0	463.0	512.0
Net MOIC* (x)	1.23	1.24	1.30	1.27
Unlevered net IRR (%)	11.3	6.8	11.3	11.4

Source: BPCR. Note: *Multiple of invested capital. Covers funds whose investment period has already ended.

Exhibit 3: Realised IRR of Pharmakon's past transactions



Source: BPCR. Note: Realised gross internal rate of return on each investment. Realised transactions include loans and synthetic royalties (exclude convertible bonds and equity).

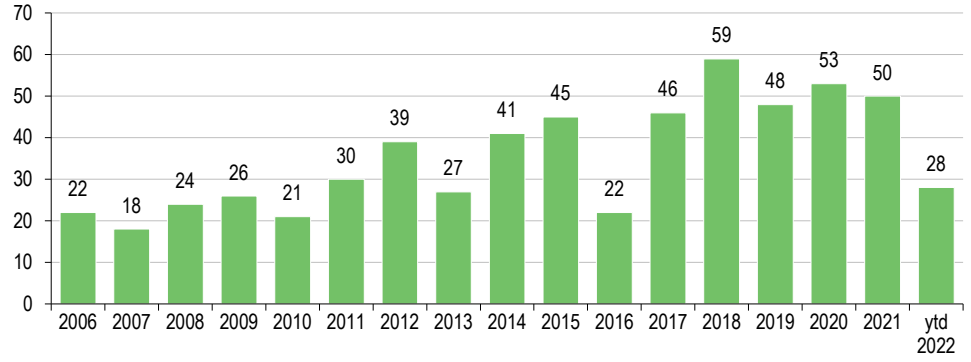
Market outlook: Opportunities from secular trends and weaker equity markets

Fragmentation of biopharma market expands the pool of potential borrowers

BPCR benefits from the shift from the traditional fully integrated pharmaceutical company model to greater market fragmentation. This is illustrated by the increasing share of newly approved drugs coming from smaller pharmaceutical companies (56% in 2017–20 vs 45% in 2009–12), according to Pharmakon (based on Bloomberg data). The vast number of spinoffs or new biotech companies being set up, which do not have the older mature cash-generating products to fund their research pipeline, greatly changes capital requirements and significantly increases the number of capital-seeking entities. This is coupled with expected growth in worldwide pharma R&D spending of 4.2% pa in 2021–26, according Evaluate Pharma's forecasts published in July 2021. R&D spending of smaller biotech companies is likely to grow at a faster pace than expenses of large pharma companies. The recent trend of Big Pharma players to sell non-core products to smaller companies also creates new lending opportunities.

Finally, the overall number of approved healthcare products has been increasing in recent years, with c 51 novel drug approvals by the US Food and Drug Administration (FDA) on average annually between 2017 and 2021 compared to c 24 on average in 2007–11 (see Exhibit 4). Consequently, more companies are becoming creditworthy by having their own marketed products or generating royalties (as products are being out-licensed to larger pharmaceutical companies); they are BPCR's preferred collateral.

Exhibit 4: FDA novel drug approvals



Source: FDA

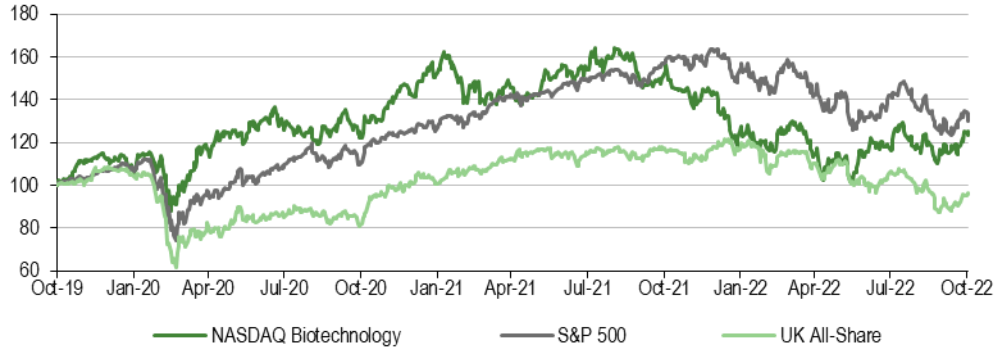
BPCR has few direct competitors

BPCR operates in a niche of lower-yield debt (though still at attractive rates of c 8–12%) backed by approved drugs (thus being somewhat lower risk). It sees little direct competition in its segment as banks often lack the necessary expertise to thoroughly assess the borrower and have more conservative lending practices, while there are no large, dedicated lenders or specialised debt markets focused on the biopharma sector. Moreover, the few existing specialised debt funds tend to operate in the higher-yield debt to fund pre-approval stage drugs (and charge higher fees to borrowers). Interestingly, when BPCR walks away from a deal because it considers the borrower too early stage, some of these debt funds often step in to provide funding which at a later stage may be refinanced by BCPR once the borrower becomes more mature and obtains drug approvals. BPCR's management considers the company's major competition to be equity, hedge and royalty funds specialising in the healthcare sector, whose investment mandate also covers occasional debt investments. According to BPCR's management, it usually faces only a few specialised lenders competing for a given deal. Thus, we believe that the main factor shaping BPCR's opportunity universe is the attractiveness of other financing options available to biopharma companies, including most notably equity and convertible debt issues.

Downturn in public equities makes BPCR's debt a more attractive source of funding

The attractiveness and availability of equity funding through public markets have deteriorated amid the sell-off, with the Nasdaq Biotechnology Index down c 14% ytd and c 25% from its peak in September 2021 (see Exhibit 5). As a result, the last 12 months (LTM) P/E ratio (based solely on companies posting positive earnings) now stands at 12.0x compared to a five-year average of 17.1x. There were only three IPOs of pure-play drug development companies on Western exchanges in Q322 (Third Harmonic Bio, Maia Biotechnology and Paxmedica), which was a third consecutive quarter of subdued flotation activity. The companies raised a mere c $153m (c $342m in Q222) based on Evaluate Pharma data, which is hardly comparable with the more than $3.0bn raised in each quarter from Q220 to Q321. This reflects broader market trends, as global IPO issuance reached five-year lows in 9M22 at $138.0bn (compared to $607.7bn raised in 2021), according to PwC's Global IPO Watch. The IPO market will likely take some time to recover before the gap between sellers' and buyers' expectations closes, with 60% of IPOs in the US year to date being withdrawn.

Exhibit 5: Nasdaq Biotechnology Index over three years



Source: Refinitiv

While biopharma venture capital (VC) funding declined markedly in Q222 compared to last year, it has been broadly in line with the quarterly investment pace seen in 2018–19 (even if deal count was visibly lower), based on Evaluate Pharma data. Corporate mergers and acquisitions (M&A) activity in the sector was also relatively modest, with the $25bn deal volume in Q222 boosted by the Pfizer acquisition of Biohaven Pharmaceutical for $11.6bn. However, we note that the Q222 figures were likely influenced by a slowdown in the broader private deal market at the beginning of the quarter amid macro uncertainties and the acceleration of public market sell-off. As expectations of buyers and sellers gradually converge, deal volume may pick up again. This should be stimulated by the vast amounts of dry powder in the VC and private equity industries after record-high fund-raising last year, and corporate M&A as large players with strong balance sheets face approaching patent cliffs. A combination of muted public markets (in terms of valuations and IPOs) and a revival in M&A deals would be a particular supportive combination for BCPR's investment pipeline. At the same time, high acquisitive activity may also trigger loan prepayments as illustrated by the recent announcements (see below for details).

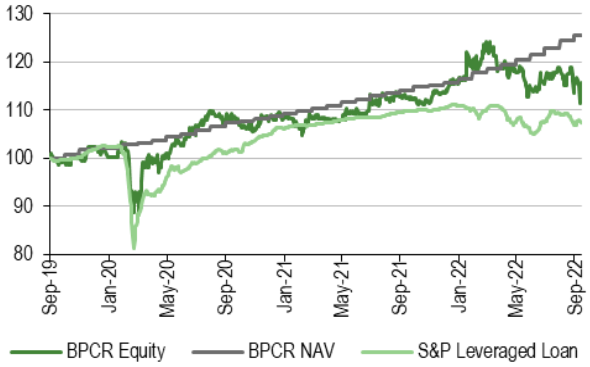
Performance: In line with 8–9% target on an LTM basis

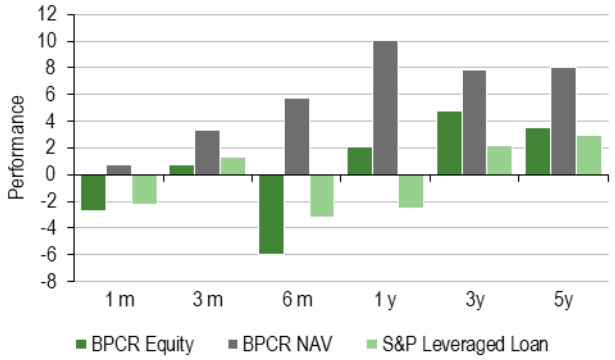
We believe that BPCR's four-year net NAV TR of 7.8% pa is a good basis for assessing its long-term performance, given that it has fully deployed its IPO proceeds by August 2018. This performance is only slightly below the 8–9% target and allowed for the consistent delivery of its dividend payout target of 7c per year (as well as some special dividends, see below), translating into a dividend yield of 7%+. While BPCR's loans are often prepaid (which resulted in an average net cash position of c 20% over this period), this has been at least partially offset by the prepayment and make-whole fees that are triggered in these instances.

It is worth highlighting that BPCR has been able to realise a solid IRR on all its completed senior loan investments, irrespective of the returns the borrowers generated for its equity investors (most of BPCR's borrowers are US-listed biotech companies). Examples of BPCR's borrowers whose share price declined significantly over BPCR's investment period include Lexicon (share price down c 80% but BPCR realised a 12.1% net IRR) or more recently Epizyme, with Ipsen's acquisition price valuing the company significantly below its market valuation in early 2020 (BPCR realised a 15.2% net IRR).

Exhibit 6: BPCR's performance to 30 September 2022 in US dollars

Price, NAV and benchmark total return performance, three-year rebased | Price, NAV and benchmark total return performance* (%)





Source: Refinitiv, Edison Investment Research. Note: *Three- and five-year performance figures annualised.

Returns assisted by high investment level and a rising Libor

BPCR posted a solid one-year NAV TR to end-September 2022 of 10.1%, above its medium-term target of net NAV TR of 8–9% pa. This has been assisted by a relatively high investment level following the deployment of the prepayment proceeds BPCR received in 2020 from the Lexicon, Novocure and Amicus loans. The remaining net cash balance turned into a net gearing position from March 2022 onwards (as the company drew down $138m from its credit facility and term loans to fund the Collegium and Urogen deals (the credit facility was subsequently repaid on 20 September 2022 from the prepayment proceeds). BPCR's performance has also been supported by the Federal Reserve's monetary tightening, which resulted in an increase in the three-month Libor rate from c 0.1% at end-August 2021 to 3.1% at end-August 2022, although the positive impact on BPCR's returns just started materialising in April 2022 as the market rate surpassed Libor floors on several of BPCR's senior loan investments. The continued increase in the three-month Libor should further assist BPCR's performance given that 70% of its current senior loan investments are floating rate (after accounting for the recently announced prepayments, see above) and none of these loans (except for the relatively small Akebia loan) have any Libor caps in place. Management highlighted recently that all term sheets BPCR has been sharing with potential borrowers assume a floating rate. While this may be subject to negotiation, we believe that BPCR will demand to be richly compensated for a fixed rate.

Exhibit 7: Five-year discrete performance data

12 months ending	Share price (%)	NAV (%)	S&P Leveraged Loan (%)	ICE BofA High Yield (%)	UK All Share (%)	S&P 500 (%)
30/09/18	2.35	8.92	5.2	2.9	2.9	17.9
30/09/19	1.13	7.80	3.1	6.3	(3.0)	4.3
30/09/20	7.52	7.50	1.1	2.3	(12.5)	15.1
30/09/21	4.83	6.06	8.4	11.5	33.4	30.0
30/09/22	2.11	10.05	(2.5)	(14.1)	(20.5)	(15.5)

Source: Refinitiv. Note: All % on a total return basis in US dollars.

Net cash at c 40% of NAV after recent prepayments, but collected fees provide a good income runway

We also note that the c $66.5m in prepayment and make-whole fees from the three closed prepayments (Sarepta Therapeutics, Global Blood Therapeutics and Epizyme) give BPCR a good income runway (adding c 4.8pp to its NAV TR before management and performance fees). Two of these prepayments are triggered through change of control (Epizyme was acquired by Ipsen and triggered a $110m loan repayment and $9m fees received in August 2022; Global Blood Therapeutics was acquired by Pfizer in October 2022), while Sarepta's prepayment was funded by

its $1.0bn convertible senior notes issue and resulted in $16m received by BPCR in paydown, prepayment and make-whole fees. We calculate that the principal repayment from the above-mentioned prepayments alone will, all else being equal, translate into a cash position of c 40% of NAV (broadly similar to BPCR's balance after the 2020 prepayments). Management confirmed that the company has a rich pipeline of potential investment opportunities, which should help BPCR become fully invested again. As a broad reference point, it took BPCR about six months to re-deploy the prepayment proceeds it received between July and September 2020 and bring its net cash position to c 10% of NAV. However, we note that BPCR's cash re-deployment in the near term will be slowed down by its requirement to hold cash for the purpose of its recently triggered discount control mechanism (see the Discount section below for details).

Peer group comparison

As a specialist life sciences lender, BPCR has no close listed peers. Hence, we compare its performance against two broader AIC sectors: direct lending and loans and bonds (see Exhibit 8), which contain funds with a wide variety of credit investment strategies, although none focuses on the life sciences credit market. Most of these funds are also much smaller than BPCR (with a market cap of up to £500m vs over £1.0bn for BPCR). Nevertheless, we believe these are a reasonable reference point in terms of the investment opportunities in the broader corporate debt market.

BPCR's one-year net NAV TR of 32.9% in sterling terms was significantly ahead of the peer group, underpinned by its solid performance (see above) and the appreciation of the US dollar against the sterling. Over the last three years, BPCR outperformed the loans and bonds peers and performed broadly in line with the direct lending peers. Here, we highlight that BPCR's portfolio valuation methodology normally results in its loans being recognised at par (as opposed to some of its peers, especially in the loans and bonds group, who mark them to market), hence its NAV return reflects primarily coupon and fee income. Consequently, an equally important factor in comparing BPCR with other credit funds is the income generation potential of its current portfolio. We estimate that before the recent prepayments, BPCR's portfolio generated an annualised unlevered income (excluding fees) of c 9.0–9.5% at end-June 2022. This compares with an annualised interest rate for GCP Asset Backed Income of 7.4% at end-June 2022, a H122 annualised investment yield of 9.0% for Pollen Street, a weighted average annualised drawn coupon at entry of 9.5% at end-June 2022 for Riverstone Credit Opportunities Income and a weighted average coupon rate of 11.15% at end-June 2022 for VPC Specialty Lending Investments. We note that BPCR's figure is comparable with the average rates in the US high yield market, as illustrated by the c 9% effective yield of the ICE BofA High Yield Index at end-June 2022. The above comparison obviously does not account for any possible losses arising from defaults.

BPCR's current dividend yield with reference to its share price (based on LTM payments) stands at 7.3%. While this is somewhat below the 9.6% average for its direct lending peers, we note that BPCR's figure does not include any special dividends, and the recently announced special dividend (to be paid from Q422 profit) of $0.045 implies a 12.0% yield, the highest among peers. Moreover, we note that the direct lending peers trade at a wider average discount to NAV (20.6% vs 5.9% for BPCR), which may to some extent reflect company-specific catalysts (eg the recent merger of Honeycomb with its investment manager, Riverstone's ESG repositioning and GCP Asset Backed Income's issue with a co-living loan), stock liquidity and investors' credit risk perception of peer portfolios.

When looking at BPCR's dividend yield on NAV of c 7% (further enhanced by special dividends), it has been broadly in line with the above peers. GCP Asset Backed Income targets a 2022 DPS of 6.325p, which represents a 6.4% yield on its last reported NAV at end-June 2022. The remaining

three direct lending peers recently paid dividends which imply a c 8% annualised yield compared to their IPO price (c 7.5–8.0% compared to last reported NAV). Here, we note that Pollen Street (formerly Honeycomb Investment Trust) expects the combined group to pay a lower annualised DPS at 63p and 64p in 2022 and 2023, respectively (vs 80p recently), as a result of the merger with Pollen Street. BPCR's dividend yield to the current share price is more attractive than the average of loans and bonds peers of 6.9%, but we note that the group includes funds that pursue both income and growth and may thus offer a lower dividend yield.

Exhibit 8: Selected peer group* at 2 November 2022 in sterling terms**

% unless stated	Market cap £m	NAV TR one year	NAV TR three year	NAV TR five year	Discount (ex-par)	Ongoing charge (%)	Perf. fee	Net gearing	Dividend yield (%)
BioPharma Credit	**1,285.4**	**32.9**	**38.5**	**77.1**	**(5.9)**	**1.2**	**Yes**	**100**	**7.3**
Debt – Direct Lending									
GCP Asset Backed Income	377.5	3.6	13.7	30.9	(9.0)	1.2	No	100	7.3
Pollen Street	456.5	8.2	29.1	50.6	(30.2)	2.4	Yes	138	11.3
Riverstone Credit Opportunities Income	65.9	37.2	41.7		(22.9)	2.0	Yes	100	10.1
VPC Specialty Lending Investments	229.0	2.1	44.5	75.0	(20.4)	2.4	Yes	100	9.7
Direct Lending median	**303.3**	**5.9**	**35.4**	**50.6**	**(21.7)**	**2.2**	**-**	**100.0**	**9.9**
Debt – Loans and bonds									
Axiom European Financial Debt Fund	76.2	(8.9)	12.4	19.6	(7.9)	1.5	Yes	100	7.2
CQS New City High Yield	250.3	(0.2)	9.7	20.0	7.8	1.2	No	110	8.7
CVC Credit Partners Euro Opps GBP	120.9	(8.3)	5.7	10.0	(5.1)	1.6	Yes	101	5.1
Eurocastle Investment	484.0	3.8	4.6	17.3	(15.3)	0.3	No	131	6.4
Henderson Diversified Income	121.3	(22.2)	(11.8)	(3.8)	(2.8)	0.9	No	113	6.6
M&G Credit Income Investment	127.2	(5.3)	4.2	N/A	(2.6)	1.1	No	100	4.7
NB Global Monthly Income Fund GBP	168.5	(16.1)	(0.4)	7.1	(6.8)	1.1	No	100	6.7
TwentyFour Select Monthly Income	157.3	(19.7)	(4.1)	3.0	3.2	1.2	No	100	9.0
Loans and bonds median	**142.2**	**(8.6)**	**4.4**	**10.0**	**(4.0)**	**1.1**	**-**	**101**	**6.6**
Peer group median	**162.9**	**(2.7)**	**7.7**	**18.4**	**(7.4)**	**1.2**	**-**	**100**	**7.3**
Trust rank in group	**1**	**2**	**3**	**1**	**6**	**7**	**-**	**6**	**7**

Source: Morningstar, Edison Investment Research. Note: *Funds in realisation phase, focused on distressed assets and with limited disclosures were excluded from the broader AIC subgroups. **Performance to 30 September 2022. Net gearing is total assets less cash and equivalents as a percentage of net assets, where 100=ungeared.

Asset allocation

BPCR's portfolio has normally been quite concentrated, with nine investments at end-September 2022 – all senior secured loans except for one priority royalty stream (Bristol Myers Squibb, BMS) and a minor equity-like exposure through warrants granted as part of the investment in OptiNose (see Exhibit 9 for details). For a detailed examination of these investments, please see our initiation note (for BMS) and subsequent review notes on BioDelivery Sciences, OptiNose, Akebia, Collegium, LumiraDx, Evolus, Coherus and UroGen. We note that the ambition of the investment manager is to expand the portfolio to 20 positions in the longer term.

In October 2022, BPCR entered into a definitive five-year $140m senior loan agreement with the listed biopharma company Insmed. At the same time, Insmed announced raising $150m through a synthetic royalty sale and a further $275m through a follow-on equity offering, bringing its cash, cash equivalents and marketable securities to c $1.3bn. BPCR's loan will bear an annual interest rate based on the secured overnight financing rate (SOFR, subject to a 2.5% floor) and a margin of 7.75%. BPCR will also receive an additional consideration of 2.0%. Insmed's first commercial product, ARIKAYCE, is a first-in-disease therapy approved in the US, Europe and Japan to treat a chronic, debilitating lung disease, with sales over the 12 months to end-June 2022 of $221m. Insmed also has a pipeline of investigational therapies targeting areas of serious unmet need, including neutrophil-mediated inflammatory diseases and rare pulmonary disorders.

Exhibit 9: Portfolio composition at end-September 2022

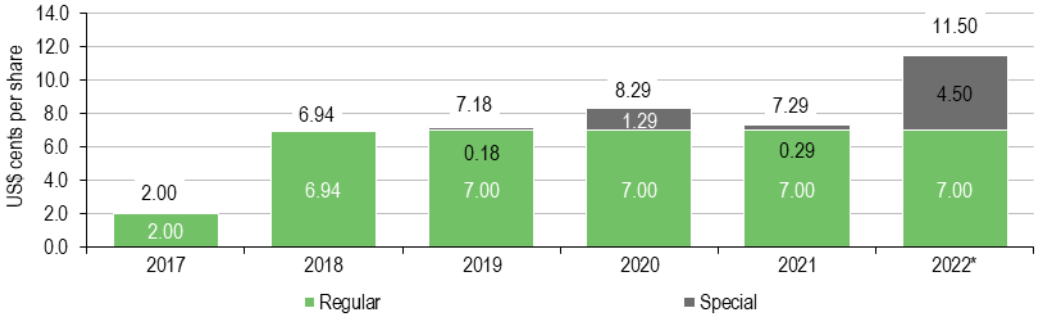
Counterparty /borrower	Asset	Underlying products	Fair value in $m (% of GAV)	Expected maturity	Coupon/ royalties	Fees and other	IRR to maturity
Collegium Pharmaceutical	Senior secured loan	Xtampza, Nucynta	300.0 (21%)	March 2026	Libor 3M + 7.5% (1.2% Libor floor)	Amortisation: $100m after one year, then quarterly; funding fee 3.0%; two-year make-whole arrangement; prepayment fee at 2% and 1% if prepaid before third or fourth anniversary	11.4
LumiraDx	Senior secured loan	LumiraDx Platform	150.0 (11%)	March 2024	8.0% (fixed)	Funding fee 2.5%; exit fee 1.5%; two-year make-whole arrangement; prepayment fee 1.0%	9.9
Bristol Myers Squibb	Priority royalty stream	Onglyza, Farxiga	115.2 (8%)	December 2025	Royalty stream	N/A	High single-digit
Coherus	Senior secured loan	Udencya	125.0 (9%)	January 2027	Libor 3M + 8.25% (1.0% Libor floor)	Amortisation: 48 months interest only; %; funding fee 2% of commitment; two-year make-whole arrangement; prepayment fee at 3%, 2% and 1% if prepaid before third and fourth, or after fourth anniversary	10.4
OptiNose	Senior secured loan ($71.5) + warrants	Xhance, Onzetra	71.5 (5%)	September 2024	10.75% (fixed)	Amortisation: 36 months interest only; funding fee 0.75% of drawn and undrawn; 2.5-year make-whole arrangement; prepayment fee at 2% and 1% if prepaid before third or fourth anniversary	11.8
Evolus	Senior secured loan	Jeuveau	37.5 (3%)	December 2027	Libor 3M + 8.5% (1.0% Libor floor)	Amortisation: 36 months interest only; %; funding fee 2.25% of commitment; two-year make-whole arrangement; prepayment fee at 3%, 2% and 1% if prepaid before third and fourth, or after fourth anniversary	10.7
UroGen	Senior secured loan	Jelmyto	37.5 (3%)	March 2027	Libor 3M + 8.25% (1.25% Libor floor)	Amortisation: 48 months interest only; %; funding fee 1.75% of commitment; two-year make-whole arrangement; prepayment fee at 3%, 2% and 1% if prepaid before third and fourth, or after fourth anniversary	10.5
Akebia	Senior secured loan	Auryxia	33.5 (2%)	November 2024	Libor 3M + 7.5% (2.0% Libor floor; 3.3% Libor cap)	Amortisation: 30 months interest only; funding fee 2%; two-year make-whole arrangement; prepayment fee at 2% and 1% if prepaid before third or fourth anniversary	10.8
Global Blood Therapeutics	Senior secured loan	Oxbryta	132.5 (9%)	October 2022 (prepayment)	Libor 3M + 7% (2.0% Libor floor)	Amortisation: 36 months interest only; funding fee 1.75%; exit fee of 2%; three-year make-whole arrangement; prepayment fee at 3%, 2% and 1% if prepaid before third, fourth or fifth anniversary	10.7
Cash and other	-	-	419.9 (30%)	-	-	-	N/A

Source: BPCR, Edison Investment Research

Dividends

BPCR has been able to adhere to its dividend policy of paying a 7c annualised regular dividend since becoming fully invested in the second half of 2018, with an additional special dividend paid in each of the last three years (see Exhibit 10). Given its NAV per share has been close to $1.00 since inception (as BPCR pays basically all its net income in dividends), this represented a solid dividend yield on NAV of 7%+. Overall, BPCR aims at distributing all the net income it generates through dividends. After the strong NAV TR so far this year, BPCR will pay a sizeable special dividend of $0.045, translating into a total dividend yield of 12.4% (given BPCR's current discount to NAV). We believe that in the current interest rate environment, BPCR may be able to regularly pay out a dividend in excess of 7c once it fully re-deploys its recent prepayment proceeds.

Exhibit 10: BPCR's historical dividend payments

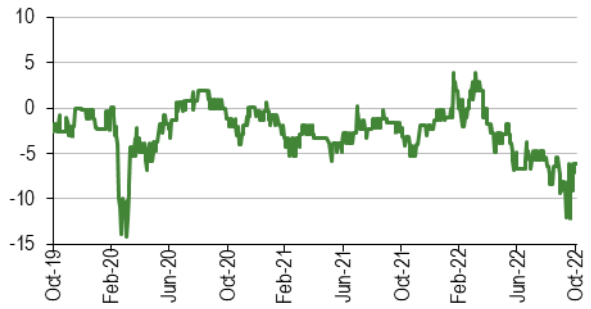


Source: BPCR. Note: *Including announced dividend payments.

Discount: Control mechanism triggered

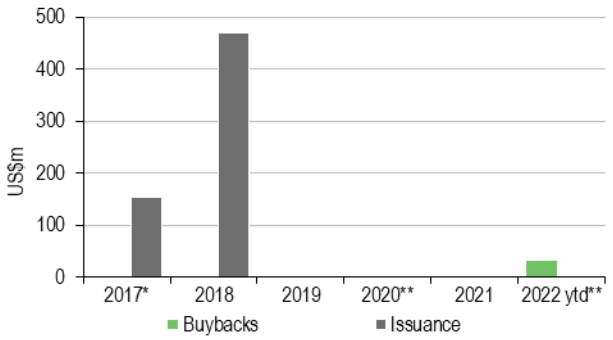
In the initial years after listing, BPCR mostly traded at a single-digit premium to NAV (normally up to 5%), which after the COVID-19 outbreak turned into a discount. This encouraged BPCR to make opportunistic buybacks of c 1.5m shares in July 2022. More recently, however, the average discount at the end of three consecutive months exceeded 5% (currently at c 5.9%), which has triggered BPCR's discount control mechanism (the company started buying back shares on 15 September and so far has repurchased c 33.4m shares). This requires BPCR to use up to 50% of its capital and income proceeds to repurchase shares until such time as the discount to NAV narrows below 1%. We also note that if during the last month of a performance period (ie December) BPCR's shares trade at a discount to NAV in excess of 1%, the investment manager should use 50% of the performance fee received in respect of the respective performance period for buybacks until the discount narrows below 1%. A successful narrowing of the discount would represent an additional share price total return of c 6% from the current level.

Exhibit 11: Discount over three years



Source: Refinitiv, Edison Investment Research

Exhibit 12: Buybacks and issuance



Source: BPCR, Morningstar, Edison Investment Research. Note: *Excluding IPO proceeds. **BPCR performed minor buybacks in 2020 and 2022 ytd, spending c $60k and $32.7m, respectively.

Fund profile: Specialist life sciences lender

BPCR is a UK-domiciled fund investing in the life sciences sector, predominantly in debt and to a lesser extent royalty-based instruments. It was incorporated in October 2016 and completed its IPO in March 2017. The shares are listed in the specialist funds segment of the LSE, and on 30 September 2021, BPCR's AGM agreed to an uplisting to the premium segment of LSE's Main Market.

BPCR's portfolio is composed of debt assets secured by cash flows from approved life sciences products, covering pharmaceuticals, biopharmaceuticals, medical devices and clinical diagnostics. This includes, in particular, senior secured loans granted to life sciences companies, which currently make up c 86% of its investment portfolio excluding debt/cash. The loans are secured by all or some of the borrower's assets and may also include royalty collateral as well as other intellectual property (IP) and marketing rights. Other portfolio constituents may be royalty debt instruments, where the borrower is the owner of royalty rights whose obligations are secured by royalty collateral, and priority royalty tranches, where BPCR obtains the right to receive all or a fixed percentage of future royalty streams from the sale of a defined set of commercial-stage drugs. The royalty rights account for c 14% of BPCR's investment portfolio at present. BPCR does not intend to allocate a meaningful part of its portfolio into equity instruments (its investment policy includes a cap on its equity allocation at 15% of portfolio). At end-August 2022, the company's exposure to warrants/equity was less than 1% of the portfolio.

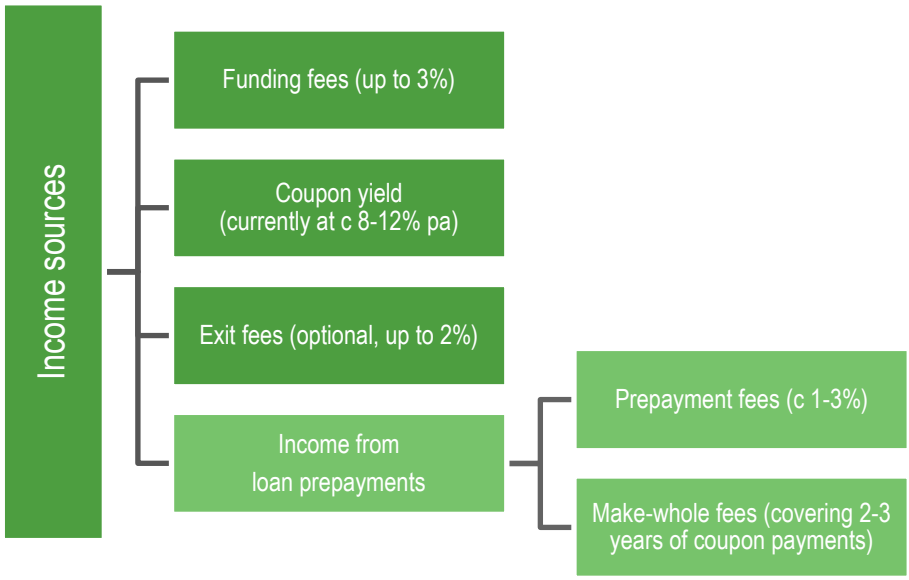
Investment process: Targeting an 8–9% net return pa

Additional upside from prepayment/make-whole fees

BPCR invests in debt instruments backed by recently (or soon to be) approved products from life sciences companies. It aims to generate an 8–9% net NAV return per year, predominantly from stable coupon income, which in turn should be distributed to investors quarterly through dividends, targeting a DPS of $0.07 pa. The investment universe of BPCR consists of companies with products in the early stage of commercialisation or that have just been approved and are nearing market launch. These companies offer a more predictable revenue stream (compared to the broad biopharma industry, which includes businesses with pre-approval drugs), limiting the risk involved in the investment, while having little to no history of attractive results.

Potential upside to BPCR's return over the regular coupons may come from prepayments. The loan agreements often include a make-whole call provision covering two to three years of coupon payments and/or a prepayment fee of c 1–3% (with the exact rate dependent on the unexpired loan term). Once the underlying product proves successful in generating revenue, the companies often have the motivation to prepay the debt to refinance it on more attractive terms (eg extended maturity or lower interest).

Exhibit 13: BPCR's sources of return



Source: Edison Investment Research

Highly experienced and specialised investment team

In 2020, Pharmakon Advisors screened 243 investments (vs 205 in 2017). In the first step, the manager assesses the market potential of the underlying product and financing needs of the borrower. The future sales potential of respective drugs is evaluated based on direct discussions with external experts and leading physicians. Pharmakon may also rely on market research in the form of physician studies to examine safety, familiarity, usage and acceptance of respective products by practising doctors. Finally, outside counsel may be contracted to evaluate IP rights and the patent estate of the royalty collateral.

After the initial screening, the remaining candidates (64 in 2020) are reviewed from the perspective of credit worthiness of the counterparty. Pharmakon evaluates the borrower's credit profile and how the potential investment is structured. In terms of the borrower's credit metrics, Pharmakon takes into consideration expected product margins, coverage ratios (projected free cash flow to total debt and/or EV to debt), access to equity markets to raise fresh capital, quality of the management team, production capacity, as well as overall capital structure and other existing liabilities.

In performing analysis, Pharmakon Advisors relies on the expertise of its principals, as well as that of its growing research team. Pharmakon also benefits from its access to Royalty Pharma's internal analyst team (analysts with a medical degree or background in biochemistry, biology or material sciences) based on the shared services agreement it has signed with Royalty Pharma.

Preliminary terms of the agreement are presented to parties chosen in the above process, and the due diligence process and negotiations are initiated. The analysis of the investment structure is largely focused on the expected yield and duration, quality of collateral, covenants, call protections, as well as structural yield enhancement (eg additional coupons linked to sales). Pharmakon normally rejects eight out of 10 potential deals and targets around four to six transactions a year on average.

BioPharma Credit's approach to ESG

Through the funds it manages, Pharmakon provides capital to a growing number of emerging life sciences companies that are developing critical therapies to improve human health. A large part of Pharmakon's investments (including those made through BPCR) help fund clinical trials and research on several serious diseases, including various types of cancer and orphan diseases (R&D of Pharmakon's partners during 2021 stood at $1.8bn). Pharmakon's focus in terms of Sustainable Development Goals (SDG) are on SDG-3 (Good Health and Well-Being), SDG-9 (Industry, Innovation and Infrastructure), SDG-10 (Reduced Inequality) and SDG-17 (Partnerships for Goals). It believes that consideration of material ESG factors is critical to its credit underwriting process. We note that Pharmakon is a signatory to the New Commitment to Patients signed in January 2020 by 215 biopharma CEOs and industry leaders.

In terms of its own operations, Pharmakon's emphasis is on the reduction of its environmental footprint (even if the majority comes from daily office-based activities), the continuous support of its employees' health, well-being and growth, and robust governance structure (a highly experienced and independent board at BPCR, as well as executive-level oversight of ESG). Pharmakon also supports its communities through philanthropy by promoting access to healthcare and health equity.

BPCR itself does not disclose any details under environmental, human rights, employee, social and community issues (and has not set any targets with this respect), as the requirements under the Companies Act 2006 do not apply to BPCR as it has no employees (all functions are outsourced to third parties) and all directors are non-executive. The remuneration of BPCR's board of directors is reviewed on an annual basis and put to a shareholder vote at least once every three years.

Gearing: Enhanced the recent NAV performance

In September 2021, BPCR negotiated an amendment to its credit facility agreement with JPMorgan Chase Bank, reducing the committed amount to $50m (from $200m previously), together with changes to the accordion feature allowing for an increase in the credit facility to $100m and up to $200m in term loans. BPCR has drawn $138m of the above debt to fund the Collegium and UroGen investments in March 2022 (at end-August 2022 $92m remained drawn). The debt has a margin of 2.75% over Libor (significantly below the average spread on BPCR's floating rate senior loan investments) and matures in June 2024. BPCR announced that it has fully repaid the credit facility on 20 September 2022.

BPCR has a leverage cap of 50% of NAV calculated at the time of the drawdown. However, the fund manager is only allowed to incur indebtedness on behalf of the company of up to 25% of NAV without prior approval of BPCR's board.

Fees and charges

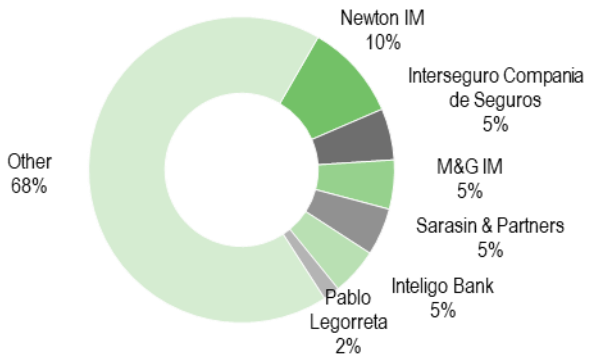
BPCR pays Pharmakon Advisors a management fee equal to 1% of NAV less $100,000 per year (calculated monthly and payable quarterly). The investment manager is also entitled to a performance fee (calculated at end-December), subject to a high watermark and an annualised hurdle rate of 6% per year (since inception). It is calculated as the lesser of 10% of the annual NAV accretion or 50% of the excess return in the respective performance year over the hurdle rate. The ongoing charge ratio, which takes into account other operating costs of the company and excludes performance fees, stood at c 1.2% in FY21 (stable vs FY20). Including performance fees, the ongoing charges ratio stood at 1.4% in FY21 (vs 1.6% in FY20).

Capital structure

BPCR's share capital consists of 1.4bn ordinary shares, of which 35.0m are currently held in treasury. The company is subject to a continuation vote, with the last resolution passed at the AGM in September 2021. The next continuation vote will be held at the AGM following the fourth anniversary of the admission to the Prime Segment of the LSE's Main Market (ie 5 October 2025), with the subsequent vote after another four years, and then every three years – subject to proposing a vote resolution. Additionally, a continuation vote should be held if BPCR's shares trade at a discount higher than 10% on average over the period of 12 months.

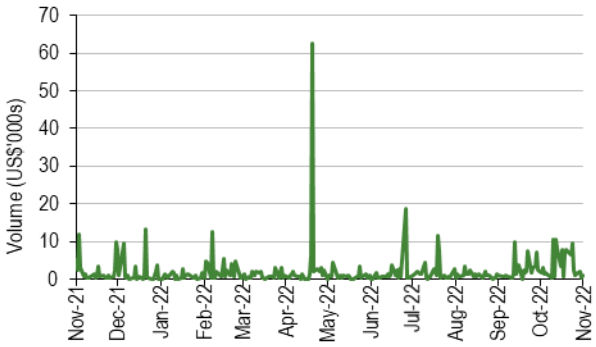
On 21 April 2022, Pablo Legorreta (founder and CEO of Royalty Pharma and co-founder of Pharmakon Advisors) sold 55m shares (representing 4.0% of total BPCR shares) and reduced his holding in the company to the current 1.7%. Legorreta used the transaction to raise funds to support other personal investments including ProKidney and ITB-Med, as well as to fund commitments related to philanthropic activities including Alianza Médica para la Salud, The Legorreta Cancer Center at Brown University, The Kidney Health Foundation and The Open Medical Institute, among others.

Exhibit 14: Major shareholders



Source: Refinitiv, at 2 November 2022

Exhibit 15: Average daily volume



Source: Refinitiv. Note 12 months to 2 November 2022.

The board

BPCR's board comprises five directors, all of whom are non-executive and independent. Rolf Soderstrom was appointed as a director of the company in September 2020 (see our October 2021 note for details). Harry Hyman, Colin Bond and Duncan Budge joined BPCR prior to its IPO (see detailed biographies in our initiation note) and Stephanie Léouzon was appointed as director in 2018 (see our previous note).

Exhibit 16: BPCR's board of directors

Board member	Date of appointment	Remuneration in FY21	Shareholdings at end-FY21
Harry Hyman (chairman)	27 February 2017	100,000	102,506
Colin Bond	15 November 2016	85,000	100,000
Duncan Budge	24 October 2016	70,000	100,000
Stephanie Léouzon	5 December 2018	70,000	-
Rolf Soderstrom	16 September 2020	70,000	100,000

Source: BPCR

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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
1185 Avenue of the Americas
3rd Floor, New York, NY 10036
United States of America

Sydney +61 (0)2 8249 8342
Level 4, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia