

93/08-A Chicken's Guide to Biotech

By Peter Lynch

In my last column, I discussed the perils of biotech investing, particularly in the small "start-up" companies over which much ado has been made, and often about nothing. For those who are still attracted to biotech, but not to the risks, there may be a chicken's way out.

Now that investors have lost faith and money in the recent biotech sell off, the 225 or so publicly traded companies in this industry can no longer depend on the public generosity to keep them solvent. In the past, when a biotech lab ran out of cash, it could always sell more shares to an eager crowd of buyers but not today. The new-issue market has all but shut down for lack of interest.

As a result, biotech companies that are low on cash are being forced to enter into mergers, joint ventures, or licensing agreements with richer partners, mostly the pharmaceutical giants. Thus, the new chicken's approach to investing in biotech: Buy the pharmaceutical giants.

For the drug companies, the chance to get involved with biotech couldn't have come at a better time. They've got problems that go far beyond Hillary Rodham Clinton. In the halcyon days of the 1980s (when even adjectives like halcyon were turned into drugs), the pharmaceutical giants went along happily increasing their earnings at an annual 12% to 20%. But lately, as many of the patents on their traditional best-selling drugs have expired (Cardizem, Procardia, Ceclor), they've run into fierce competition from the generics.

Now, as these traditional best-selling drugs are losing their money-making potency, new biotech products have emerged from the labs. Not only do these marvels of genetic engineering have the potential to cure many diseases that were incurable in the past, they also have the protection of new patents that won't expire for many years.

Every biotech analyst on Wall Street has a story about a pharmaceutical giant that will benefit from a biotech alliance. Stuart Weisbrod of < wam-co NYSE:MER>Merrill Lynch told me about Schering-Plough. It sounds like what happens when a tractor hits a rock, but Schering-Plough's a prosperous enterprise that's expected to earn \$4.20 a share in 1993. It would earn 50 cents more but for the \$125 million it spends annually on biotech R&D.;

In addition to this in-house research, Schering-Plough has a licensing agreement with Biogen to market alpha interferon, which has been highly profitable to date. Currently, Schering-Plough's stock is selling at about 15 times 1993 earnings, and the earnings are expected to continue to grow at a 15% rate. And another success from the biotech lab would speed that up.

Then there's Eli Lilly, which manufactures recombinant insulin in a joint venture with Genentech__ Genentech getting an estimated 8% of the proceeds, Lilly the rest. Lilly is doing other joint ventures with Centocor. Meanwhile, Roche Holdings, the parent company of Hoffmann-La Roche, another pharmaceutical giant, has spent \$2.1 billion to acquire 60% of Genentech. In similar fashion, American Home Products has acquired 67% of Genetics Institute.

American Home was given this opportunity after Genetics Institute lost an important patent suit to Amgen. Since then, the scientists at Genetics Institute have produced a blood-clotting protein by implanting a modified gene in the ovary cells of Chinese hamsters. How they think of these things is beyond me, but the result is a breakthrough in the treatment of hemophilia.

Genetics Institute is also pushing ahead with a family of cloned proteins that can repair bone cartilage and tissue, to take the place of tissue and bone transplants. Its blood cell work may revolutionize the treatment of infectious diseases. These could be very important developments for American Home, which all along has been doing something that even I can understand__raising its dividend for 41 years in a row.

Then there's a reverse chicken's approach to investing in biotech: Buy the biotech companies that are being absorbed by the pharmaceutical giants, or those that are involved in the major joint ventures. When a Roche spends billions to acquire 60% of Genentech's shares, it's a pretty good sign there's some value left in the remaining 40%. In fact, it was the announcement of Roche's plan to purchase a majority interest that convinced me that the biotech industry was for real.

This occurred in September of 1990. It took four months for Genentech stock to start its climb from \$21 to \$39. Roche still has the option to acquire all of Genentech's remaining shares, at a prearranged price well above the market, that increases each quarter. This gives the stock some built-in support. American Home Products has a similar arrangement with Genetics Institute.

Biotech companies that partially merge with the pharmaceutical giants have solved the liquidity problem that plagues their independent rivals, who are always scrambling around for more cash. To survive and to compete, a biotech company must have the wherewithal to support the scientists in the labs, then to pay for the clinical trials. Finally, if they do get an FDA approval, they may have to defend their ownership of the product when a rival biotech company claims it had developed the same thing first.

As it turns out, Biogen, Amgen, Genentech, and Genetics Institute are among a handful of biotech companies that have produced anything at all that's been approved by the FDA. Amgen, the most prosperous of the four, is beginning to resemble a pharmaceutical giant__an established enterprise with decent earnings from current products, and with potentially valuable new products in the pipeline. Last year, it earned \$2.40 a share, or \$358 million.

Amgen was recognized circa 1989 by Mike Gordon, Fidelity's biotech analyst at that time. Gordon was urging the in-house fund managers, including yours truly, to load up on the stock when it was selling in the \$5 to \$7 range. Later in 1989, when Amgen's first saleable compound, Epogen, got its final clearance from the FDA, the stock price had reached \$10. At the end of 1991, the price had reached a high of \$76. So in about two years, shareholders had made more than ten times their investment.

This lesson applies not only to biotech, but to investing in general: Just because the good news is already out doesn't mean it's too late to invest. While it's true that the biggest profits in biotech have been made from speculating in start-up companies and their untested ideas, Amgen's stock doubled again in 1991-92, after it had won all the patent battles over the Epogen compound.

Then, whacko, the entire biotech sector takes a fall because one other company fails an important clinical test, and Amgen's stock price drops with the rest, in sympathy. What had been a \$70 stock is promptly marked down to \$35, and Amgen the \$10 billion company becomes Amgen the \$5 billion company. An investor in biotech shares has to have a strong stomach and it helps to be farsighted as well.

It's times like these, when the entire biotech market has taken a hit, that brave investors can look for bargains, such as companies with share values close to their cash holdings. Of course, biotech companies can go through cash pretty quickly. However, limiting the search to companies that already have drugs on the market, or at least in clinical trials, and some revenues coming in will reduce some of the risk. (ImmuLogic Pharmaceutical Corp., for example, has allergy vaccines Catvax and Ragvax in the pipeline, a joint-venture agreement with Marion Merrell Dow, a joint R&D; project with Merck, \$13.2 million in revenues, and has been selling for near its cash value for three months.)

For the average investor with a normal stomach who lacks the training to analyze a pharmaceutical giant and its biotech connections, the ultimate chicken's way out is to purchase a mutual fund. Although I spend much of my time telling people they can be successful stockpickers in almost any industry they follow, biotech is the exception. It's so volatile and so complex that it may make sense to let the pros do the picking. Your neighborhood investor's edge won't help you here.

At present count, there are 14 biotech-related funds on sale in the U.S. Most combine biotech stocks with health-care stocks, so the investor has only a partial exposure to biotech, although with all the complicated deals, it is getting harder to decide what a "pure" biotech investment might be.

The two funds that appear to have the most exposure to biotech are Fidelity's Select Biotechnology, managed by Karen Firestone, and Oppenheimer Global Bio-Tech, managed by Sandra Panem. Panem is far from your average stock jockey. She has a PhD in microbiology and once worked at the Brookings Institution in Washington writing on the economics of biotechnology. This is typical of the experts in this field, both the analysts and the fund managers, many of whom have multiple degrees. Weisbrod of Merrill Lynch also has a PhD in biochemistry and an MBA from Columbia; this is the kind of background a person needs before he can discuss ovary cells of Chinese hamsters as well as price-earnings ratios.

Two other biotech mutual funds are the closed-ended kind, which trade on the New York Stock Exchange. These are H&Q; Healthcare and H&Q; Life Sciences, both managed by Alan Carr at Hambrecht & Quist, hence, the H&Q; prefix. Carr thinks this is a good time to invest in biotech, now that the worry over health-care profits has driven down the prices of all related stocks, including the biotech issues, even though most don't have any profits.

At H&Q; Healthcare, Carr has put 42% of the fund's money into biotech. He is also investing some of that money as a venture capitalist would__to provide capital for biotech companies that have recently gotten started. With fewer venture capitalists investing in biotech these days, the mutual funds are beginning to play this role.

Let me leave you with this footnote:

Usually, my favorite method for investing in high-growth areas where the competition is fierce is the pan-and-shovel technique. This technique gets its name from the 19th century owners of general stores who got rich selling equipment to the prospectors who went bust in the Gold Rush. When I see a mania, such as computers, where dozens of companies are struggling to sell the same thing, I look for a supplier who provides them all with some basic gizmo they all need.

I never found such a company in biotech, but Stuart Weisbrod says there was one: Applied Biosystems. According to him, this was the best-performing stock in the whole group. Applied Biosystems made the DNA and protein synthesizers and other stuff used by all the biotech labs. It was a good stock until it was taken over by Perkin-Elmer, which unfortunately is too big a company to buy just for the Applied Biosystems part. It's uncanny how often the pan-and-shovel technique has worked.

Peter Lynch retired in 1990 from managing the Magellan Fund, the best-performing of all mutual funds over a 15-year period. He is a trustee of the Fidelity Group of funds and his new book, *Beating the Street*, was published in March by Simon & Schuster.

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