My favourite share: fund manager Keith Ashworth-Lord

Keith Ashworth-Lord, manager of the ConBrio Sanford DeLand UK Buffettology fund, explains why he likes Bioventix

There are two aspects to investment: the business and the valuation. In this article, I will guide you through the first; the go / no-go decision of evaluating the quality of a business. In 2014, only two new investments were made for the ConBrio Sanford DeLand UK Buffettology Fund. Bioventix was one of them. Here's why:

1. Circle of Competence

Bioventix develops and refines monoclonal antibodies harvested from immunised sheep. These are used by equipment manufacturers as the basis for clinical diagnostic tests. You don't have to understand the science, just accept it, but you must understand how the company makes its money.

Fees are earned during the development phase and there is a perpetual royalty on sales of any diagnostic that uses these antibodies. The main clients are the companies that manufacture blood testing equipment, namely Siemens, Roche, Abbott Labs, Johnson & Johnson and Beckman. The beauty of the royalty based revenue model is that it resembles an annuity payment. Every time a test is done, a payment is received. Even if the manufacturers miniaturise their equipment to consume less reagent, the same royalty is paid. In some cases the client funds the R&D, in others Bioventix does. Likewise manufacture can be undertaken in-house for the client or the client can do it with Bioventix providing the clone. All development work is expensed as incurred, not capitalised. The company is therefore in the process of building deep value for the long-term whilst benefiting now from the annuity revenues already secured.

2. Barriers to Entry

There is no intellectual property right per se. However, each monoclonal antibody is unique and cannot be copied. Any company raising its own antibody for a diagnostic assay must complete the full battery of tests – a significant amount of work – to gain a new regulatory approval. Therefore it is the regulation of in-vitro diagnostics that is the key barrier to entry.

3. Risk Factors

There are the following risk factors:

The company relies on a small team of ten highly educated, professional and dedicated research and production employees.
The company is dependent on the diagnostic companies that licence its antibodies to bring assays to the market.
All new antibodies are now licensed on a perpetual basis but this isn't the case with some of the older ones.
Competitor risk in the area of sheep antibodies is low but not zero. The main competitors tend to be the diagnostic companies themselves using mice or rabbit antibodies.

4. Sales, Margins & Earnings

Bioventix established 7 of its 8 in-market antibodies between 2006 and 2014. Sales have grown, not always smoothly, from £593k to £3.35m, a compound annual growth rate (CAGR) of 24.1%. Over the last five years, the CAGR is 15.2%, mainly driven by royalty & licence fees, not product revenue or R&D income. Clients are global as seen in the 2014 mix of sales: USA 44.6%; EU (ex UK) 44.3%; UK 3.3%; and Rest of the World 7.8%. With most of the costs incurred in sterling, this renders Bioventix sensitive to currency movements.

Margins are very high, which is to be expected for a business with a moat and pricing power, and where the cost to the client is a fraction of its expenditures. During each of the last 7 years, gross margin has stood either side of 90% and operating margin either side of 60%. The main costs are staff and R&D. Both have been falling as a percentage of sales as the business matures and more revenue streams are consolidated.

The business was minimally profitable in 2006 and incurred a small loss in 2007. But over the last 5 years pre-tax profit has climbed from £877k to £2.22m – a CAGR of 20.4%. There has been a consistently lower than normal tax charge rate, reflecting R&D enhanced expenditure relief. Over the last 5 years, normalised diluted earnings per share has grown from 13.0p to 35.4p – a CAGR of 22.2%. Following the admission to AIM, a new dividend policy was established and last year a total dividend of 24.1p was paid – a 2/3 pay-out ratio.

5. Cash Flow

Over the last 6 years, 98% of gross cash flow has come from operating profit, which is to be expected in a quasi-annuity style business model. But working capital requirements are big, having absorbed an aggregate of £1.44m of cash to support a £2.35m increase in turnover. The bulk of the absorption is related to trade debtors and prepayments & accrued income, down to the y-o-y growth of royalty income. Both capex and depreciation are de minimis. Laboratory and office equipment is pretty fully written down and of a nature that seldom needs replacement. Aggregate free cash of £5.85m has been generated over this time from £6.66m of accounting earnings (88%). The conversion ratio has remained in the range of 65% to 126% during this time.

6. Balance Sheet

The balance sheet is squeaky clean. On the assets side, there is no goodwill and the main item of tangible fixed assets is freehold land and property. Net working capital stood at £457k at end Jun-14 with net cash of £3.35m. However, trade debtors covers only product sales; royalties due but not yet paid are included in prepayments & accrued income. On the capital side, retained earnings make up £4.93m (94%) of the £5.24m book value of shareholder equity. The return on average gross equity is 36.9%. The sales-to-equity ratio has been little changed for four years now – with a hardly impressive

68p-75p of sales generated per £1 of equity invested – so that the superior return to equity is down to the chunky earnings margin.

7. Shareholder Orientated Management

Bioventix was an MBO out of Xenova Group plc, led by the present Chief Executive, Peter Harrison, at the end of 2003. Harrison is a scientist who has worked in the field of antibody technology since 1986. He has extensive experience of the development and commercialisation of antibody technologies. Post the MBO, he has led the commercial development of the company. He owns 15.1% of the equity.

MY VERDICT: Comfortably passes most quality of business criteria.

Learn more

Watch this video interview with Keith Ashworth-Lord to learn more about his value investing style.

ABOUT AUTHOR

Keith Ashworth-Lord

Keith Ashworth-Lord, manager of the ConBrio Sanford DeLand UK Buffettology fund...