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Harness Biotech Volatility with an Options Strategy: Theta Strategy Capital's Eden Rahim

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COMPANIES MENTIONED

- BELLUS Health Inc.
- **BrainStorm Cell Therapeutics Inc.**
- **Cipher Pharmaceuticals Inc.**
- Microbix Biosystems Inc.
- Portage Biotech
- **RepliCel Life Sciences Inc.**

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Volatility is the nature of the biotech beast, and it must be tamed or utilized to advantage. That's the philosophy of Eden Rahim, portfolio manager and option strategist at Theta Strategies Capital. Can you grow a portfolio if some of your more successful names are called away by option buyers before the stock goes into the stratosphere? The answer is yes, and in this interview with *The Life Sciences Report*, Rahim describes his technique and leaves readers with six names that he fully expects to reap very large gains.

Source: George S. Mack of *The Life Sciences Report*

The Life Sciences Report: You are CEO and cofounder of Theta Strategies Capital, and also the portfolio manager and innovator of the Next Edge Theta Yield Fund, which derives income from the options strategies you have developed over two decades. These strategies profit, in part, from the decline in pricing that occurs as options approach expiration. Could you describe that strategy?

Eden Rahim: Yes. My partner, Mike Bird, and I formed Theta Strategies Capital a couple of years ago to provide institutions with income and hedging solutions using option strategies as an advantage. We thought we would be able to add yield to institutional portfolios, dampen volatility and protect against downside. We have designed and traded a variety of strategies through virtually every crisis in the past couple of decades.

*"**BrainStorm Cell Therapeutics Inc.** is an inexpensive way to get exposure to a potential blockbuster technology."*

In January, we launched a prospectus fund called the Next Edge Theta Yield Fund. Essentially, what we do is exploit the mathematical property of all options to lose value with the passing of time. That property is called *theta*. If you own an option, it loses a little bit of value every day, regardless of the underlying security or index. We first conceived of this fund back in 2002, and thought of it as a novel way to provide yield. Bond investors are always trying to pick the best income funds. We created a yield product that exploits strategies option market makers use, and we brought that to average investors through this prospectus-based fund.

TLSR: So, at least with your income fund, you don't care which way the market is going?

ER: No. Our mandate is agnostic. We don't rely on forecasts and market direction. We're not trying to predict whether the market will go up or down, as a traditional fund would do. We know the market is going to do whatever it wants to do. We can't control that. The Theta Yield Fund basically holds 90–95% cash, and we invest in limited-risk option spreads that exploit time to expiration.

TLSR: As simply as possible, give me an example of how writing an option works for you.

ER: Sure. We use a variety of risk-defined strategies, one of them being a call calendar, for example. Let's say the S&P 500 is sitting at 2,100 right now. A one-month call option trades at about $25, and it loses value, or decays, about $0.60 a day. A two-month option with a 2,100 strike price costs $40, or 60% more, but that option loses only $0.40 a day. So the longer-dated option loses less value each day than the shorter-dated option. If you short the one-month option at $25 and buy the two-month option with a 2,100 strike at $40, it costs you $15, but with the whole position, you benefit by a gain of $0.20 a day. You're not making a market call because you're long and short at the same strike price. All you're doing is exploiting that property of options to lose value, and you benefit from it. Again, exploiting that property is what we call a *theta* strategy.

TLSR: Why do you hold so much cash in the Theta Yield Fund?

ER: We only write premiums equal to 2–3% of the net asset value (NAV) of the funds because we're not there to hit home runs. We're just trying to hit singles for average. We want to have very low volatility. We want to be agnostic to market changes.

We could obviously have higher returns. The goal is to earn about 0.5% to 1% per month, with very low volatility. If we do that, the fund earns its stripes.

TLSR: Let's talk about your Bio-Tech Plus Fund. It's a growth fund. Do you hedge this fund? You limit your upside that way, don't you?

ER: Yes. That's a great point. I do hedge the portfolio. And that does, at times, limit the upside of the portfolio, but with the key ancillary benefit that it also limits the downside exposure. You and I both know that with biotech, it can be up by the escalator, then down by the elevator at times. During this five-year bull, in 2010, 2011 and 2013 we had 15% corrections, and in 2012 and 2014 we had 25% corrections. And yet the bull goes on. It's just par for the course in the sector. Even this year, in March and April we had 10% selloffs from the peak to the trough, all within this bull move. That's just natural to biotech. We accept it for what it is, and we take steps to dampen that volatility because we're counting on stock picking to deliver our returns.

*"When I can get potential blue-sky regenerative technologies like **RepliCel Life Sciences Inc.'s** at this small valuation, I'm buying."*

One of my holdings is Inotek Pharmaceuticals Corp. (ITEK:NASDAQ). It's up more than 100% in a very short period, and that one position adds about 1% return to the fund. I rely on stock picking for excess returns, and then I try to dampen the sector volatility with hedges and written calls. That's the philosophy behind it.

TLSR: Eden, you have some stocks in the Bio-Tech Plus portfolio that range from $20 million ($20M) to $60M in market cap. These are true micro-cap stocks. You also have some small caps, in the $200–300M range. But you can't write options on the very small names, can you?

ER: No. Most of the options we have written are in the mid-cap area. I've written calls against Acadia Pharmaceuticals Inc. (ACAD:NASDAQ), Amicus Therapeutics Inc. (FOLD:NASDAQ), Halozyme Therapeutics (HALO:NASDAQ), Portola Pharmaceuticals (PTLA:NASDAQ), Raptor Pharmaceutical Corp. (RPTP:NASDAQ), Supernus Pharmaceuticals Inc. (SUPN:NASDAQ) and Synergy Pharmaceuticals Inc. (SGYP:NASDAQ). They're in the $1–2 billion ($1–2B) range. Each of those are roughly 1.5–2% weights in the fund. And they have all had big moves. I'm trying to hold them for the long term, but when they get extended and move far above their moving averages in a short period of time, as some of them have, I will write options.

*"**Cipher Pharmaceuticals Inc.** is a decent risk/reward proposition."*

Every once in a while you miss it and a company might move higher, like Ultragenyx Pharmaceutical Inc. (RARE:NASDAQ). I sold options on my Ultragenyx position at $100 after it moved up from $54, but it then went to $127. It was crazy. I did leave some upside on the table there, but you don't know these things in advance. Ultragenyx could just as well have fallen back to $90 or $85.

Over time, options just add an extra form of defense for our unit holders because nothing grows to the sky. When these stocks move far above their 50-day moving averages, I'll write the options.

TLSR: Your Bio-Tech Plus Fund invests in small- and mid-cap Canadian and U.S. biotech companies, as well as some specialty pharmas. My understanding is that over nine years, from 1995 to 2003, you achieved a 26% annual compounded rate of return in a biotech mandate at RBC. You are obviously seeking and achieving growth. If you had to narrow it down, what handful of critical principles should investors adhere to when investing in small-cap biotech stocks?

ER: I think the first principle is to have a healthy respect for the volatility of the biotech sector, and to find ways to use that volatility to your advantage. It's going to be there anyway, so try to make volatility your friend.

A second principle would be to reduce complexity by following a proven discipline. It doesn't have to be mine; everyone can find their own. Not straying too far is the key. My discipline is to focus primarily on midstage companies that report efficacious data from well-designed, controlled trials where the data are peer-reviewed. That's my wheelhouse. I tend not to play overwhelmingly in the preclinical or Phase 1 stages. My exception is that I do play in early-stage regenerative medicine and central nervous system (CNS) indications.

I also rely heavily on key opinion leaders (KOLs), paying attention to what they say about a drug and how it's going to be adopted by physicians and patients. This is one way to reduce complexity, and is very important.

> "We're in a secular bull market—probably a decade-long bull at a minimum—and it is behaving in a very orderly fashion."

A fourth principle might be to watch what the big money is doing. What technologies are big biotech and big pharma spending on? I try to watch the Genentechs (a unit of Roche Holding AG [RHHBY:OTCQX]), the Amgens (AMGN:NASDAQ), the Biogens (BIIB:NASDAQ), and so on. They have enormous, limitless resources with which to look at molecules, receptors, target sites and mechanisms of action. See what they're doing, and then find the smaller companies working on something similar.

If I could suggest a fifth principle, it would be to focus on companies that, even though they may be in midstage development, have identified a path to profitability. I've seen too many companies get through the approval process and never make money. Perhaps they developed a me-too drug with too small a market, or something like that. The path to profitability has not been mapped out, and the company just burns capital.

TLSR: What is the most favorable environmental factor for biotech today? Is it the technicals? Is it regulatory? Is it the group of new technologies—immune checkpoints, gene and cell therapies, antisense—that are going to feed pipelines for the next two decades?

ER: The new technologies are certainly drivers. There have been revolutionary advances. Illumina Inc. (ILMN:NASDAQ), for example, was able to take the cost of sequencing a genome down from $2.7B to $10,000 ($10K), and that's now down to about $1K. We're seeing a technology revolution in biotech enabled by enormous computing power. Our understanding of protein folding right now, for instance, is revolutionary. What CRISPR (clustered regularly interspaced short palindromic repeats) is doing to gene editing is revolutionary. A genome can be edited now in any location. These are drug discovery tools that never existed before, and the increase in scale has been exponential. The technology revolution is one of the underpinnings.

The regulatory environment is another area where things have changed. The FDA started issuing breakthrough designation statuses, generally for rare indications with high fatality rates. Then another group of companies began developing drugs for very narrow populations, and their costs of capital plummeted because the barriers to approval and commercialization went way down. There was also a whole group of initial public offerings that came of age in 2012, 2013 and 2014, and some of these have soared.

It's going to be there anyway, so try to make volatility your friend."

I think the stock and biotech index charts showing the multiyear biotech breakouts are capturing the spirit of what's going on collectively in the space. They confirm that we're in a secular bull market—probably a decade-long bull at a minimum—and it is behaving in a very orderly fashion. Lots of people have stood on the sidelines and not participated in it. They've been calling it a bubble because they remember 2000. I remember 2000 well, and I remember 1992 well, and I remember 1983 well. *This* is not *that.* There is something unique happening here, and there's a fundamental basis for it.

TLSR: Could we talk about some companies in your portfolio?

ER: One of the names on my list is BrainStorm Cell Therapeutics Inc. (BCLI:NASDAQ). I became aware of this company after it reported Phase 2a data in amyotrophic lateral sclerosis (ALS) back on April 21 at the American Academy of Neurology annual meeting in Washington D.C. It was a small trial—just 14 patients and open-label, but it showed up on my radar. I'm always looking for companies in the CNS space, and this one intrigued me.

The data showed that in reinfusing its proprietary NurOwn cells (neurotrophic factor-secreting mesenchymal stem cells [MSC-NTF]), BrainStorm was able to trigger expression of neurotrophic growth factors (NTFs), and there was a definite trend to reduction in the rate of deterioration in ALS six months out. This activity is very interesting. This is an autologous therapy, derived from the patient's bone marrow. The stem cells are administered directly by injection into the subarachnoid space in the spinal canal. This is called intrathecal administration. They are also injected into muscles—all close to the damaged sites.

It intrigues me that BrainStorm is able to separate the mesenchymal cells from bone marrow and then trigger secretion of neurotrophic growth factors. With a $52M market cap and about $15M in cash on the balance sheet, BrainStorm is awfully cheap for having a compound that has shown a trend toward reduction in ALS progression. It may turn out that multiple doses need to be used.

Right now these are basically safety studies looking for little signals of efficacy, so the company is using a single dose. I think BrainStorm is an inexpensive way to get exposure to a potential blockbuster technology.

TLSR: Why do you think BrainStorm is inexpensive? Since this is an autologous therapy, do you think investors could be thinking about Dendreon Corp.'s (DNDN:NASDAQ) bankruptcy?

ER: You're dead right about Dendreon. But when I look at the autologous nature of this technology, I think of that as an advantage, given the relative safety of using a patient's own cells. Another thing is that Dendreon's cancer vaccine, Provenge (sipuleucel-T), addresses a very different issue compared to a neurodegenerative disease. But it could be that BrainStorm's NurOwn is painted with the same broad brush.

TLSR: The company began a Phase 2b trial with NurOwn in ALS in May 2014. This is a 48-patient, double-blind study. Will results of this study be the next share-price catalyst? When will we be hearing the data?

ER: Those data are due out in early spring 2016. As often happens, I suspect the stock will start to anticipate the event and begin to accrue upward in anticipation of it. Brainstorm shares moved up between February and mid-April in anticipation of the 14-patient trial data, but then pulled back pretty sharply. Speculative investors looked at it and said, "Oh, there's nothing here for a year, so I'm going to move on."

TLSR: Go ahead to the next name, please.

ER: An interesting little Canadian company called RepliCel Life Sciences Inc. (RP:TSX.V; REPCF:OTCQB) has, again, an autologous cell platform. It's a regeneration technology. One indication the company is going after is chronic Achilles tendinosis, and that is based on the non-bulbar dermal sheath (NBDS) cells of the hair follicle. These RCT-01 (NBDS fibroblast therapy) cells are used to restore functional deficits in the tendon, and they are harvested from a single punch biopsy. Another indication is androgenic alopecia; the company is utilizing dermal sheath cup (DSC) cells isolated from the bottom of the hair follicle with its RCH-01 therapy.

> "Options just add an extra form of defense for our unit holders because nothing grows to the sky."

Here you have a micro-cap company with a technology that essentially has been endorsed by Japan-based Shiseido Company Ltd. (4911:TYO) in alopecia. RepliCel has also created a unique injector to load the stem cells back into the epidermis. This injector has a market of its own. The company also has a Phase 1 program with RCS-01 for sun-damaged and aging skin.

RepliCel is in three different trials. RCT-01 is in a 28-patient, Phase 1/2 study in Achilles tendinosis. RCS-01 is in a German Phase 1 trial in aging and damaged skin, which could be a big market eventually. And RCH-01 is in a Phase 2 for alopecia with Shiseido. We'll see alopecia data in a couple years. With three indications being developed, plus the injector technology, RepliCel is highly intriguing. When I can get potential blue-sky regenerative technologies like this at this small valuation, I'm buying.

TLSR: Except for the chronic Achilles tendinosis indication, RepliCel is developing technologies that are going to be largely out-of-pocket for patients. There will be no reimbursement for treating baldness or sun-damaged or aging skin. Is that a plus or a minus for RepliCel?

ER: It's probably a minus, but there are people who are willing to pay premium prices for these esthetic services. Keep in mind that for a company this size, with a $23M market cap, it doesn't have to be a gigantic market. Think about Botox (onabotulinum toxin A; Allergan plc [AGN:NYSE]), which was able to grow an enormous business for an esthetic therapy. I think the same thing will be true for alopecia and sun-damaged skin.

TLSR: If you could go to the next company, please.

ER: Cipher Pharmaceuticals Inc. (CPHR:NASDAQ; CPH:TSX) is a company I know really well. I know both current and former management. I invested in the company personally four years ago at around $0.70/share, before I had the fund. When it got FDA approval for CIP-isotretinoin (Absorica; an acne treatment), and went to $1.50–2/share, I bought more, because in biotech a company is less risky when it actually succeeds.

Cipher had a big bull move on the back of isotretinoin's great success. The stock peaked at CA$18–19/share, then fell back. When I launched the fund, I bought in at around CA$12/share, which is what my cost is. I was basically waiting to see how new management would begin to execute its transition. The company could not live off its existing portfolio. It had to transition to another growth phase.

TLSR: Cipher is up about eight-fold over the past three years, but its shares have pulled back over the past year. Was this profit taking?

ER: Yes. I think when the stock broke out and went into the low-mid teens, a lot of momentum guys jumped on that bandwagon. When it lost that momentum —combined with some higher business costs and with margins down a bit—those investors bailed. As is often the case, rational selling turns into irrational selling. That's where I think we got to. I've been buying, and I suspect other value guys have been buying as well, because I think Cipher is a decent risk/reward proposition. We now have some visibility to growth in the second half of the decade.

TLSR: Could you go to another name?

ER: Microbix Biosystems Inc. (MBX:TSX) is a tiny company with about a CA$33M market cap, but it has three shots on goal in its various business segments. It has a virology business, selling infectious virus antigens and molecular diagnostics, and this segment is annualizing about CA$10M and growing at about 15–20% a year, with high EBITDA (earnings before interest, taxes, depreciation and amortization) margins. The virology segment helps fund the company's other two projects. CEO Vaughn Embro-Pantalony has done a great job jumpstarting that business and refocusing the company, and he's added stability. But the company is not getting recognition in the market yet—which is fine, because it's an opportunity as far as I'm concerned.

> "With biotech, it can be a two-way street, up by the escalator, then down by the elevator."

There are a couple of blue-sky opportunities not priced into the stock. One is a technology called LumiSort, which is an animal genetics product. It is able to sort livestock semen utilizing an optical light technology, and this improves the yield of livestock. The technology in place now is highly inefficient. This year the company will be moving from a prototype to a scale-up model, and it is in partnership discussions with three animal genetics companies. At some point, Microbix will sign an agreement, and it will scale up. When the product is commercialized it will have a substantial market—especially for a CA$33M market cap company. This will be the biggest innovation in this space in decades.

Microbix also holds the rights to urokinase (Kinlytic), a clot-busting drug it acquired from Abbott Laboratories (ABT:NYSE). Even though it's FDA-approved, Kinlytic has been dormant for a while, and the company needs a plant committed to manufacturing scalable quantities to compete with recombinant tissue plasminogen activator (tPA), which is used in treatment of stroke.

There is a big market for Kinlytic. Two or three partners have approached Microbix about potentially licensing the product. A plant is probably going to cost somewhere north of $20M, and the company will have to run an equivalence study, so we're looking at maybe 36 months to get Kinlytic on the market. Kinlytic's future revenue stream has potential for $100M in sales, but that is not factored into the net present value or discounted in Microbix's stock price. I've known the company for a long period of time, and I think this is another hidden gem, but not a single analyst covers this name. Microbix's shares can rise five- or 10-fold over a period of time.

TLSR: Microbix's shares are about flat from one year ago, but it's down about 16% over the past month. With this tiny market cap, will the company have to raise more capital and give away a lot of warrants to build the plant for Kinlytic?

ER: I don't think Microbix will have to be onerously diluted. For one thing, this company is cash flow positive. It will have to raise funds at some point to pursue its growth platform, but there may be financial considerations from either of the two partnership discussions the company is involved in, for LumiSort and for Kinlytic. A partnership could provide some relief for its capital needs. I think raising funds will be an opportunity for Microbix because it might be able to gain coverage from the Street. To this point, it's an orphaned little stock.

TLSR: Could you move to another name, please?

ER: Portage Biotech (PTGEF:OTCMKTS; PBT:U-CN) is another micro cap, but there are a couple of big catalysts here. It has a cell penetration peptide technology used to deliver active cargo into cells, and the peptide also crosses the blood-brain barrier. It's still preclinical, but the company feels that, with this innovation, it can target intracellular proteins, whereas the majority of technology right now targets extracellular proteins. There are about 400 addressable extracellular proteins out there, but the potential of intracellular proteins could be 10-, 15-, 20-fold higher. But Portage is early stage.

TLSR: Where are the opportunities for investors?

ER: The real opportunity in Portage is in a subsidiary that it has a controlling interest in, Biohaven Pharmaceutical Holding Company Ltd. (private). The intellectual property for Biohaven comes out of Yale University. It is developing glutamatergic agents for treating neuropsychiatric disorders, such as anxiety and depression. It has a drug, BVH-0223 (a glutamate modulating agent), and just filed an Investigational new drug (IND) application with the FDA to begin a Phase 1/2 trial for generalized anxiety disorders. Portage just wants to get indications of safety, equivalency and activity from this trial. If that works, then the company will go into a 12-24 week Phase 3 trial in the fall or winter. If successful, Portage plans to spin off Biohaven with an IPO. The team at Portage believes the opportunity is that large.

There are a couple of the key shareholders in Portage. One of them is Greg Bailey, a cofounder of Medivation Inc. (MDVN:NASDAQ), the company that developed the giant Xtandi (enzalutamide) prostate cancer success story. The other is Jim Mellon from the U.K., who wrote an excellent biotech book three years ago called *Cracking the Code*. He's a big bull on biotech. There's fairly good sponsorship of this company, but I feel it's an overlooked, unknown opportunity.

TLSR: Portage's shares are up about 80% over the past 12 weeks. What is that about?

ER: Portage succeeded in getting financing in the U.S., where its main trading volume is. It also trades in Canada. Even with this run-up, Portage remains very cheap in the longer term.

TLSR: Do you have one more name from your portfolio that you might mention?

ER: BELLUS Health Inc. (BLU:TSX; BLUSF:OTCPK) is another interesting little company. It is in Phase 3 with its small-molecule, orally bioavailable Kiacta (eprodisate disodium), which is addressing a rare, fatal kidney disease called AA amyloidosis.

A lot of data have been accumulated from a prior Phase 2, and a lot is known about Kiacta already. I like companies in Phase 3 because they are not dealing with the hiccups or hurdles of earlier phases. I can hold the stock, and it will accrue value going up into that special binary event when the data are released.

Results from the Phase 3 for Kiacta are expected around the middle of next year. It's important that Kiacta is addressing a rare, fatal indication, as we are seeing the FDA cut rare-disease companies some slack right now. The FDA has typically been a hostile force in biotech, but not for some of these orphan indications, where patients have few or no alternatives.

TLSR: Here we have a Phase 3 company with a $41M market cap. Why such a low valuation, given that it is in a pivotal trial?

ER: Once again, I don't think there's any analyst coverage on the stock. The stock is held closely. There are large controlling blocks. One is Power Corporation of Canada (POW:TSX), and the other is Francesco Bellini, who founded BioChem Pharma in 1986. BioChem Pharma developed 3TC Epivir (lamivudine), the first HIV drug to be commercialized, and was acquired in late 2000 by Shire Plc (SHPGY:NASDAQ; SHP: LSE). The stock is being held closely, and there is no need for financing. In addition, BELLUS is partnered 50/50 with Auven Therapeutics Management, which is funding this Phase 3 study. You're looking here at that Canadian phenomenon where investors are buying revenue-generating specialty pharmas, not development-stage therapeutic companies. BELLUS also has a royalty agreement with Alzheon Inc. (private), which is developing tramiprosate (ALZ-801) in Phase 3 for Alzheimer's disease.

TLSR: Thank you, Eden.

Eden Rahim, cofounder and CEO of Theta Strategies Capital, applies options to source income and returns through strategies not easily accessible to investors, while protecting capital with hedges designed over his career. His experience includes two decades of portfolio and hedge fund money management, as well as work as an options strategist, derivatives and biotech analyst and portfolio manager. Rahim has managed and traded an options book spanning 250+ securities globally and four commodities, with open interest of 500,000 contracts *in addition to 14 covered call ETFs (over $0.5B AUM) in Canada, the U.S. and Australia, employing his options writing discipline at Horizons Exchange-Traded Funds. Rahim possessed a top-quartile, five-year, five-star growth fund portfolio manager track record on over $1B in assets across four mandates at RBC Global Asset Management. In addition, Rahim has delivered a +26% compounded annual return across a biotechnology mandate between 1995 and 2003. He also has extensive institutional hedging experience through major crises, and experience in the structuring of notes to create specific payoff profiles.*

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