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Dr Boreham's Crucible: Universal Biosensors

By TIM BOREHAM

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Market cap: $73.8 million; **Share price:** 42 cents; **Shares on issue:** 175.8 million

Executive chairman and acting chief executive officer: Andrew Denver

Board: Andrew Denver, David Hoey, Denis Hanley, Judith Smith, Marshall Heinberg, Craig Coleman

Financials (March quarter): revenue $7.9 million***** (up 56%), net profit $2.5 million (previous $1.6m loss), operating cash flow -$1.1 million (-$2.3m), cash $17.8 million, expected current quarter cash outflows $7.2 million.

***** Includes $872,000 of Xprecia Stride sales.

Major shareholders: Viburnum Funds/Wyllie Funds Management 15.5%, KFT Investments 10.2%, Denis Hanley 3.77%, Talu Ventures (CM Capital) 3.6%.

We've all heard of Brexit, a.k.a. the 'Theresa May or May not survive' debacle.

Here's another one: Strexit, as in 'strip exit'.

In this case the Strexit decision is not in the hands of the people, but diagnostic group Universal Biosensors' partner on the blood sugar testing side of its business, Johnson & Johnson offshoot Lifescan.

In the near future - and we’re deliberately being vague - Lifescan must decide whether to pay Universal a lump sum, in return for ceasing the profit-sharing deal on Universal’s single-use Onetouch Verio blood testing strips.

The strips are based on a proprietary electrochemical sensing system.

Should Lifescan choose to Strexit rather than to Stremain, Universal will pocket a lump sum on future quarterly service fees (QSFs) estimated at $80-90 million. Under a complex formula, the Strexit decision is crystallised when cumulative Onetouch Verio QSFs reach $US45 million ($58 million).

Universal earns a royalty of 1.25 US cents for the first 500 million strips sold every year and then 0.75 US cents per strip thereafter.

Lifescan sold 1.4 billion strips in calendar 2016. This year, Lifescan expects to sell around two billion strips, so at this rate the $US45 million threshold should be attained later this year.

Universal’s management assumes Lifescan will avail of the Strexit option, because if Onetouch Verio sales continue at the current momentum it will be up for a lot more than $80-90 million lump sum.

“The rational decision would be to exercise that right,” Mr Denver says.

If the union remains intact, broker Veritas Securities values Universal’s blood glucose business at up to $361 million, or $2.05 a share.

Another broker, Taylor Collison estimates just under $US60 million ($A78 million) paid in January 2018 as “one potential scenario”. However given Lifescan is free to decide any time in 2018, payment may not be received until 2019.

The firm notes that demand for the Verio strips has been “robust” since being launched in early 2010 - and is likely to remain so.

For the history buffs, Universal listed in December 2006 after raising $22 million at 50 cents apiece. For a while, the stock traded above $1 until the usual setbacks and delays occurred. But the company’s core story is little changed over the decade.

Coagulation thickens the plot

The Universal story gets even more interesting because there are two sides to the business, the other being measuring the effectiveness of the anti-coagulation (blood thinning) drugs, like warfarin.

Universal has a separate deal with Siemens to market these strips, called Xprecia Strides.

With the blood testing, J&J owns the intellectual property, even though Universal Biosensors has the technical knowledge and retains the commercialization rights.

The Siemens deal is different in that Universal controls the intellectual property and is the exclusive manufacturer.

“We make money by selling the strips,” Mr Denver says.

The Xprecia Strides won US Food and Drug Administration approval in October last year and have only been marketed since January. But they are also sold in Europe, the Middle East, the Asia Pacific, Canada and Latin America - which just about covers the world.

By the numbers

At Universal’s recent annual general meeting, Mr Denver said the March quarter Xprecia Stride sales of $872,000 were five times the value of sales in the whole of 2015-’16.

“We expect to see Xprecia Stride test strips make an increasingly important financial contribution to Universal’s financial position in 2017,” he said.

The company, of course, is working off a low base.

Encouragingly, Universal’s bottom line is looking plumper: after reporting a cumulative $28 million of net losses over four years, the company posted a $1.3 million net profit in calendar 2016 and this was augmented with a $2.4 million surplus in the March quarter.

The company has also been net cash flow positive for the last four years.

Dr Boreham’s diagnosis:

Universal’s current $70 million market valuation makes for an interesting disconnect with the implied underlying value of both sides of the business.

Brokers value the coagulation side around $100 million and this does not include the emerging home testing market, over which Universal retains the full rights.

The company values the US blood glucose home-monitoring market at $US12 billion, with anti-coagulation monitoring worth a further $US1.3 billion.

The latter is a “quasi monopoly market” dominated by Roche.

In theory, Universal should be worth $200 million or more taking the diabetes and coagulation sides into account.

So why the yawning valuation gap? “I wouldn’t be doing what I’m doing if I knew why,” Mr Denver says.

Fair enough, Andy.

There are a few possible reasons: one is that the expected growth in the coagulation side is over-stated; the second is that competition on the blood thinning side is under-rated.

The third is that warfarin therapy has been declining as other novel drugs (that don't require the same level of monitoring) are developed. But warfarin has been the standard-of-care since 1954 and clinical behaviour won't change overnight.

The fourth explanation for the valuation chasm is that investors are simply stupid.

Dr Boreham believes investors are never dumb, but possibly sometimes a bit slow on the uptake.

The Strexit vote (around the J&J boardroom table in this case) eventually will determine whether this discrepancy is justified or not.

Disclosure: Dr Boreham is not a qualified medical practitioner and does not possess a doctorate of any sort. He wouldn't be doing what he does if he knew why the market behaves so erratically.