ROGER MONTGOMERY
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For What It's Worth

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Double Edition

Floating a business plan

What are the key things to consider when investing in an Initial Public Offering (IPO)?

By Roger Montgomery

Opportunities from an ageing population

CogState has a potentially important role in the global race to treat dementia

By Tony Featherstone

In May, we warned in one of our regular columns about the prospects for Allmine, the one-stop mining servicing company. Allmine was founded by an investment banker who had experience in structuring deals within the sector. The plan was to create a company that catered to every aspect of a mine's life by rolling up a number of diversified services.

Consolidations usually involve the purchase and amalgamation of private companies to list on the share market and realise a higher trading multiple. The success of this strategy relies on disciplined management, a stable operating environment, the ability to drive through synergistic benefits and a little luck. Unfortunately, Allmine was a victim of the slowdown in the mining boom, and the company went into administration shortly after our article was published. What sounds good in theory can often be challenging in practice.

With optimism abounding in the share market, we at Montgomery Investment Management are once again warning readers against investing in companies with business plans but unproven performance. There has been considerable demand for Initial Public Offerings (IPOs) in recent months, and many vendors are hoping to capitalise on this appetite.

While Montgomery Investment Management has recently participated in some compelling floats, there are a number we have avoided due to their lack of proven fundamentals. We believe buying into a plan or vision is a very risky way to manage money, and those who think it is a shortcut to quick financial return should understand the following before parting with capital.

The vendors of a business plan typically ask investors for capital to acquire a portfolio of assets. The benefits of a roll-up typically increase with scale and the synergistic benefits of putting similar assets together under one "company" roof are detailed. Investors should examine every asset in the proposed portfolio to ensure that the purchase price is reasonable.

It is often difficult to assess the fundamentals of a business plan due to the lack of history and hard numbers. The statements provided in the float will typically have the earnings of the aggregated assets, with a one-period forecast for the merged entity. It may be hard to take these estimates at face value since the company may be in the formation process and the credibility of these numbers rests largely on the competency and experience of management and their accountants.

Buying into a plan or vision is a very risky way to manage money

Vendors that bring these roll-up plans to market may have more experience with coordinating a roll-up, rather than running the businesses that they plan to purchase. Having a disciplined board that is capable of making acquisitions at reasonable prices is necessary to generate long-term value with consolidation plays. Equally important is having a management team at the helm that has an intimate knowledge of the sector, the individual businesses and a vision for growth.

We have seen some proposals where the executives of a proposed roll-up have minimal experience in the sector and hence it is more likely that additional costs will be incurred with consultants, lawyers, and accountants needing to conduct due diligence. Generally, we are somewhat sceptical of management teams that are highly reliant on the consultants.

This brings us to what is perhaps the most important consideration for any float – where will the capital be directed? When a business plan is brought to market, it is prudent to identify how much the "promoters" are taking out, how much they are being remunerated for their "vision", how much "skin in the game" they will have after the float, and how many dollars they have actually invested to get their shareholding. Avoid companies where the "promoters" have paid a small price for a considerable shareholding, either in dollar terms or in sweat equity terms.

And always remember that when a highly informed seller meets an uninformed buyer, you err on the side of caution.

Roger Montgomery is the founder and Chief Investment Officer of The Montgomery Fund.

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Returns to 31 October 2013

Code		Change	Outperfomance
MPF	**The Montgomery [Private] Fund**	**44.57%**	**-**
XNAJI	ASX 200 Industrials Accumulation Index	19.43%	25.14%
XTOAI	ASX 100 Accumulation Index	31.40%	13.17%
XJOAI	ASX 200 Accumulation Index	28.54%	16.03%
XAOAI	All Ordinaries Accumulation Index	25.48%	19.09%
XKOAI	ASX 300 Accumulation Index	26.92%	17.65%
XTLAI	ASX 20 Accumulation Index	36.43%	8.14%
XMDAI	ASX Midcap 50 Accumulation Index	8.86%	35.71%
XSOAI	ASX Small Ordinaries Accumulation Index	-13.55%	58.12%

Benchmarked returns are since inception (23 Dec, 2010) of the Montgomery [Private] Fund and assumes distributions are reinvested. Past performance is not indicative of future performance.

Minimum investment $1,000,000

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Few investment trends are more profound than that resulting from the dramatic increase in the ageing population. Between now and 2050, the number of Australians aged 65 to 84 is expected to more than double, and those aged 85 or over will quadruple to 1.8 million. Almost a quarter of our population will be 65 or over.

Those figures, from The Treasury's 2010 Intergenerational Report, provide a glimpse of the challenges ahead: for the economy as labour-force participation declines; for the property sector as a vast increase in retirement housing is required; and for the healthcare sector.

The scary part is nobody really knows how an ageing population will transform developed nations in coming decades, because so much depends on the rate of medical breakthroughs. What happens if living well past a hundred becomes the norm in wealthy countries?

It's obvious that demand for healthcare services for the aged will boom in coming decades and vast riches await biotechnology companies that develop treatments to cure diseases prevalent in older people, such as Alzheimer's.

Alzheimer's Australia says 321,600 people live with dementia in this country and that without a medical breakthrough there will be 900,000 by 2050. It estimates one in four people over 85 have dementia and that 1.2 million Australians care for dementia sufferers.

Almost $5 billion was spent on health services for those with dementia in 2009-10, and within two decades, dementia will be the third-greatest source of health and residential aged-care spending in Australia. By 2060, spending on dementia will outstrip that of any other health condition.

That's just in Australia. Worldwide, 682 million people will live with dementia by 2055. Clearly, there is a desperate need for a medical breakthrough for dementia, which is a collection of symptoms that affect thinking, behaviour, and the ability to perform everyday tasks. Causes of dementia include Alzheimer's disease, vascular dementia and Parkinson's disease.

Worldwide, 682 million people will live with dementia by 2055

Curing Alzheimer's would go a long way to reducing the incidence of dementia in older people, but the global pharmaceutical industry has so far been unable to develop a treatment for the underlying disease. Several firms, including US pharmaceutical giant Merck & Co, are trying, but any treatment still seems a long way off.

Micro-cap ASX-listed biotech CogState has a potentially important role in the global race to treat dementia. It was founded in 1999 to develop technology to detect the first signs of the disease. The Guardian newspaper recently reported that up to 800,000 are living with dementia in the United Kingdom, and less than half have not been officially diagnosed. CogState's test could, one day, help those who do not know they have this terrible disease.

Although there is no treatment, knowing the early signs of dementia can allow sufferers to plan for and manage the onset of the disease, seek support, and make caring and financial arrangements. It's not hard to imagine millions of older people having their cognitive function tested in coming decades.

CogState's computer-based Cognigram test allows general practitioners to assess cognition in patients in and identify subtle changes that could indicate the early onset of a neuro-degenerative disease such as Alzheimer's. Cognition is the mental process of knowing.

Merck announced in October that two new studies further confirmed Conigram as a sensitive assessment to detect and monitor cognitive decline over time, and the test is being used in several leading international studies on Alzheimer's, dementia and brain function.

It is early days: in June 2012, CogState provided Merck with a five-year exclusive right to market and promote

Cognigram in Canada. It launched a pilot trial to GPs in March 2013 and so far 450 physicians have registered, and 20 testing centres are live. The test has a cost of CAD$125 a session.

CogState believes Alzheimer's testing is a $500 million annual global opportunity, and that it is uniquely positioned to capture this market through its test. After Cognigram gains acceptance in Canada, the plan is to commercialise it in Europe and the United States.

CogState believes Alzheimer's testing is a $500 million annual global opportunity

The big hope is that Merck's current research trials lead to an Alzheimer's treatment in the next five or six years, and thus sharply higher demand for Cognigram. It is far too early to know if the compound will work; the only certainty is much greater focus on developing Alzheimer's treatments and higher government funding worldwide to combat an incredibly costly disease in coming decades.

CogState has two other key divisions: global pharmaceutical companies use its test in clinical trials for cognitive-related illnesses; and its Axon Sports division tests cognitive function in elite athletes. This is potentially a growth market as sporting teams invest in technology to measure the effects of concussion. Lawsuits brought by players who allege their employer breached a duty of care by allowing them to play too soon after concussion is a growing risk for contact sports worldwide.

About $11.6 million of CogState's $12.6 million revenue for 2012-13 came from the clinical trials division. Although revenue rose 4 per cent on a year earlier, the net loss was $1.9 million, thanks to higher expenditure on Axon, which made its first revenues this year, and the promising Cognigram test.

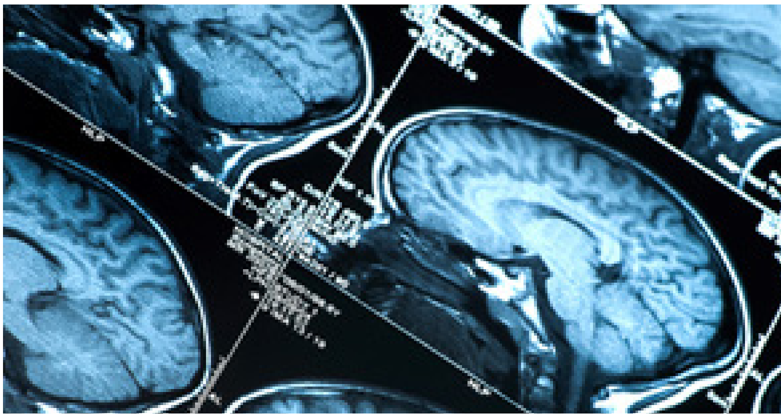
CogState ticks several boxes for an emerging biotech. Unlike many of its peers, it does not face years of costly research trials that often disappoint. Its core research is approved and well regarded, and its great upside – the Cognigram test – is being commercialised in Canada.

The Merck relationship is another tick. Having an alliance with a global pharmaceutical company is vital for small players that do not have the scale to promote their technology globally. It also provides a potential funding source and exit strategy if CogState is eventually acquired. Management has clearly done a good job to get CogState to this point, and it has an A rating for quality from Montgomery Investment Management.

CogState also has an interesting business model. The profitable clinical trials divisions provides cash flow to invest in Axon, which should grow revenues rapidly in the next few years, and Cognigram, which will take longer but potentially have a payoff many times greater.

The ability to fund investment internally is a highly attractive trait for emerging companies. Some of the best exploration companies, for example, develop a producing mine that gives early cash flow to invest in other projects, meaning less equity capital is raised through dilutive share issuance. The same is true of emerging life science companies that can engineer early cash flow, to fund drug discovery or medical devices that have a much bigger pay-off.

CogState also has a potentially lucrative position in a huge, growing global market as more money is spent on Alzheimer's testing in coming years. As harsh as it sounds, few diseases have more commercial upside than dementia, given that more than half a billion people worldwide will have it by 2055.



All of the above sounds promising, but that does not mean CogState suits value investors. For one thing, loss-making companies should almost always be avoided: why waste time on the "long tail" of unprofitable ASX-listed companies when strong returns can be made on hundreds of profitable companies, at lower risk, if you know how to assess value?

Moreover, emerging biotech companies are highly speculative. For every Mesoblast, many more biotechs destroy shareholder value. This is not a sector for conservative investors, income seekers or those with a short investment time horizon. CogState, for example, has already taken 14 years to develop.

The other problem is valuation. The investor's task is to identify exceptional companies that trade below their intrinsic value at bargain prices. But without current or near-term future profits, there is little to go on, or to compare with the share price to judge if value exists.

One valuation technique used for loss-making emerging companies is the Enterprise Value (EV) to Sales multiple. Enterprise value is market capitalisation plus debt, less cash and cash equivalents.

This formula has limitations: using capitalisation as an input means relying on market price, which is an inherently flawed way to calculate value (as shown by the Price Earnings multiple). Another flaw is that high cash balances reduce the enterprise value, but may also reduce the company's future growth prospects if not enough funds are reinvested for growth.

However, in the absence of a profit, EV/Sales at least gives a clue as to how much investors are paying for the company's sales, and a comparative benchmark with peer companies.

CogState is capitalised at $34.7 million, has no debt, and cash reserves and short term investments of $3.1 million in the September quarter. The enterprise value, therefore, is $31.6 million. Based on trailing sales of $12.6 million, the enterprise value to sales ratio is 2.5 times ($31.6 million/$12.6 million).

To put that in perspective, Resmed and Cochlear usually trade on an EV/sales multiple of 4-5 times; less-established biotechs in the loss-making phase often trade around 3 times sales, and low-growth biotechs can have an EV/ sales of 0.5 to 1 times. High-growth biotechs trading on an EV / sales multiple closer to 2 times sales are often viewed as undervalued, on this simplistic metric.

But prospective investors in CogState – and most emerging biotechs, for that matter – are betting on potential, rather than assessing relative valuations, which can increase or decrease dramatically and suddenly.

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On that score, CogState has plenty of upside potential and arguably less risk than many emerging biotechs, given it has a developed product, established revenue base, and is on the cusp of faster commercialisation of its newer products.

Even so, value investors would need great conviction to buy the stock, given the dangers of investing in speculative loss-making companies - and that better investments can be found in the smaller universe of profitable listed companies, even in an overvalued market.

Tony Featherstone is a former managing editor of BRW and Shares magazines. This column does not imply stock recommendations. Readers should do further research of their own or talk to their adviser before acting on themes in this article. All prices and analysis at October 31, 2013.

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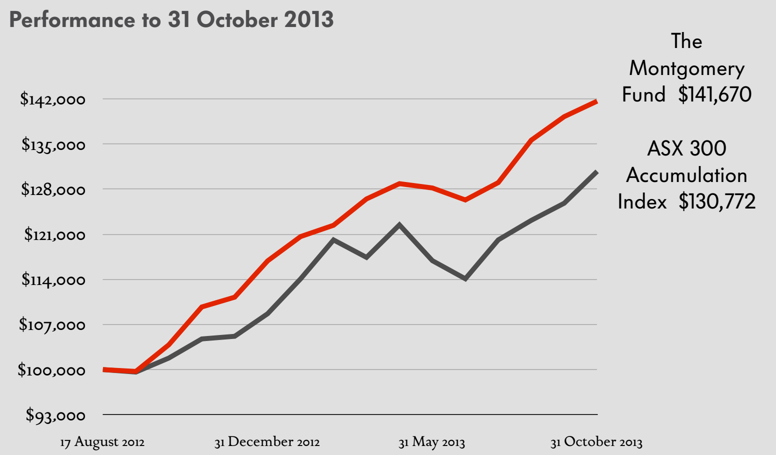

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