Biotech for Beginners

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Caught up in the ongoing tech wreck, biotech stocks have sold off despite the relative strength of other health-care sectors and in the face of last year's enthusiasm.

Although some market leaders have fared better, a broad index of biotechnology companies is down about 25 percent since peaking last September. What's changed since then?

Other than investor sentiment, not much. Biotech breakthroughs continue to grab headlines, and even though earnings are scarce for some of these companies, earnings warnings are scarcer.

"In periods of uncertainty, people are less willing to pay for future (earnings) potential," observes Kris Jenner, manager of the T. Rowe Price Health Sciences Fund.

That mindset - requiring earnings sooner rather than later -- works against biotech stocks, which are mainly about tomorrow. Drug and gene discoveries tend to capture headlines, but they are just the beginning of the road for biotech firms, which must then test, perfect and market their products - all with regulatory approval.

"A new product can take 15 years and $500 million to create," says Michael Becker, biotechnology analyst with Wayne Hummer Investments in Chicago. That's rough even on an investor with a longer-term outlook, and it's a definite disincentive for a momentum investor.

Further muting enthusiasm, most products (some 80 percent) fail to ever exit the pipeline -- a statistic that explains why so many biotech companies fold and why typical stock valuation methods often fail the sector.

So if news releases and basic investing metrics, such as price-to-earnings ratio, aren't particularly useful how do you evaluate biotech stocks? Or more important, why bother?

Jenner calls this the "Golden Era of Biology," and he thinks investing in biotech is definitely worth the bother. He regards last year's excitement over the human genome project as just "a milepost in a multi-year cycle" of discovery and expects the advancement of biology over the next 20 years to be as dramatic as the last 20 years of advancements in electronics.

In short, he sees the industry's fundamentals improving, with the number of actual products coming to market accelerating along with profitability over the next several years.

Becker agrees.

"Contrary to prior boom-or-bust environments, the number of products in late-stage development, new product approvals and companies reporting profitability, licensing and partnering deals are all historically high," he reports. That adds up to high potential rewards for patient investors.

Okay, assuming investing in biotech stocks is worth the bother, the question remains, how do you evaluate them?

Thomas Malley, the manager of the Janus Global Life Sciences Fund, suggests looking at the larger companies first -- companies like Amgen {AMGN, News, Boards}, Genzyme {GENZ, News, Boards} or IDEC Pharmaceuticals {IDPH, News, Boards} -- since these companies have measurable profits and revenue.

It also helps to understand what a company's potential products are and what they will treat. This enables "you to decide if they make sense both in terms of science and market opportunity," says Malley.

The next step is to assess whether the market opportunity will be big enough to justify the market capitalization of the company.

Malley offers Cellegy {CLGY, News, Boards} as an example of how to assess opportunity at a biotech. It has market cap just shy of $100 million. It also has two products in its pipeline headed for FDA approval in 2002. If approved, Malley estimates, each could achieve $100 million market share -- in total, more than twice the stock's current market capitalization.

This makes Cellegy's upside rather attractive to him, particularly given that the company's shares are trading near 6, down more than 36 percent from their 52-week high of 9.5.

"There are other companies where the market cap is well in excess of five-to seven-year sales projections," says Malley. His point: The hype already is present in such stocks, and their future earnings potential has probably been fully discounted.

In evaluating biotechs, Becker stresses knowing where in the pipeline the promising new drugs are. If they are still in or about to enter Phase I testing, you likely face a 15-year wait and a high probability (80 percent) that the drug will never make a dime. Compare this to Phase III drugs, which are roughly 12 to 18 months away from becoming products and whose success is more probable.

Evidence of good management is another way of separating real earnings potential from easily deflated hype, according to Becker. Determining the strength of management isn't so hard as it sounds.

Brilliant scientists are a requirement for a successful biotech, says Becker. But "brilliant scientist" isn't often associated with "brilliant business acumen."

For this reason, Becker looks for outside business influences to assess management quality. How? Look for executives, or announcements of executives joining the company, who were formerly with either more established, profitable biotech firms or big pharmaceutical companies.

Also look for cash. "You don't want to see less than a three-years supply on hand," says Becker. Being well capitalized is too important to the process.

The best tip Becker has for evaluating biotechs is to "ride the coattails of those in the know." Look at which biotechs Merck {MRK, News, Boards}, GlaxoSmithKline {GSK, News, Boards} and other heavy-hitters are licensing research from or partnering with.

Their involvement indicates the science is valid and the market potential is worthwhile. The risk of failure remains, but the odds of success are greatly improved.

Despite long-term enthusiasm for this sector, no one is forecasting less market volatility.

Understand even the good companies are risky and can get whipsawed, says Malley. Which is why he discourages putting too much money in any one company. "If you are buying 10 stocks, you really don't want to put 10 percent in one biotech company," he advises. Sure, you could make a killing, but you could also get creamed.

Instead, Malley suggests -- and he is far from alone in this -- buying biotech companies in bundles. This can be done through a pure biotech fund, whether a traditional mutual fund, closed-end fund or exchange-traded fund. Buying a basket of stocks mitigates the risk of any one company doing poorly, though it doesn't protect you when the entire sector is falling.

Investing in broader health care funds that also own biotechs, such as T. Rowe Price's, is another option, he offers. Malley's own fund is not. It is currently closed to new investors.

"Longer term, biotechs are very attractive, especially given how far market values have fallen," summarizes Malley. But he would take it slowly just now. As long as biotech trades in sympathy with the rest of tech, he suggests investors ease into this area over a period of months, not with one trade.