Biotech Daily
Marc Sinatra's Bioguide

March 31, 2008

MARGIN LENDING: EDDY GROVES, TRICOM, OPES PRIME AND BIOTECH

Given the events of the last few months, the role of margin lending and the effect it can have on share prices has come under scrutiny.

Margin lending is a process whereby an investor borrows money to buy shares using their current share holdings as collateral.

For example, at the moment, Commonwealth Securities will loan you the money to buy seven additional shares in National Australia Bank for every three shares you own (Leverage = 70%). It will lend you the money to buy four Arana shares for every six shares you own (Leverage = 40%).

Using NAB as an example and holding 30 shares at $50 each, Commsec will lend $3500 for 70 more shares giving an investment of 100 shares for $5000. If the share price falls to $40 a share the total investment is worth $4000 and the leverage has moved up to 87.5 percent and you will receive a margin call and will have to either sell some of the shares bought with borrowed money or buy more of your own shares.

Taking out a margin loan can see your net worth increase dramatically in a good market. In a bad market it can have devastating effects on your net worth, as Eddy Groves of ABC Learning found out. Falls in the price of ABC Learning saw Eddy forced to sell all but 3000 of his 20 million shares.

Obviously, this isn't good for Eddy, but it also isn't good for other ABC shareholders because the dumping of such a large quantity of stock on the market pushes the share price down further.

With Tricom and Opes Prime, clients take out a lending agreement, as opposed to a simple margin loan, where legal ownership of the shares passes from the client to Tricom and Opes Prime.

These companies can then make money from the stocks they now own by using them to finance loans in places where they can take advantage of rate differentials or loan the stock out to be short sold.

If markets move away from them, however, they can suffer the same fate as Eddy Groves. Even worse, when a company such as Opes Prime goes under, all clients can do is wait until the dust settles to see what is left because, having given up ownership of their shares, they are just another unsecured creditor.

Having taken the long way around, what does this mean for biotech stocks?
So far, it seems to have meant little with no real stories of problems surfacing. Problems have surfaced with speculative resource stocks, such as Admiralty Resources and given the similarities between resource and biotech stocks, at least some problems seem likely to occur eventually in the biotechnology sector.

It seems unlikely that listed biotech companies will take a concentrated hit given the bigger investors in the sector take a much more responsible approach to their investing.

For biotech investors, company directors included, I think the lesson to be learned is simple: these stocks are too volatile and illiquid to leverage yourself into, to any great extent, if you have a poorly diversified portfolio.

It may well come back to bite you and quite possibly other shareholders.

The other lesson is that investors should scan the registers for large highly-leveraged investors that may add to the risk of a stock before investing in it themselves.

Since seeing the financing arrangements of other shareholders is very difficult, the challenge for the regulators is how to make this risk visible.

In a phrase the message on margin lending is: don't do it with high risk stocks.

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