Genentech faces the consequences of growth

When Genentech held its investment community gathering in New York on March 23, there was one overweening question on everyone's mind: what do you do with a biotech company that's too large to be a biotech company and lacks the core competencies to be a pharma?

That's the dilemma that S. San Francisco, California–based Genentech is facing. And it's relevant to the industry as a whole because Genentech is biotech's success-story role model in much the same way Microsoft is the software industry's, albeit Microsoft's success is on a much larger scale. How the question is resolved could affect the entire industry.

But unlike in the software industry, in biotech the question of scalability is still open to question. In software, the more you sell, the higher your profit margins because your sales could be an infinite number whereas your costs are fixed. It generally doesn't work that way in biotech because the size of the population for any given indication is capped—therefore, so are your sales. In addition, much of what made Genentech special was dependent on its small size. As they've lost that, the culture, by necessity, changes.

Genentech, by its own admission, is up against the law of large numbers. It just can't generate the pipeline it needs to have a significant impact on the overall financial numbers if only because the company is so large now. It is this dynamic that may change the management of the company.

No longer is Genentech a research-driven company buoyed by advances in science. Its focus now is on market share, earnings growth and being more efficient. In short, it's become just another public company, driven by market imperatives.

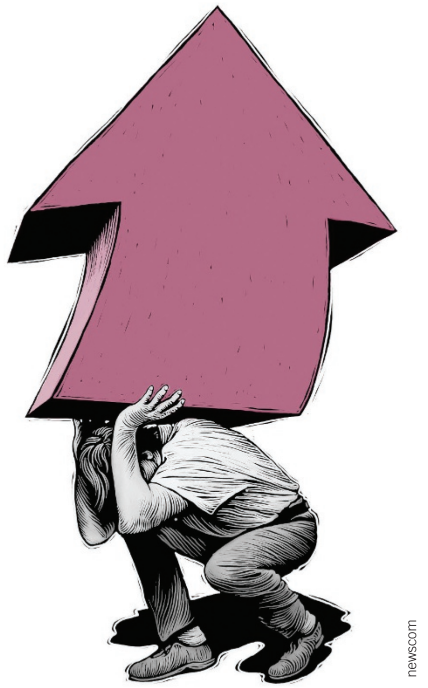
It could be just a mini-pharma, no different than, say, Amgen, its downstate neighbor in Thousand Oaks.

You can see the trend in the analysts' reports.

For example, on January 11, 2007, Edward Nash, a research analyst with Stifel Nicolaus' New York office, commented: "We reiterate our Buy rating on shares of Genentech and raise our target price from $89 to $96 based on a 35× multiple of 2007E EPS." That means that the analyst believes that the company should be valued at 35 times his estimate of 2007 earnings per share.

In short, what's driving the company are earnings and sales, not research or a pipeline.

Nash goes on to cite several factors that support that recommendation. He wrote that the "rapid penetration of Lucentis [ranibizumab] was responsible for the increase in fourth quarter earnings above consensus," and that "label expansion and increased penetration will be necessary for Genentech to *sustain a favorable level of growth*" (italics added).



Because of its size, Genentech can no longer generate the pipeline it needs to have a significant impact on earnings. It must find ways to avoid being crushed by the weight of its own growth.

That is not to say that Genentech will not continue to have a strong pipeline through in-licensing, acquisitions or through its own in-house research programs. In fact analysts continue to look with favor on the company's pipeline. "With a multitude of discrete clinical programs, and several products in late-stage clinical development, [Genentech] has what we view as one of biotech's strongest, most well-balanced pipelines," said analysts Christopher Raymond, David M. Nierengarten and Brent Finck of Robert W. Baird in Milwaukee, Wisconsin, in a recent research note regarding the Cabilly II patent rejection (News in Brief, p. 373).

"They are putting a lot of money into research," Nash says, "but they are overshadowed by Avastin." As the earnings and penetration from other indications slow down for Avastin (bevacizumab), the company faces a dilemma. The company will not be able to sustain the hypergrowth that is the hallmark of success in the biotech industry. Indeed, a summary of earnings growth projections on the ThomsonFN investment website (now discontinued) in February showed that analysts expect Genentech earnings to slow down to 26% annually over the next five years versus a 68.5% annual growth over the last five years.

If the company can't figure a way to improve its growth rate, analysts might be tempted to give the company a lower valuation, valuing it not quite as cheaply as a pharma, but not as richly as a biotech either.

The solution of course would be to do a lot of in-licensing and to make strategic acquisitions, much as Gilead has. Late last year, the Foster City, California–based biotech purchased two companies—Seattle-based Corus Pharma and Myogen of Westminster, Colorado—in part to bolster their pipeline. Wall Street has so far had a mixed reaction to the acquisitions. Gilead's share price has remained relatively flat, although the company's earnings are expected to accelerate.

However, thus far Genentech has not been a serious player in the acquisitions market. In part this could be because the major danger in acquisitions comes from trying to integrate two different corporate cultures. Often times an acquisition ends up destroying the culture of both companies. And most would agree that if anything makes Genentech special, it is the blue-jeans-and-tennis-shoe-with-an-attitude culture.

Short term the company has some other obstacles to tackle as well. Medicare reimbursement for oncology drugs continues to be a concern. The company has also said that it continues to operate at 100% capacity, "leaving a very narrow margin for error in order to meet expected demand," Nash points out.

The worry about Genentech being at the crossroads of growth is not new. And certainly the company benefits from its special relationship with Basel-based Roche that frees it from some costs associated with production. Suggestions of Genentech being too big to remain special have been swirling around the firm for five years or more. So far the company has gratified its friends and surprised its critics with its financial and stock price performance in spite of the obstacles.

"They don't have the bureaucracy that big pharma has in drug development. They are still able to move deftly," added Nash, while noting that there are probably not many layers between CEO Arthur Levinson, who joined Genentech in 1980 as a senior scientist and rose through the ranks himself, and the research scientists.

That may be true. But for how long?

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