proactive

UK: +44 (0)207 989 0813
NA: +1 646 896 3065
AU +61 2 9280 0700
action@proactiveinvestors.com

Synairgen PLC

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Synairgen, Verona Pharma and why DCF analysis doesn't provide the full picture

A familiar refrain of Proactive's finance director when talking about our all-singing, all-dancing new accounting software is that the package is only as good as the data you plug in.

The same could be said of discounted cash flow (DCF) analysis.

DCF is the default method of benchmarking research-stage life sciences companies because it provides a seductively simple method of valuing potential future revenues from drugs that have yet to find their way to market.

Input into the DCF model are elements such as the market potential of the research firm's drug candidate, its likely share of the said market, the treatment's expected price tag and the royalty rate if the drug is licensed out.

Guesstimate
In other words, you are trying to essentially 'guesstimate' the future free cash flow.

The major discounting factor is the chance of regulatory success. Along with this, development costs are layered into the mix, along with the cost of capital and the time value of money.

But to be truly effective, the number cruncher compiling a DCF valuation of a biotech requires a fully functioning crystal ball.

That's because the per share valuation that pops out the bottom of the spreadsheet should be seen in the context of the information it omits as much as the data it includes.

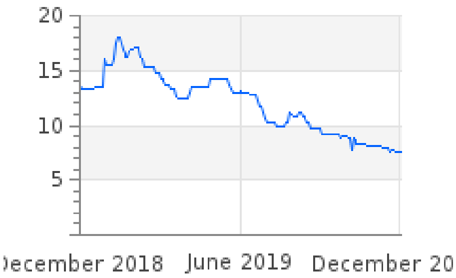
For one thing, the forecast doesn't always capture value triggers such as licensing deals.

Innovation key
Neither can it convey just how innovative the drug actually is, or whether, after tens (or even hundreds) of millions of pounds invested, insurance companies and health services around the world will pay for the new medication.

Price: 7.625

Market Cap: £8.34 m

1 Year Share Price Graph



Share Information

Code:		SNG
Listing:		AIM
52 week	**High**	**Low**
	18.25	**7.3**
Sector:		**Pharma & Biotech**
Website:		**www.synairgen.com**

Company Synopsis:
Synairgen is a drug discovery and development company founded by University of Southampton Professors Stephen Holgate, Donna Davies and Ratko Djukanovic. The business, focused primarily on severe asthma and COPD, uses its differentiating human biology BioBank platform and world-renowned international academic Key Opinion Leader network to discover and develop novel therapies for respiratory disease. .

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Expanding on the first point: very few small biotechs hit the home run of taking a drug from first principles all the way to the market.

Instead, they rely on the deep pockets of big pharma companies that step in (usually once Phase II trials are complete) to fund the remainder of the development.

A licensing deal with a larger firm is a value inflexion point for the smaller company (and its investors) as it will likely involve a significant upfront payment, further cash awards once certain milestones have been reached and a royalty on sales if the compound makes it out into the market.

Often the staged cash instalments involved dwarf the market capitalisation of the minnow that first spawned the innovative drug picked up by the industry's 600-pound gorilla.

Management track record

Your DCF model, however elegant, won't take into account whether a company's management has a track record of tying up licensing deals with big pharma; but it's a filter worth applying.

Neither will it identify those businesses incapable of finding an industry partner that is happy to burn through shareholders' cash.

Another factor overlooked is the quality of the product being developed.

Of course, the holy grail is the newly-discovered blockbuster with the capacity of generating peak sales in excess of US$1bn a year.

But they are hard to find. A fall-back might be to develop 'me-too' copies of the blockbusters, or 'me-better' products that have bells-and-whistle enhancements.

Me-too and me-better

While arguably easier to create, they are entering crowded markets where there may be a reluctance to switch from the brand leader.

The path to regulatory sign-off can be a little more fraught. 'Me-toos' and 'me-betters' tend to have to show superior efficacy and safety to their forerunners to receive the regulatory seal of approval.

By contrast, if you have a genuinely innovative drug that tackles an area of unmet medical need, then the regulatory pathway is shortened.

But even where there isn't explicit guidance from the drugs watchdog, common sense and precedent suggest good innovative medicines are likely to find sign-off less taxing than a fifth or sixth me-too cholesterol drug.

Using the DCF and putting on the additional filters, we trawled AIM to see what, other than a landmine and a rusty pram, that process has brought to the surface.

Interesting case study

An interesting case study can be found in the respiratory segment of the drugs sector.

Verona Pharma PLC (LON:VRP, NASDAQ:VRNA) is developing an inhaled medicine for people with chronic obstructive pulmonary disease (COPD), which is normally induced by smoking. The company is making the preparations to take the treatment into Phase III trials.

With a £120mln market capitalisation, Verona's progress thus far points to the uplift its competitor, Synairgen plc (LON:SNG), might enjoy if its drug SNG001, an inhaled interferon beta, delivers similarly emphatic results in Phase II.

Its COPD drug has been developed to offer protection to sufferers who contract cold or flu, which is a much-needed innovation for people with COPD.

The shock is Synairgen's market-capitalisation, which is £20mln - so there's a long way to go to catch Verona up.

In SNG001, which embarked on Phase-II trials earlier this year, the company hopes to deliver a significant advance on current treatments. Interim data suggests the inhaled treatment is having the desired effect in boosting the antiviral defences of COPD sufferers.

Commercially savvy
Commercially, the Synairgen team is savvy and has a track record of negotiating lucrative out-licensing deals.

SNG001 was originally farmed out to AstraZeneca PLC (LON:AZN) (more of this later), while it currently has a deal with Aussie outfit Pharmaxis for its LOXL2 programme for fibrosis.

That collaboration has already generated a £5mln for Synairgen, which will receive 17% of all future partnering proceeds.

The money from the Pharmaxis collaboration combined with cash it already has in the bank, give Synairgen the runway required to get SNG001 through its current Phase II trial.

Both SNG001 and the LOXL2 programme have significant potential, according to the analysts who reckon peak sales could be in the order of US$2bn each (though remember Synairgen now only has 17% of LOXL2).

You plug those numbers into a spreadsheet and the valuation is well in excess of the current share price of around 18p. City broker finnCap's price target is 63p, which is derived using a risk-adjusted net present value calculation rather than bog-standard DCF.

Out of whack with latest estimates
So why is the current valuation so out of whack with analysts' current estimates?

The AstraZeneca (AZ) deal mentioned earlier holds the key to that conundrum.

SNG001 was being developed by AZ, which handed it back last year, stating the interferon beta drug didn't meet pre-defined criteria for progression.

One analyst Proactive spoke to, pointed out the drug was jettisoned before AZ received the whole data set, particularly around viral events.

Why this happened is unclear. But many of the big pharma companies have been under pressure to cut R&D programmes irrespective of their merit in order to get costs down.

SNG001 may or may not have been a victim of this baby-out-with-the-bathwater mentality.

In the aftermath of the AZ disappointment, a small number of long-term holders of the stock bailed.

Big hitters involved
However, the big hitters, Woodford and Lansdowne Partners, along with the major individual high net worth investors Richard Griffiths and Leonard Licht, remained loyal.

That said, this loyalty has come at a price. It has meant the stock has been illiquid.

In common with many small companies with a preponderance of institutional and high-net-worth shareholders, the lack of trading volume has left Synairgen adrift.

Data and deals will change this. We've had safety and biomarker data, which have lifted the stock from its recent floor. An 80-patient efficacy study should read out in the first-half half of next year.

And it's thought Pharmaxis could complete a deal for the LOXL2 programme by the end of the year.

In other words, the value catalysts are there.

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