MATARIN CAPITAL

Investing with Insight and Integrity

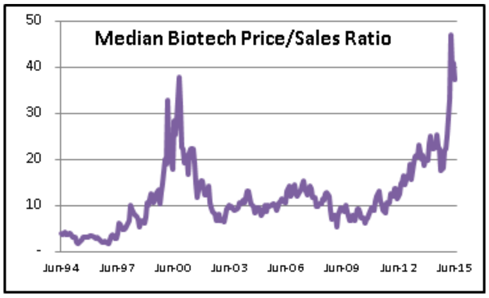
Q2 2015 Newsletter

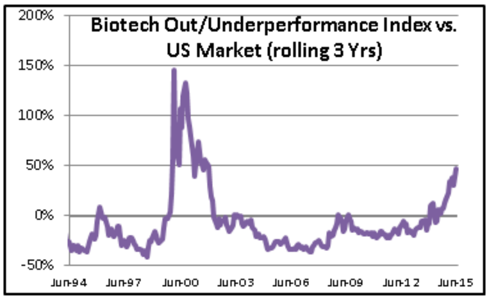
Matarin Capital Management aspires to be a symbol of stewardship within the investment management industry. We are dedicated to delivering excellent investment performance through insight, passion, and diligence. We aim to build strategic alliances with our clients based on the highest ethical standards.

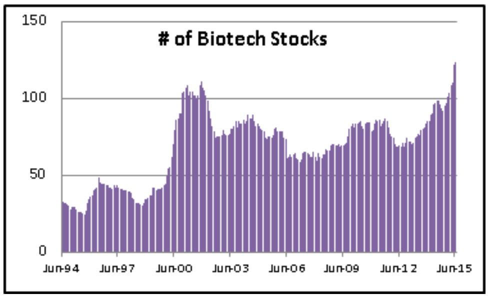
A Little Bubbly, Anyone?

Like the recent summer weather here at Matarin HQ, biotechnology industry stocks ("biotechs") are HOT. Over the past 12 months on an equal-weighted basis, the biotechs have been the top performing industry returning 52% vs. 4% for the market, and over the past 5 years the biotechs have again topped the leaderboard returning a whopping 316% vs. 118% for the market. Biotech bulls contend the rise is warranted and cite the tremendous scientific achievements being made by these companies, the increasing rate of FDA drug approvals, and the wave of buyouts (at huge premiums) across the industry. The biotech bears contend it's largely speculation, and warn that we are in the midst of a biotechnology bubble poised to burst.

At Matarin, we are neither bullish nor bearish on the biotechnology industry, but are instead focused on selecting the right stocks within the industry. Given our preference for lower expectation, higher quality businesses, with shareholder focused management teams, we tend to be attracted to the later stage biotechnology names that actually have saleable drugs in the marketplace. An example of a stock we love within the industry is United Therapeutics (UTHR). UTHR has a market capitalization of $8.5 billion and is in the business of developing unique drugs to address unmet medical needs of patients with life threatening conditions. They have several successful products in the marketplace and a robust pipeline. We like UTHR for many reasons: 1) it is inexpensively valued relative to peers despite an attractive portfolio of drugs and a stocked pipeline 2) they have had strong and steady growth and generate free cash flow 3) company management has exhibited an ability to add value for shareholders through low priced stock repurchases and 4) sales trends are strong, price momentum is positive, and speculative activity in the name is relatively low. UTHR has many of the qualities we like to see.







Sources: Bloomberg, FactSet and Compustat

On the other hand, we tend to dislike those biotechs where much is expected but little has been produced, cash burn is high and share issuances are needed to keep the company afloat. These companies are in many ways like a lottery ticket where all you need is a "dollar and a dream"… most will lose, but a handful will win big. While we prefer not to name names as it relates to our short book, "Company X" (a real company whose identity has been masked) provides a good example of the incredible optimism expressed in the marketplace for many biotechnology names. Company X was founded over 10 years ago and is in the business of selling a diagnostics platform which helps doctors better treat infections and develop therapies. The stock of Company X has risen 1000% over the last 3 years and now has a market capitalization in excess of $1 billion. Over the past 10 years, several larger companies have evaluated the company's technology and have declined to proceed further. In fact, over the past 10 years, cumulative SALES for Company X have been $6 MILLION, total net loss has been close to $100 million, and shares outstanding have skyrocketed as the company needs the money to remain in business. While it is possible Company X ultimately proves successful and earnings catch up with the stock price, the weight of the evidence here leaves us doubtful.

To get a better sense of the "big picture" biotechnology stock landscape, we put together a visual display for a small and mid cap universe of roughly 2400 stocks. There are several observations we can take away from these charts: 1) as quantified by price-to-forward one year estimated sales, biotechnology industry stocks' current relative valuations look higher than those in the fall of 2000 2) on a relative to the market basis, biotech stocks have significantly outperformed over the last three years, but not by as much as they did ending in the 2000 bubble and 3) IPO activity within the biotechs is high. When we calculate the number of biotech stocks in this universe, it is higher than the fall of 2000.

While it appears that speculation is high and valuations within biotechs are stretched, this alone cannot be relied upon as a timing tool. There is no reason why overvalued stocks cannot become more overvalued and it is difficult to time the mood of the market. Remember, it was almost a year ago, in her testimony to Congress when Fed Chairwoman Janet Yellen warned, "…valuation metrics in some sectors do appear substantially stretched—particularly those for smaller firms in the social media and biotechnology industries."

At Matarin, our research and experience has taught us that it pays to be humble. So instead of trying to predict when biotechs will top out, we would rather focus on buying biotechs with good fundamentals and would caution investors against buying biotechs with extremely high price/sales ratios in this frothy biotech environment. We also encourage investors to pay close attention to the price momentum of these highly speculative names, for when the tide goes out and the focus turns to the fundamentals, we will see who is swimming naked.

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