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Chairman on Coal Investment



Open Briefing interview with Chairman Iain Kirkwood

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In this Open Briefing®, Iain discusses:

- Rationale for investment in US coal mine
- Extensive due diligence on projected returns
- Adequate funding for early stage programmes until coal cash flows received

Record of interview:**openbriefing.com**

Avexa Limited (ASX: AVX) recently announced a proposed US\$4 million (A\$3.9 million) investment in the North Pratt Coal Mine in Alabama, US. Avexa will own 25.5 percent of the mine and will also lend it US\$6 million at 6 percent per annum. Why has the company decided to put the majority of its cash in a business outside its area of expertise?

Chairman Iain Kirkwood

Our existing cash resources are insufficient to fund the development of our HIV drug apricitabine (ATC) through late stage, Phase III trials to marketing approval, which the directors conservatively estimate will cost in the range of \$30 million to \$40 million. Given the current market capitalisation of Avexa and the current risk averse equity capital markets, the directors have concluded that a sufficiently large capital raising to fund these trials is unlikely to be achieved.

The board has been searching for opportunities for some time, and the North Pratt Coal Mine stood out in terms of rate of return, low risk, and short pay back period. We've looked at many other opportunities and this was by far the most attractive path forward to generating the funds needed to allow us to develop our assets, particularly ATC.

The directors have concluded that the proposed investment in the mine will give us the best chance of locking in an annuity revenue stream to assist us to develop our portfolio of drug assets, as far as possible in-house.

We believe the US\$10 million investment opportunity contained in the Alabama coal project's business plan is compelling. The technical and economic assumptions used in the business plan have been reviewed and verified by two independent qualified consultants, PERC, based in the US and Censere, based in SE Asia. Censere was engaged to undertake an investigation and analysis, including conducting a business plan review and feasibility study with regard to the project.

Censere reported that nothing had come to its attention that indicated it was not feasible to operate the Alabama coal project based on the business plan submitted. Censere's review of the base case, using the assumptions in the business plan, showed an NPV of approximately US\$72 million which indicates an internal rate of return of 42 percent. The investment has a pay-back period of less than two years.

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To what extent does the decision to invest in the North Pratt mine mean you've given up trying to get co-development funding for your drug programmes from the major pharmaceuticals companies? What other investment options were considered?

Chairman Iain Kirkwood

Quite the contrary – the board and management have not given up!

As explained in some detail in Avexa's 2012 directors' report, it's become very clear that the number of large pharmaceutical companies active in the area of HIV drug discovery and development has shrunk considerably. The likelihood of funding the ATC Phase III trials by securing a meaningfully large out-licensing deal is considered by the directors to be improbable. Therefore, the company's original commercialisation strategy for ATC (that is seeking co-development partners) had to be adapted by pursuing regional specialist pharmaceutical sales and marketing companies with the goal of entering into a co-marketing arrangement with a suitable party.

So mid year, we initiated a global search for such sales and marketing companies with a view to establishing a potential sales network for ATC. The strategy is to create a sales network in order to establish a metric for potential revenue returns as a basis for an investment strategy to secure the additional capital required for Avexa to take ATC to market.

Over the past 12 months we've considered and rejected a multitude of potential investment and merger opportunities, many of which attributed no value to our anti-infective projects, and most if not all of which were based on the other parties hoping to use our cash reserve to fund their own portfolio of drug assets.

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You expect the investment in the mine to earn \$12.5 million pre-tax per year, based on annual production of 660,000 tonnes at a selling price of US\$130/tonne and production costs of US\$40/tonne. What due diligence have you done on these assumptions, particularly costs, which seem low compared with an average of around US\$70/tonne in the Appalachian region? What are the key risks to your return assumptions?

Chairman Iain Kirkwood

As mentioned earlier, the technical and economic assumptions used in the business plan have been reviewed and verified by two independent qualified consultants. The production cost assumption used in the base case is actually \$55 per tonne. The North Pratt coal seam is in Alabama and not part of the Appalachian (coal) region – it's much further south.

The main risk is the metallurgical coal price which has been assumed in the base case to be US\$130 per tonne. The average export price of metallurgical coal for the second quarter of 2012 was US\$157 per tonne.

Further due diligence is still underway and the agreement we propose to sign with Coal Holdings is a conditional one, with satisfactory due diligence results a condition to be satisfied before completion of the investment.

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If the mine offers such attractive potential returns, why is it currently closed and sealed?

Chairman Iain Kirkwood

A previous mining operation targeting the Pratt Coal Seam was located at the site and operated on and off for approximately six years prior to 2006. The mine was last operated by Sunrise Coal LLC until it closed in February 2006, when despite rising coal prices (and resulting cost increases) Sunrise Coal LLC was not able to negotiate a suitable increase in the sale price with the larger coal company to which it had contracted to sell the coal. The

increased pressure on margins made the deposit uneconomical under the prevailing conditions at the time and the mine was closed. This contractual constraint is no longer relevant.

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To what extent will Avexa need to take an active role in the management or board oversight of the North Pratt mine?

Chairman Iain Kirkwood

The parties have agreed that operational supervision of the mine will be the responsibility of Stray Dog Mining, while management and financial control will be vested in Avexa, in consultation with Jonathan Lim, a co-investor in the mine (25.5 percent) and a substantial Avexa shareholder (17.1 percent). So the overall operational and technical supervision will rest with the very experienced US coal miner, Jimmie Ryan, and an experienced mining contractor Colin Macdonald. Each of whom will enter into a service agreement with Coal Holdings to provide their services to the Alabama coal project for a period of at least three years.

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You expect Avexa to receive its first cash flow from the North Pratt investment in about 18 months. Given Avexa's cash on hand was \$12.0 million as at 30 September, and assuming about \$10 million invested/lent to the mine, do you have adequate funding for continuing activities in the interim? Does this mean your clinical programmes will be on hold until you receive first cash flow from the mine?

Chairman Iain Kirkwood

We have adequate funding because in addition to the cash, we have some \$3 million in liquid investments. Also, the investment in the project will be staged, so it's not an immediate \$10 million cash out. With regards to the clinical programmes, we can easily continue to pursue our HIV integrase and anti-bacterial projects without constraint. Only the ATC project is proceeding more slowly than we'd like, until we can access the larger amounts required for the clinical trial, but this would still be the case even if we didn't pursue the North Pratt investment, since we don't have \$30 million and as mentioned before, there's little prospect of raising that from the equity capital markets in the immediate future. We need to break the "stalemate".

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What has been the progress in your search for a co-marketing partner for ATC?

Chairman Iain Kirkwood

Mid year we kicked off the global search by engaging Egamid, a London-based brokering company that specialises in the in-out licensing of pharmaceutical products and M&A support in the international healthcare sector with operations in Europe, the US, Japan and other countries. The company is led by Dr Giancarlo Mennella who was responsible for identification and acquisition of new products for in-licensing while at Shire and led Shire out-licensing activities in Japan.

Since July, over 200 companies have been approached to determine their interest in ATC. Of these a number have progressed through confidentiality agreements to review of confidential data, and are actively undergoing due diligence. Our goal is to consolidate these leads into partnerships in the near future.

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What milestones should Avexa shareholders look for over the next 12 to 18 months?

Chairman Iain Kirkwood

We'd expect to commence pre-clinical trials for our Integrase candidate and report further progress on our anti-bacterial project with Valevia. Also within that time frame, we'd expect

first cash flows from our US coal investment and to announce marketing agreements for ATC.

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Thank you Iain.

For more information about Avexa, visit www.avexa.com.au or call Iain Kirkwood on (+61 3) 9208 4300.

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