Any diamonds in the diagnostic coal?

Tom Jacobs

Although you might have been led to believe there is a 'clear vision' for the molecular diagnostics revolution, in reality the investing picture is much murkier. Revenues haven't produced much profit or free cash flow (and are unlikely to do so anytime soon). And rather than stand-alone diagnostics makers or drug companies with diagnostics divisions making good investments, it is clinical testing and medical technology (medtech) companies that are most likely going to turn out winners.

False starts

First tries at sustainable molecular diagnostics businesses bombed. In the genomics boom, Celera Genomics (Norwalk, CT, USA; NYSE: CRA) and Incyte (Wilmington, DE, USA; Nasdaq:INCY), then Incyte Genomics, formed the leading database companies that hoped to make bioinformatics a business to empower drug and diagnostics makers.

The business model failed. Today, over six years after Celera's initial public offering (IPO) and coming up on 13 years for Incyte's, both bleed cash and investors have floundered. Celera Genomics shares closed recently at \$13.25, up \$0.75 from their first-day adjusted close of \$12.50 on April 28, 1999, a compound annual growth rate (CAGR) of 0.8%, far below the rate of inflation. Incyte shares finished at \$4.32, up from a \$1.88 close on November 4, 1993, or a 6.8% CAGR, about a third less than the Standard & Poor's (S&P) 500's 10.1% per year, including dividends. High risk, little reward.

Affymetrix (Santa Clara, CA, USA; Nasdaq: AFFX) carved out a niche providing its 'GeneChip' testing arrays to customers and licensing that technology to, among others, Roche Molecular Diagnostics (Basel; SWX: ROCZ) for its AmpliChip. Myriad Genetics (Salt Lake City, UT, USA; Nasdaq:MYGN) used its database of Mormon genetics to develop tests for diseases, such as breast cancer. Like Myriad, deCODE genetics (Reykjavik, Iceland; Nasdaq:DCGN) has a specialized database (Icelanders) through which to comb for markers and also an alliance with Roche. Gene Logic (Gaithersburg, MD, USA; Nasdaq: GLGC) sought to be a pharmacogenomics outsourcer, facilitating drug and patient testing for individualized responses.

Checkered results

With one exception, investors here have done poorly. Affymetrix shows accounting profits, not sustained free cash flow; that said, it has rewarded IPO-day investors, who paid at the June 6, 1996 close \$8.69 for shares now selling for \$24.10. This is a very good 10.7% CAGR, comfortably ahead of the S&P 500's 8.0% per year for the same period.

Myriad Genetics is far worse off financially, without either accounting profits or free cash flow, and its investors there have earned a mediocre 7.1% CAGR since the October 6, 1995 IPO close, versus 8.1% for the S&P 500.

Far worse, cash-bleeding Gene Logic closed recently at \$1.27, earning its investors a tragic –19% CAGR since its November 27, 1997 IPO-day close of \$8.00. Worse still, deCODE has neither accounting profits nor free cash flow, and has declined from \$25.44 on its July 18, 2000 IPO close to \$5.85, or an abysmal –21.7% CAGR.

Many other companies, including drug makers such as Millennium Pharmaceuticals (Cambridge, MA, USA; Nasdaq:MLNM), have tried to profit either alone or in combination with molecular diagnostics companies, but they too provide a mixed picture. Biosite (San Diego, CA, USA; Nasdaq:BSTE) has decent financials, but a too-risky valuation. Digene (Gaithersburg, MD, USA; Nasdaq:DIGE), known for its cervical cancer test, is on the cusp of sustained cash generation. Companies, such as Clinical Data (Newton, MA, USA; Nasdaq: CLDA)—purchaser of Genaissance (New Haven)—and Genomic Health (Redwood City, CA, USA; Nasdaq:GHDX, are very speculative, and not yet sustainable.

The rise of medtech

Diagnostics operations don't produce the returns on invested capital that pharmaceutical company shareholders demand, and we have no evidence of synergies of molecular diagnostics with drugmaking. Thus, Pfizer (New York; NYSE:PFE) shed Pharmacia Diagnostics (Uppsala, Sweden) after it acquired Pharmacia (Kalamazoo, MI, USA) in 2003, and in June, Bayer (Leverkusen, Germany; NYSE:BAY) sold its nondiabetes diagnostics business to Siemens medtech operations (Munich; NYSE:SI).

Expect more medtech firm ownership of diagnostics. Siemens' and General Electric's (GE; Fairfield, CT, USA; NYSE:GE) big-ticket products, such as magnetic resonance imagers, must be complete diagnostics centers; these giants are buying diagnostics companies with strong molecular expertise. You can bet that Siemens, GE (which bought Amersham Biosciences (Little Chalfont, UK) in 2003) and other large medtech companies, such as Becton-Dickinson (Franklin Lakes, NJ, USA; NYSE:BDX), that already have a diagnostics division, will acquire more diagnostics companies.

On the flip side, both Roche, with shares depressed to a giveaway valuation, and Abbott (Abbott Park, IL, USA; NYSE:ABT) will likely have to sell their diagnostics operations to satisfy shareholders.

The future

The next ten years promise an immense shift in the large healthcare company. Diagnostics companies will not be stand-alone businesses for long or divisions of large pharmas, such as Roche or Abbott, but instead part of large medtech firms—unless large pharmas become more like medtechs.

Tom Jacobs is cofounder of Complete Growth Investor, http://www.completegrowth.com/, a stock service for individual investors. Tom owned no shares of the companies mentioned here at time of writing.