Ag & Vet Weekly

Friday December 4, 2020

All the news on ASX-listed agriculture and veterinary companies

Dr Boreham's Crucible: Palla Pharma

By TIM BOREHAM

ASX code: PAL

Market cap: $103.2 million; **Share price:** 82 cents; **Shares on issue:** 125,947,977

Chief executive officer: Jarrod Ritchie

Board: Simon Moore (chair), Mr Ritchie, Todd Barlow, Stuart Black, Sue MacLeman

Financials (six months to June 2020): revenue $12.3m (down 55%), loss of $9m (previously $4 million deficit), net tangible assets per share 34 cents (previously 36 cents), cash of $1.64 million, debt of $12.8 million

Identifiable major holders: Washington H Soul Pattinson 19.9%, Thorney Opportunities 18.7%, Wentworth Williamson 8.5%, Sico Holdings ATF Oranje Trust 6.6%, Australian Ethical 6.3%.

While dozens of ASX-listed cannabis stocks vie for supremacy in the overgrown weed patch, Palla Pharma enjoys an elite status as one of only six legal medical opium growers in the world - and only one of three that are fully integrated from opiate extraction to tableting.

But that doesn't mean Palla has enjoyed drug-lord style margins on its products. On the contrary, the company has struggled to turn a profit since it listed as TPI Enterprises in August 2015.

One reason is that Palla has focused on providing either the raw material (the poppy straw) or narcotic raw material (such as morphine and codeine) to other manufacturers as an active pharmaceutical ingredient.

As a result, it’s missed out on some of the best margins.

But management promises all of this will change with the company entering the British market to sell codeine phosphate/paracetamol tablets.

Britain’s Medicines and Health Products Regulatory Agency (MHRA) in November approved Palla’s marketing application for the tablets, which consist of 30 milligrams codeine phosphate and 500 milligrams of paracetamol (best known to users as Panadeine Forte or strong Panadol).

“All our approvals and interaction with the regulators have gone well and we are on track to start selling codeine to the UK by [early 2021],” Palla founder and chief executive Jarrod Ritchie says.

He says revenue for every kilogram of codeine phosphate sold in tableted form is 2.4 times higher for that sold as an active pharmaceutical ingredient: $1,200 a kilogram versus $500 a kilogram.

Early this year the company won a contract to supply 270 million codeine phosphate tablets to a “major UK customer”.

In late breaking news, the MHRA has asked for more information about the application, but the company assures us the timelines remain intact.

From Apple Isle to Opium Island

Mr Ritchie founded the then Tasmanian Poppy Industries in 2004 to exploit the company’s patented technology and to “disrupt the traditional and outdated processes and dynamics of large players in the industry”.

He said high barriers to entry such as regulatory hurdles and the cost of production normally made it difficult for smaller companies to compete.

TPI’s first crops were in Tasmania, where fields of colorful poppies flourish by public roads.

Known as Opium Island, the Apple Isle accounts for at least half of the world’s legal poppy supply, with Palla rival Johnson & Johnson establishing the rival Tasmanian Alkaloids in the 1980s.

(Tasmanian Alkaloids is now owned by private equity and headed by Dr Ross Murdoch, the former chief executive of Phosphagenics, now Avecho).

Until 2014, Tassie was the only place in Australia where the crops could be legally grown. But following a succession of poor harvests there, the Victorian government opened up its fiefdom for growing.

In 2015, Palla paid $8.15 million for an 8.5 hectare property with a 17,428 square metre (1.7ha) factory in an undisclosed Melbourne location.

In 2017, the company shelled out $25.7 million for a Norwegian tableting facility at Kregero, 200km south-west of Oslo.

The factory, which will supply the British customers, is capable of producing 35 tonnes of active pharmaceutical ingredient and 1.66 billion finished tablets annually.

Palla, by the way, is a Nordic verb meaning “to have the energy to do something”.

Where did the marijuana go?

Also in 2017, TPI said the Federal Office of Drug Control had granted licences allowing it to research the cultivation of marijuana and produce marijuana or resin for research relating to medicinal cannabis and cultivate plants and produce marijuana or resin for medicinal purposes. And that was the last public mention of marijuana by the opiate company.

Palla transferred its opiate manufacturing operations to Melbourne in 2018. Under its “dual hemisphere” strategy the company has contract growers in New South Wales, Victoria and Hungary while Tasmania remains a key growing region.

In September, Palla sold its Tassie manufacturing facility for $2.98 million, but struck a long-term lease with the new owners to store poppy straw before being freighted to Melbourne.

In 2019, the company attempted to acquire a stressed UK customer, but the deal never happened.

But not to worry: Palla ended up with the unnamed entity’s seven UK marketing authorizations anyway.

Palla’s secret formula

Because the sector is so strictly regulated, opium-derived medications essentially are of the same quality no matter who provides them.

The suppliers therefore need to compete on costs and in this respect Palla has an advantage with its patented water-based extraction process.

The method replaces organic solvents, which are highly explosive and therefore require special facilities. Because of this obviated risk of detonation, Palla’s plants are one-fifth cheaper to build. Mr Ritchie says that as well as requiring less capital, the process is kinder to the environment as it does not produce toxic solvents (unlike the traditional methods).

Finances and performance

Palla expects earnings generated from its UK codeine phosphate tablets to be a "significant contributor ... at a significantly higher gross profit margin."

Mr Ritchie says other factors come into play too, including increases in product pricing and increasing monthly finished dosage formulation (FDF) revenue to $12 million after the Norwegian capacity expansion.

In Palla's first (June) half accounts, external auditor KPMG studiously noted the material uncertainties that "may cast doubt on the group's ability to continue as a going concern."

At June end, Palla had cash of $1.6 million, with its biggest shareholder Washington H Soul Pattinson extending a $16 million facility to support working capital. The directors argue that the cash and the $3.7 million undrawn component of the facility will keep the wolves from the door (our words, of course).

After the British medical gatekeeper approved the marketing authorizations in November, Washington Soul temporarily extended this limit to $20 million. The facility reduces to $13 million next April when the Tasmanian property sale proceeds are expected to be banked.

In a "transition period", Palla's six months revenue to June 30 slid 55 percent to $12.3 million, with an underlying loss of $9.1 million compared with a $2.3 million deficit previously. Apart from the aforementioned customer loss, revenues were affected by unfavorable growing weather and the exit of a legacy non-opiate supply agreement.

"This year's sales and earnings will be heavily skewed to the second (current) half as we transition from a producer of low-margin, non-opiate products to higher margin opiate-based products sold via Palla-owned marketing authorizations," Mr Ritchie says.

While calendar 2020 revenues are expected to be "modestly lower to flat" on the previous $54.8 million, the effect of the higher margin sales will be felt from the December quarter.

To meet demand, Palla plans to spend about $4 million expanding its Norway facility, to give the capacity to increase monthly revenues from $4 million to $12 million.

Palla shares have traded between 48 cents (March 30 this year) and $1.31 (July 26 last year). The stock has perked up from 68 cents in late November to around 80 cents now.

Mandatory Covid-19 bit

Palla has been able to continue its normal operations with the usual precautions.

"Pain relief products are deemed essential goods, so we're not affected by general lockdown decrees," Mr Ritchie says.

"Our supply chains and operations remain relatively unaffected; however, logistics and general cash flow preservation by customers have created some volatility."

He adds that the company's diversified production across all of the supply chain allows for more consistent and reliant supply than its competitors.

Having said that, Palla was affected by disruptions relating to shipping costs and slower receivables. In Italy, orders were delayed because the company could not get hold of material such as paracetamol.

The coronavirus pandemic means Palla is carrying more inventory than usual, but working capital will be freed up as stock levels return to normal over the next six months or so.

America's state of addiction

Of course, there's a dark aspect to the opioid trade and it's America's startling addiction to the euphoria-inducing substance.

Much of the addiction problem stems from prescription medication, but the powerful synthetic opioid fentanyl illegally sourced from China is a huge issue as well.

According to the US Centres for Disease Control and Prevention, 46,802 Americans died from opioid overdoses in 2018, two-thirds from the synthetic variety.

Opioid drug makers have been subject to a barrage of litigation and the plaintiffs are chalking up huge wins.

In October, the maker of Oxycontin (oxycodone), Purdue Pharma agreed to pay $US8.3 billion of damages and plead guilty to criminal charges relating to payments made to doctors and healthcare companies to encourage prescriptions (paid for by public health programs). The family-owned company entered bankruptcy protection last year.

In a landmark civil case in August last year, an Oklahoma court ordered Johnson & Johnson to pay the state $US572 million over opioid misuse.

Plenty of other cases are in progress and there will be more pain to come.

Dr Boreham's diagnosis:

The US opiate crisis aside, Mr Ritchie notes that opioids remain the most effective and affordable treatment for acute and chronic pain - but are inaccessible to three-quarters of the world's people.

Palla has partnered with agents in Africa, South America and Asia to increase the availability of opioid-based pain relief in hospitals.

"Morphine remains the gold standard for acute pain relief and palliative care globally and is listed on the World Health Organisation's Model List of Essential Medicines," he says.

“With now over 5.5 billion people with limited or no access to pain relief treatment because of international drug controls, it is becoming imperative that we provide quality and affordable pain relief to those who cannot easily access it.”

His view is backed by Australian Ethical, which owns 6.3 percent of Palla.

Palla has kept a low profile since listing, partly because of the nature of the product and partly because the stock is tightly held. Long-time backer Washington H Soul Pattinson accounts for 19.9 percent, while Thorney Investments has dibs on 18.7 percent.

More recently Sydney value investor Wentworth Williamson joined the register with an 8.3 percent stake.

The company is focused on Britain because it’s easily the biggest codeine phosphate market in Europe.

But the company is also eyeing “opportunities” in Spain and France, the second and fourth largest European markets respectively.

If British prices hold up, Palla’s ‘farm to pharma’ strategy should start reaping financial benefits from next year - and start to get its balance sheet into better shape.

As broking firm CCZ Equities aptly notes: “Palla is a business in transition recently undergoing short term pain.”

If all else fails, Palla does a nice side-line in poppy seeds for the culinary market.

Disclosure: Dr Boreham is not a qualified medical practitioner and does not possess a doctorate of any sort. If pain persists, see your real doctor.