EDISON

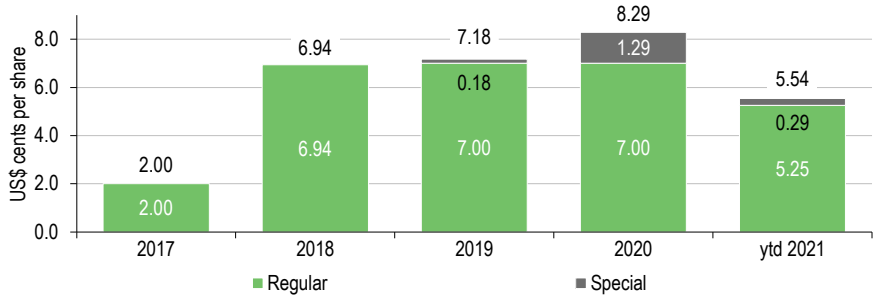
BioPharma Credit

Now listed in the Premium Segment of LSE

Investment trusts
Debt: Direct lending

BioPharma Credit (BPCR) delivered a 7.3% NAV total return (NAV TR) pa in the three-year period ending 30 September 2021 (Edison calculations), somewhat below its 8–9% target. We believe that this was partially due to cash drag from several loan prepayments (although partially offset by prepayment fees). In H121, BPCR invested US$150m in diagnostics company LumiraDx, and reduced its cash position to 18% at end-September 2021. BPCR has sustained its targeted dividend payout (7c per share pa, 7.4% yield currently), although we calculate it needs to deploy some of its cash to cover the payments from income alone in the long run. Until then, it may pay a portion of the dividend from capital.

BPCR distributes dividends above its target



Source: BPCR

Why invest in BioPharma Credit now?

The pandemic has underlined the importance of the life sciences sector, and renewed interest in the pharmaceutical industry, which results in strong capital inflows as illustrated by the recent IPO activity, convertible bond issues and private market deal volumes. BPCR offers a high and sustainable dividend yield (with a target of 7% pa), backed by recurring income from a portfolio composed largely of senior loans secured by revenues from approved drugs. Hence, it provides investors with exposure to the biotech industry while allowing for diversification and avoiding the high market valuations of equities. The recent uplisting and resulting indices inclusion may result in additional buying activity.

The analyst's view

BPCR has consistently delivered an attractive dividend yield of c 7% based on recurring coupon/royalty income, fees and balance sheet reserves. Having said that, in order to fully cover the dividend based on income alone, BPCR needs to deploy some of its cash position. The flow of new investment opportunities is supported by the high level of M&A activity in the biotech market, which often leads to product portfolio reorganisation that can affect funding structure, as well as swift drug approvals. This is somewhat offset by the high valuations of listed biotech equities, which encourage companies to lean towards equity and/or convertible bond issues to finance their operations (although we have seen some moderation in IPO and convertible issue activity lately).

NOT INTENDED FOR PERSONS IN THE EEA

26 October 2021

Price	**US$0.98**
	£0.708
Market cap	**US$1,346.4m**
	£972.7m
NAV*	**US$1,368.6m**

NAV per share*	US$1.00
Premium/(discount) to NAV	(2.0%)

*As at end- September 2021

Yield		7.4%
Shares in issue		1,373.9m
Code US$/£		BPCR/BPCP
Primary exchange		LSE
AIC sector		Debt – Direct Lending
52-week high/low	US$1.01	US$0.95
NAV* high/low	US$1.01	US$0.99

* Including income.

Gross gearing*	0.0%
Net gearing*	0.0%

*As at 30 September 2021

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 (7% target).

Bear points

- Highly concentrated portfolio.
- Loans are often prepaid, creating a temporary cash drag (though normally offset by prepayment fees).
- BPCR's fixed income portfolio offers limited upside potential beyond coupons and prepayment fees.

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BioPharma Credit is a research client of Edison Investment Research Limited

Market outlook: Biotech among top sector picks

Drug discovery even more specialised and costly

The traditional fully integrated pharmaceutical company model is changing and becoming more fragmented. The vast number of spinoffs or new biotech companies 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. With significant capital needs associated with R&D spending (US$200bn by the private sector in 2020 according to EvaluatePharma) with no large, dedicated lenders or specialised debt markets, this translates into new debt investment opportunities. As new healthcare products are approved (53 novel drugs were approved by the FDA in 2020 vs 21 in 2010), 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. Finally, the recent trend of Big Pharma players selling non-core products to smaller companies also creates new lending opportunities. The ongoing fragmentation of the industry is highlighted 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, citing Bloomberg findings. Simultaneously, EvaluatePharma expects R&D spending to continue to grow at 4.2% pa (compared to a 4.7% CAGR in 2012–20), and global prescription drug sales to increase at 6.4% pa in the coming years.

The pandemic has accelerated changes in the industry

COVID-19 has further strengthened the importance of the biotechnology industry, resulting in growing investor interest in drug discovery companies (especially in infectious diseases), as illustrated by the increasing valuation multiples and record-high capital raising through initial public offerings (IPOs) recently. Meanwhile, the industry faces similar challenges to the rest of the economy: the need to accelerate digitalisation processes and to facilitate remote or hybrid working. This was implemented by the industry in a swift manner, as 76% of clinical trial sponsors surveyed by Florence Healthcare already conducted most or all of their patient monitoring remotely in 2020 (vs 18% in 2019). Nevertheless, some healthcare companies see delays in patient recruitment.

Regulators have become even more agile and responsive with respect to streamlined drug approval processes recently. In 2020, the FDA's Center for Drug Evaluation and Research's number of drug approvals was the second-highest in the last 10 years. On top of that, 92% of drugs were approved on the first appraisal cycle. On the other hand, the looser approach of regulators to new drug approvals has faced some criticism over the market admission of drugs with limited clinical evidence, as evidenced by the latest Alzheimer's drug by Biogen, aducanumab. Moreover, earlier drug approvals have led to boosted valuations of drug development companies, including IPO candidates.

We also note that drug pricing has come into the spotlight again with the Biden administration calling for more affordable healthcare, which includes Medicare-negotiated drug prices and lowering the Medicare eligibility age to 60. According to experts cited by EvaluatePharma, any major reforms are unlikely to get into law due to Biden's narrow majority in Congress and likely pressure from industry lobbying. Still, this may result in some minor legislative and regulatory measures. European policymakers are also discussing whether the 10-year orphan drug exclusivity period is over-compensating the industry.

Biopharma's access to external funding

BPCR operates in a niche of lower-yield debt (though still at attractive rates of c 9%) 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 also have more conservative lending practices, while specialised debt funds tend to operate in the higher-yield debt to fund pre-approval stage drugs. According to BPCR's management, it usually faces only a few specialised lenders competing for a given deal. Having said that, 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.

Public market valuations continue to be high

High public market valuations encourage listed biotech companies to fund their operations through an equity issue (rather than straight debt). The NASDAQ Biotechnology Index posted a moderate 4.6% return in the year-to-date (to 1 October 2021), after a strong 2020 (with a 23% total return). Nevertheless, we believe that valuations remain quite demanding, as the current last 12 months (LTM) P/E ratio (based solely on companies posting positive earnings) stands at c 18.8x, with a five-year average of 18.6x. As a result, 2020 was an active year in terms of both IPOs and follow-on offerings. According to BCIQ, biotech companies raised US$22.1bn in 2020 through IPOs globally, which is 170% more than in 2019 (US$8.1bn). Similarly, biotech follow-on offerings raised 85% y-o-y more capital in 2020 (US$42bn). The trend has continued into 2021, as there were already 49 biotech IPOs in the US in H121 raising US$8.8bn according to BioPharma Dive. On top of that, 12 further companies have publicly disclosed IPO plans as at end-H121 in the United States.

Exhibit 1: NASDAQ Biotechnology Index

Source: Refinitiv

High equity valuations also encourage companies from the most sought-after sectors to issue convertible bonds, as illustrated by the fact that nearly half of the ICE BofA US Convertible Index was comprised of technology and healthcare debt as at end-2020, whereas in the ICE BofA High Yield Index they made up c 14%. Global convertible bond issuance reached US$188bn in 2020 (up 49% y-o-y) according to Refinitiv, with another US$114bn issued in H121. However, we need to note that convertibles issuance in the United States (BPCR's core target market) has been slowing down lately (at the expense of non-US issues), with Q221 volume at US$26bn after US$41bn in Q121. Furthermore, convertible issuance in the United States is dominated by tech giants, as illustrated by Tesla being responsible for 40% of index growth in 2020.

Private equity searches for targets as well

Merger and acquisition (M&A) and private equity/venture financing volumes in the healthcare sector (pharma, life sciences and healthcare services) have also been on the rise recently with a combined global deal value (including announced transactions) of c US$293bn in H121, more than four times the H120 value after a similarly strong H220, according to PwC citing data from Refinitiv and Dealogic. We need to highlight though that in H120 no megadeals were announced, while they accounted for 42% of the deal value in H121 (with the largest deal, at US$7.2bn, being the acquisition of GW Pharmaceuticals with its approved cannabidiol therapy Epidiolex by Jazz

Pharmaceuticals). Excluding the 11 megadeals, the transaction value increased 138% and 168% in H121 versus H120 and H119, respectively. The increase was driven predominantly by strong demand from private equity funds, which accounted for c 47% of deal volume, significantly higher than long-term average of 35%. The visible increase in the number and value of M&A transactions is favourable for BPCR as the transactions are commonly levered and often trigger early prepayments (calling for refinancing with new debt in some cases) and broaden BPCR's opportunity universe. Similarly to private equity, 2020 was a strong year for venture capital investments, which increased 39% y-o-y to US$22bn according to EvaluatePharma.

On the M&A front, several trends have accelerated or emerged due to the pandemic-induced turmoil. The large strategic players moving away from being pharma conglomerates into more integrated specialty platforms, and thus divesting their non-core businesses, contributes to the increase in available acquisition targets. As valuations rise and the number of transactions rapidly increases, room for more creative approaches to deal-structuring emerges. There have been a multitude of deals involving special purpose acquisition companies (SPACs) in the United States and public-to-private transactions and more sophisticated partnership deals are also increasing in popularity, according to PwC.

We should also note that recent scientific and technological developments in genomics uncovered in cancer research have applications in other therapy areas; platforms like mRNA and newer modalities such as engineered genes and cells are pushing more personalised, molecularly defined approaches into immunology, neuroscience and beyond.

The fund manager: Pharmakon Advisors

BPCR is managed by Pharmakon Advisors, which was established in 2009 and currently manages a private fund (BioPharma V) and BPCR. Pharmakon Advisors is run by Pedro Gonzalez de Cosio (co-founder and principal), Martin Friedman (principal) and Pablo Legorreta (co-founder and principal). Since inception it has invested c US$5.1bn in 41 transactions in the life sciences sector, mostly through debt investments. The four predecessors of BioPharma V are already fully realised and generated an average net internal rate of return (IRR) of 10.4% for investors (see Exhibit 2). The BioPharma V fund, unlike its predecessors, is an evergreen structure and has invested US$652.5m so far, while continuing to raise capital. All of the structures managed by Pharmakon have been focused on debt and royalty investments.

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

	BioPharma I	BioPharma II	BioPharma III	BioPharma IV	BioPharma V
Launch date	June 2009	March 2011	February 2013	December 2015	June 2019
End of investment period	May 2010	March 2013	August 2015	December 2017	Evergreen
Raised amount (US$m)	268.9	363.1	500.0	512.9	907.9 (so far)
Invested amount (US$m)	263.7	343.0	463.0	512.0	652.5 (so far)
Net IRR	11.3%	6.8%	11.3%	11.7%	N/M

Source: BioPharma Credit

The manager's view: Plenty of opportunities

The manager expects life sciences industry to continue to have substantial capital needs during the coming years as the number of products undergoing clinical trials continues to grow. All else being equal, companies seeking to raise capital are generally more receptive to straight debt financing alternatives at times when equity markets are soft (increasing the number and size of BPCR's opportunities), and will be more inclined to issue equity or convertible bonds at times when equity markets are strong. Given the moderating biotechnology equity market, and already decreasing equity issuances (H121 down 6% vs H120), the investment manager expects greater appetite for fixed income as a source of capital during the remainder of 2021. The manager also sees

acquisition financing as an important driver of capital needs in the life sciences industry, and the active M&A market helps drive opportunities for BPCR in the near term. Overall Pharmakon remains confident of its ability to deliver attractive returns, enabling BPCR to continue paying its target dividend.

Asset allocation

Current portfolio positioning

BPCR's portfolio is normally highly concentrated and currently consists of nine positions. Eight of them are senior secured loans (paired with a minor equity investment in the case of BDSI), while the investment in Bristol-Myers Squibb is a priority royalty stream. The current portfolio structure is presented in Exhibit 3 below. For a detailed examination of the underlying drugs in the portfolio, please see our initiation note and subsequent review notes on BDSI, OptiNose, Epizyme, Akebia, Sarepta and Global Blood, Collegium and Lumira Dx.

Exhibit 3: Portfolio composition as at end September 2021

Counterparty /borrower	Asset	Underlying products	Fair value (US$m)	Expected maturity	Coupon/ royalties	Fees and other	% of net assets
Sarepta Therapeutics	Senior secured loan	Exondys 51, Vyondys 53	350.0	Tranche A (US$175m) December 2023; Tranche B (US$175m) December 2024	8.5% (fixed)	Funding fee 1.75%/2.95% (tranche A/B); exit fee 2%; two-year make-whole arrangement; prepayment fee at 2% if prepaid before third anniversary	25.6
LumiraDx	Senior secured loan (US$150m) + warrants	LumiraDx Platform	151.8	March 2024	8.0% (fixed)	Funding fee 2.5%; exit fee 1.5%; two-year make-whole arrangement; prepayment fee 1.0%	11.1
Bristol-Myers Squibb	Priority royalty stream	Onglyza, Farxiga	143.1	31 December 2025	No coupon; expected high single-digit return	N/A	10.5
Collegium Pharmaceutical	Senior secured loan	Xtampza, Nucynta	103.1	February 2024	Libor 3M + 7.5% (2.0% Libor floor)	Funding fee 2.5%; two-year make-whole arrangement; prepayment fee at 3%, 2% and 1% if prepaid before second, third or fourth anniversary	7.5
Epizyme	Senior secured loan	Tazverik (Tazemetostat)	110.0	Tranche A (US$12.5m), B (US$12.5m), and C (US$10m) November 2024; Tranche D (US$75m) November 2026	Libor + 7.75% (2.0% Libor floor)	Funding fee 2%; three-year make-whole agreement. Quarterly amortisation starts around four years since drawdown of each tranche; prepayment fee at 3%, 2% and 1% if prepaid before second, third or fourth anniversary	8.0
Global Blood Therapeutics	Senior secured loan	Oxbryta	82.5	November 2025	Libor 3M + 7% (2.0% Libor floor)	Funding fee 1.5%; exit fee of 2%; three-year make-whole arrangement; prepayment fee 3%, 2% and 1% if prepaid before third, fourth or fifth anniversary	6.0
OptiNose	Senior secured loan	Xhance, Onzetra	71.6	12 September 2024	10.75% (fixed)	Amortisation: 39 months interest only, then quarterly; 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	5.2
BDSI	Senior secured loan (US$80m) + equity	Belbuca, Bunavail, Symproic	69.7	28 May 2025	Libor 3M + 7.5%	Amortisation: 30 months interest only, then quarterly; funding fee 2%; two-year make-whole arrangement; prepayment fee at 3%, 2% and 1% if prepaid before second, third or fourth anniversary	5.1
Akebia	Senior secured loan	Auryxia	50.0	November 2024;	Libor 3M + 7.5% (2.0% Libor floor)	Funding fee 2%; two-year make-whole arrangement; prepayment fee at 2% and 1% if prepaid before third or fourth anniversary	3.7
Cash and other	-	-	236.8	-	-	-	17.3

Source: BioPharma Credit, Edison Investment Research

There were two major portfolio developments in H121. Firstly, COVID-19 test provider **LumiraDx** was merged with a SPAC (CA Healthcare Acquisition) and listed on Nasdaq under the ticker LMDX

on 29 September 2021. The transaction valued the company at US$3.0bn, which compares with US$5.0bn originally assumed by the SPAC, as sales guidance was lowered on the back of a faster-than-expected slowdown in demand for COVID-19 testing. LumiraDx currently expects 2021 sales of US$300–500m compared to previous guidance of US$600m to US$1bn. We note that as part of the loan agreement in March 2021, BPCR received warrants which are currently valued at US$1.8m and are reflected in BPCR's NAV as at end-September 2021,

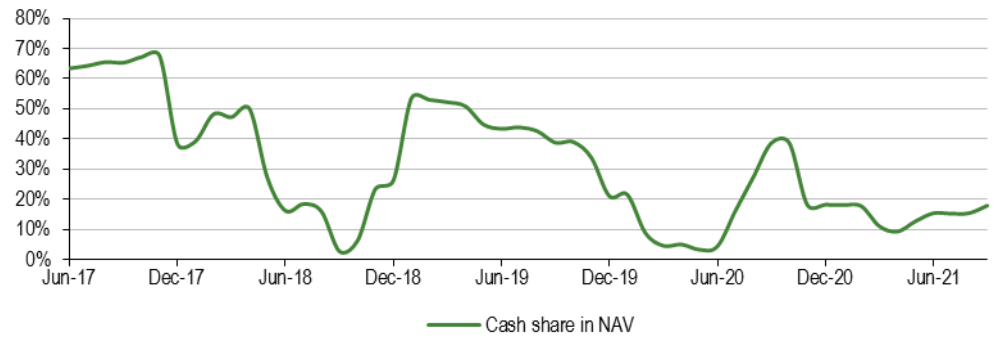
Secondly, **Sebela Pharmaceuticals** repaid early the outstanding balance of the senior secured loan provided by BPCR (US$92.3m out of the initial US$194.2m), which was scheduled to mature in December 2022. As a result, BPCR received total proceeds of US$97m including accrued coupons and a prepayment premium of US$1.5m, realising an 11.2% IRR on the transaction.

We also note that BioDelivery Sciences pre-paid US$20m of the US$80m senior secured loan in September 2021.

Performance: Stable yield on the portfolio

We calculate BPCR's one-year NAV total return to end-September 2021 at 6.5% and an annualised return since its floatation in March 2017 at 7.2%, somewhat below the 8–9% target. Having said that, we should note that returns have been affected by cash drag, initially from gradual deployment of IPO proceeds and more recently from loan prepayments (although somewhat offset by prepayment fees and make-whole arrangements). Moreover, one-year performance is calculated compared to end-September 2020, right after three significant loan prepayments between June and August 2020 (c US$425m in aggregate), which does not capture the prepayment fee and therefore excludes the income runway achieved on these transactions. We believe that a more accurate assessment of BPCR's NAV return can be made based on its three-year performance (as it fully deployed the IPO proceeds in August 2018) – which amounts to 7.2% pa according to our calculations, affected by an average cash position of 25% during the period. Over the last 12 months, two further investments have been prepaid: Lexicon (US$124.5m) and Sebela (which had been gradually amortising, US$92.3m at end-2020); and BDSI has been partially prepaid (US$20m out of US$80m). We highlight that BPCR does not revalue its loans and recognises them at par, hence the NAV return reflects primarily coupon and fees payments (BPCR has only a minor equity exposure). We calculate that as at end-September 2021, BPCR's assets generate a c 9% gross yield and its cash position stood at 18% of NAV at end-September 2021.

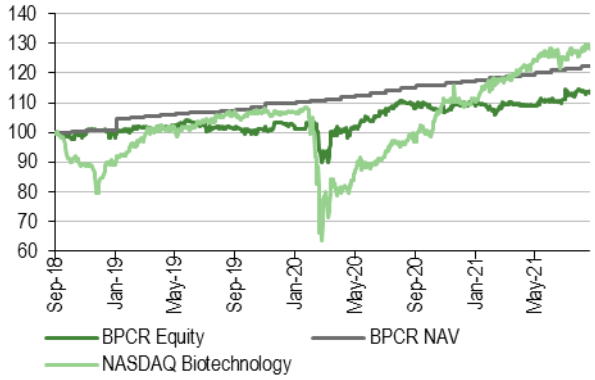
Exhibit 4: BPCR's net cash position

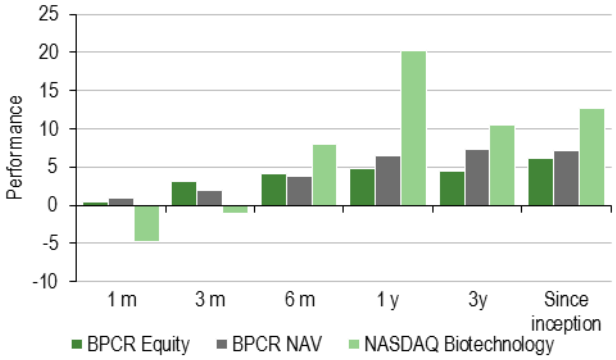


Source: BPCR, Edison Investment Research

Exhibit 5: BPCR's performance to 30 September 2021

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





Source: Refinitiv, Edison Investment Research. Note: *Three-year, five-year and since inception (24 March 2017) performance figures annualised.

Peer group comparison

As we have not identified any close listed peers for BPCR, we compare its performance against two broader AIC sectors: direct lending and loans and bonds (see Exhibit 6), which contain funds with a wide variety of credit investment strategies, although none focuses on the life sciences credit market. Nevertheless, we believe these are a reasonable reference point in terms of the performance of the broader corporate debt market.

BPCR's one-year NAV return in sterling terms was 2.1% (below the median in the peer group), affected by the appreciation of sterling, with BPCR's return in US dollars (its base currency) at 6.5%, which is more aligned with the returns of its direct lending peers. The funds in the loans and bonds subsector performed significantly better over the one-year period to end-September 2021, with a median NAV return of 18.9%. We need to note, however, that most entities in this subgroup invest actively in publicly quoted debt and benefited from the global financial markets recovery (including debt yield compression) from the COVID-19-induced sell-off in early 2020. On a three-year basis, the median NAV return stands at 14.0% in this group, significantly below direct lending funds, including BPCR. BPCR's ongoing charge and discount stand among the lowest in the peer group, while its dividend yield is somewhat below the direct lending funds, but visibly higher than the loans and bonds funds average.

Exhibit 6: Selected peer group at 26 October 2021* 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	**972.7**	**2.1**	**19.3**	**N/A**	**(2.0)**	**1.1**	**Yes**	**100**	**7.4**
Debt - Direct Lending									
GCP Asset Backed Income	432.4	4.1	18.0	33.8	1.0	1.3	No	100	6.6
Honeycomb Investment Trust	342.0	8.2	28.9	51.4	(4.7)	2.0	Yes	165	8.2
Riverstone Credit Opportunities Income	57.7	3.0	N/A	N/A	(13.3)	1.9	No	100	9.2
VPC Specialty Lending Investments	251.8	29.0	61.1	68.5	(15.7)	2.2	Yes	100	8.8
Direct Lending median	**296.9**	**6.1**	**28.9**	**51.4**	**(9.0)**	**1.9**	**-**	**100**	**8.5**
Debt - Loans & Bonds									
Axiom European Financial Debt Fund	85.9	22.8	29.7	50.1	(10.2)	1.4	Yes	100	6.4
CQS New City High Yield	260.3	26.3	15.0	35.5	10.0	1.2	No	111	7.8
CVC Credit Partners Euro Opps GBP	167.1	19.8	13.0	34.7	(3.1)	1.5	No	100	4.6
Eurocastle Investment	474.0	29.3	11.6	71.5	(11.5)	0.4	No	132	N/A
Henderson Diversified Income	159.9	7.6	25.6	32.3	(6.1)	0.9	No	117	5.2
M&G Credit Income Investment	141.2	8.0	N/A	N/A	(2.6)	0.9	No	100	4.0
NB Distressed Debt Inv Extended Life	35.1	18.9	(9.2)	(4.1)	(37.4)	2.9	Yes	100	N/A
NB Distressed Debt New Glb	16.7	4.8	(36.8)	(28.0)	(33.1)	2.9	Yes	100	N/A
NB Distressed Debt	8.3	13.1	(14.1)	(14.1)	(20.3)	2.9	Yes	100	N/A
NB Global Monthly Income Fund GBP	224.9	19.6	23.8	32.0	(11.5)	1.1	No	100	5.0
TwentyFour Select Monthly Income	184.2	10.7	24.0	48.6	4.6	1.1	No	100	6.4
Loans & Bonds median	**159.9**	**18.9**	**14.0**	**33.5**	**(10.2)**	**1.2**	**-**	**100**	**5.2**
Peer group median	**167.1**	**13.1**	**18.0**	**34.7**	**(10.2)**	**1.4**	**-**	**100**	**6.4**
Trust rank in group	**1**	**16**	**7**	**N/A**	**4**	**13**	**-**	**5**	**5**

Source: Morningstar, Edison Investment Research. Note: *Performance to 30 September 2021. Net gearing is total assets less cash and equivalents as a percentage of net assets, where 100=ungeared.

Dividends

BPCR pays quarterly dividends in US dollars and aims to pay a US$0.07 annualised dividend per share and deliver a 7% dividend yield for investors. On top of that, BPCR may pay special dividends exceeding the target, which amounted to 1.29c in 2020 and 0.29c ytd in 2021 (see the chart on the frontpage).

Dividend cover

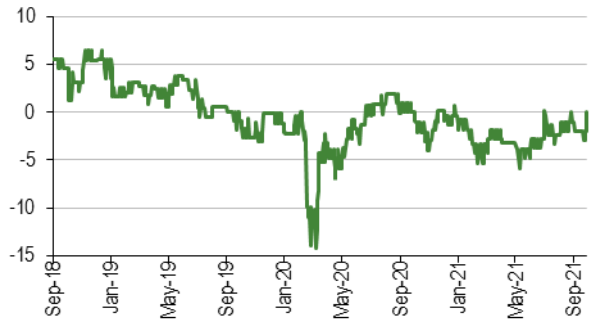
Since we last examined BPCR's capability to pay out dividends from its income stream in November 2020, its loan portfolio has been strengthened with the LumiraDx investment (US$150m), while Sebela (US$101.6m at end-October 2020) was fully repaid, generating a prepayment fee of US$1.5m. We also note that BPCR will bear a lower non-utilisation fee as the credit facility was reduced to US$50m (from US$200m), and interest rate on the undrawn amount was lowered (according to our conversation with the management). We calculate that the annual non-utilization fee currently amounts to less than US$1m from previous US$4m. While the current US dollar Libor is at a low level of 0.13%, most of BPCR's floating rate debt investments have a 2% Libor floor. Consequently, we estimate that the current portfolio generates c US$100m income (and additional c US$3m from amortisation of previously received funding fees) annually. Assuming a level of operating expenses in line with the 12 months to end-June 2021 and accounting for the above-mentioned financial expenses, we estimate BPCR's annual costs at US$16.2m excluding performance fees (around US$5m annually). Consequently, BPCR needs to invest part of its cash position to cover its dividend (US$96m pa) exclusively from income. Until then, it may pay a portion of the dividend from capital.

Discount: Trading at par

Since the recovery from the COVID-19 induced sell-off of early 2020, when BPCR's discount reached its trough level of 14.2%, BPCR shares have traded at a 0–5% discount to NAV, currently at 2.0%. BPCR delivers stable returns from interest and fees earned on its portfolio (which mostly comprises senior secured loans) and distributes its income through dividends. As a result, its shares tend to trade at par with limited volatility. Having said that, BPCR also has facilities to limit any potential widening of the discount. If the shares trade at an average discount over 5% over a three-month (10% over six-month) rolling period, subject to meeting its target dividend, the trust will use 50% (100%) of capital and income proceeds generated after this rolling period for buybacks, at least until the shares start trading at an average discount of 1% or less to NAV over a two-week rolling period. The company made use of its discount control mechanism in June 2020 for about three weeks, repurchasing 59,694 shares (representing 0.004% of its issued share capital) and successfully closing the discount. The shares have been repurchased for a total amount of US$60m and are currently held in treasury. BPCR is authorised to execute share repurchases up to 14.99% of total shares in issue.

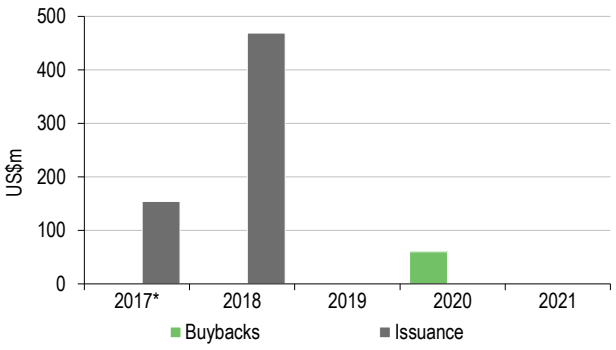
Another mechanism states that if during the last month of a performance period BPCR's shares have, on average, traded at a discount of 1% or more to the NAV per share, BPCR's investment manager shall use 50% of any performance fee paid by BPCR for share buybacks until the shares have, on average, traded at a discount of less than 1% to NAV per share over a period of five business days.

Exhibit 7: Discount over three years



Source: Refinitiv, Edison Investment Research

Exhibit 8: Buybacks and issuance



Source: BPCR, Edison Investment Research. Note: *Excluding IPO proceeds.

Fund profile: Seasoned biopharma debt investor

BPCR is a UK-domiciled fund investing in the life sciences sector, predominantly in debt and royalty-based instruments. It was incorporated in October 2016 and completed its IPO in March 2017. Its initial capital included a seed portfolio from Pharmakon-advised funds (to limit initial cash drag), which was fully exited by January 2019. 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 around 74% of the gross asset value including cash, or close to 90% if cash is excluded. The loans are secured by all or some of the borrower's assets and may also include royalty

collateral as well as other 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 11% of BPCR's NAV 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-September 2021, the equity exposure was less than 1% of the portfolio, and stemmed from a minor equity investment in BDSI accompanying the provision of a senior secured loan.

Investment process: Targeting an 8–9% return pa

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 annum, predominantly from stable coupon income, which in turn should be distributed to investors quarterly through dividends, targeting a DPS of US$0.07 pa. The investment universe of BPCR comprises 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).

In 2020, Pharmakon 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 practicing 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 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).

Deals involving other funds managed by Pharmakon may be subject to conflicts of interest as they would be considered related-party transactions. However, even though Pharmakon is normally not required to (and generally will not) submit individual investment decisions for the approval of BPCR's board, each transaction where conflict of interest might arise has to be pre-approved by the board. Moreover, it has been agreed that BPCR will be entitled to participate in at least 50% of Pharmakon's investment opportunities by value.

BioPharma Credit's approach to ESG

While BPCR has not made any explicit disclosures on its environmental, social and governance (ESG) policy, we note that it invests solely in the life sciences sector, which as a whole contributes positively to society's health and wellbeing. 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. The company 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. Having said that, we believe that additional ESG disclosures from BPCR's investment manager (Pharmakon Advisors), related for example to the sustainability criteria it applies when selecting investments to BPCR's portfolio, would be appreciated by the capital markets.

Gearing: Remaining unlevered

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. Currently there is no debt at the BPCR level.

In H120, BPCR has entered into a US$200m revolving credit facility agreement with JP Morgan Chase as described in our earlier note, when its net cash position decreased to c 5%. As its cash position increased significantly following several loan prepayments, the management decided to amend the facility, with the committed capital reduced to US$50m (although BPCR retained the ability to increase the facility to US$100m and draw another US$100m in a term loan), and the maturity extended to June 2024. The margin payable under the facility was reduced to 2.75% (from previous 4.00%). The decrease in the facility's size (supported by a lower non-utilisation coupon rate) significantly reduces the non-utilisation fee (we estimate that it is now below US$1m pa versus US$4m pa previously).

Fees & charges

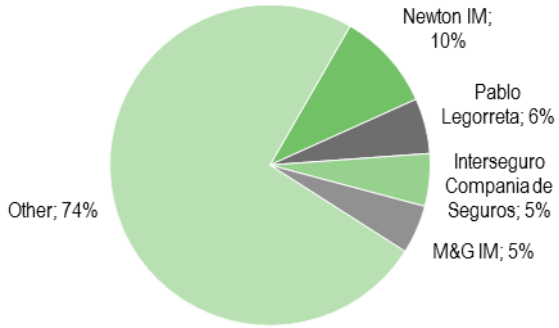
BPCR pays Pharmakon Advisors a management fee equal to 1% of NAV less US$100,000 per year. The fee is calculated monthly and payable quarterly. The investment manager is also entitled to a performance fee of 10% of annual NAV accretion (calculated at end-December), subject to a high watermark and hurdle rate of 6% per year.

The ongoing charge ratio, which takes into account other operating costs of the company and excludes performance fees, stood at 1.14% at end-H121 on a last 12 months basis, according to our calculations (slightly below 1.15% in FY20). BPCR does not pay a performance fee in the first half of the year, and taking into account the performance fee paid in H220 from the FY20 performance, the ongoing charge including the performance fee amounted to 1.50%.

Capital structure

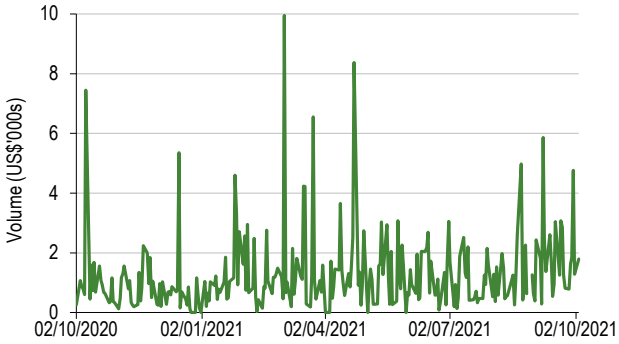
BPCR's share capital consists of 1.4m ordinary shares, of which 59,694 are currently held in treasury. The company is subject to a continuation vote, with the last resolution passed at the AGM in September 2021. The next continuation vote will be held at the AGM following fourth anniversary of the admission 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.

Exhibit 9: Major shareholders



Source: Refinitiv, as at 26 October 2021

Exhibit 10: Average daily volume



Source: Refinitiv. Note: 12 months to 4 October 2021.

The board

BPCR's board comprises five directors, all of whom are non-executive and independent. On 16 September 2020 Jeremy Sillem, who had served as a chairman since BPCR's IPO, retired and Harry Hyman was appointed to the role (formerly senior independent director). Simultaneously Rolf Soderstrom was appointed as an additional director of the company. Mr. Soderstrom has over 30 years' experience in finance, including M&A, fund-raisings, and disposals. He is currently senior independent director of Ergomed and external independent director of Tokyo-listed Sosel Group; both companies are in the life sciences sector. From 2008 to 2019 he was CFO of BTG and helped with the successful transformation of the company into a fully integrated global manufacturing and sales organisation in specialist healthcare. 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 note for details).

Exhibit 11: BioPharma Credit's board of directors

Board member	Date of appointment	Remuneration in FY20 (US$)	Shareholdings at end-FY20
Harry Hyman (chairman)	27 February 2017	78,769	102,506
Colin Bond	15 November 2016	88,185	100,000
Duncan Budge	24 October 2016	70,000	100,000
Stephanie Léouzon	5 December 2018	70,115	-
Rolf Soderstrom	16 September 2020	20,462	100,000

Source: BioPharma Credit.

EDISON

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