Time to kick that drug habit

Tom Jacobs

Drugmaking or diagnostics? Biotech investors know that the former snares headlines, venture capital, initial public offerings and investor passion, whereas the latter produces slumber. A former star-quality CEO of a product-less and profitless biopharmaceutical firm once sniffed to me that one biotech diagnostics outfit had built "a nice little business," but was "not a great business to be in." His message: real men make drugs.

Of course, he had banked $20 million or more in salary and options for his years marketing his company to investors, who have seen no stock gains in eight years and large losses if they bought at most points in the past five. Real people investing in biotech can take only so much of that. We must balance risk and reward, tempering speculation on companies like his with solid, bedrock, sleep-at-night investments. We want to play, but also live to invest another day.

Biotech through the back door

True, diagnostics is not a high-margin business like biopharmaceuticals, offering far fewer pennies per dollar in profits, but it can provide stability and predictability where the other is hit or miss. The best of the allegedly boring diagnostics companies roll along calmly, benefiting from biotech advances as they make, distribute and service products with more genetic testing and analysis components. They provide dependable if unspectacular profits year in and year out.

But here's the punch line: you don't have to forego excellent returns, after all. Consider the AMEX Biotechnology Index, which cherry-picks 17 top biotech companies. This index of the strongest has risen 80% in five years, whereas almost 400 other biotechs have struggled and worse. Meanwhile, several focused diagnostics companies—not the big pharmas with diagnostics as part of diversified operations (e.g., Bayer AG (Bayerwerk, Germany; NYSE:BAY), Roche Holdings (Basel, Switzerland; VTX:ROG.VX) and Abbott Laboratories (Abbott Park, IL; NYSE:ABT))—have doubled, quintupled and more. Hardly boring. Where do they fit in?

Gene genies

'Stable diagnostics' is most definitely an oxymoron for newer biotechs focused solely on genetic testing and analysis. Only two—Qiagen (Venlo, NV; Nasdaq:QGENF) and Affymetrix (Santa Clara, CA; Nasdaq:AFFX)—are profitable, and their current growth doesn't come close to justifying their valuations. As a group, the risks may be lower than for most biopharmaceutical companies, but so too are the potential rewards, and that has shown up in their stock performance for the past five years. I discussed one very interesting component of this risky group, Gene Logic (Gaithersburg, MD; Nasdaq:GLGC) in July 2004 (*Nat. Biotechnol.* **22**, 813, 2004). So we exclude these here and concentrate on the established, more traditional companies that are increasing their biotech product offerings. These diagnostics firms have provided the right combination of safety plus return.

Crossing the Meridian

Among companies focusing on *in vitro* diagnostics manufacturing and distribution, Meridian Biosciences (Cincinnati, OH; Nasdaq: VIVO) is an off-the-radar small company that keeps rewarding shareholders. With about 75% of its sales from diagnostics in the United States and Europe, it has beefed up its other life sciences business slowly and cautiously by branching out into manufacturing biological components, such as monoclonal antibodies. Concurrently, it steadily reduced debt and paid out an unusually high 75% to 85% of net earnings in dividends, for about a 3% yield. Solid management, conservative financials and careful growth have brought shareholders a 130% gain in five years, plus the dividends. With excellent earnings news just out, it's no longer cheap at 30 times earnings and free cash flow, but it's one to watch.

To twist the knife a bit more, Diagnostic Products (Los Angeles, CA; NYSE:DP) has gained 292% in the past five years, and another competitor, Dade Behring Holdings (Deerfield, IL; Nasdaq:DADE), has returned 246% in the last two years. These are truly phenomenal—even compared with Genentech's (S. San Francisco, CA; NYSE:DNA) stellar 200% climb for the same period—and they leave Amgen's (Thousand Oaks, CA; Nasdaq:AMGN) 40% rise in the medical waste bin.

Lab grab

Diagnostic testing service companies find that more genetic testing and analysis increases their profits per dollar. The two top US companies in this field, Laboratory Corporation of America (Burlington, NC; NYSE:LH) and Quest Diagnostics (Teterboro, NJ; NYSE:DGX) are doing deals to increase this component of their offerings. They both show decent growth and sell at reasonable valuations, and they have showered shareholders with 419% and 503% gains, respectively, in the past five years.

Lab Corp. may be more attractive for two reasons. First, although both companies have been turning more revenue dollars into real cash after expenses (their free cash flow margin), Lab Corp. has done it at a higher rate. And second, management returns a lot of that cash to shareholders by buying back shares. This benefits you by spreading earnings across fewer shares, increasing your share of company profits. It's certainly working for Lab Corp. shareholders.

Boring? Not these results

In the tumultuous biotech investing world of the past five years, it's amazing to find any investments that have doubled, tripled or and even returned six times your money. It's even more surprising that these are companies making, distributing and servicing diagnostics with more higher-profit genetic testing and analysis. Maybe it's time to kick that drug habit.

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