Great companies, bad stocks

Tom Jacobs, of the Internet site Motley Fool (<http://www.fool.com/>), provides his angle on biotechnology investments. As Jacobs points out, "Industry insiders may know about biotechnology, but (as the song should go) 'it don't mean a thing, if you haven't learned sound investing principles.'" Read on and become "Foolishly" informed*.

The Sitting Pretty Investment Club—or "Prettily", as interim president Paisley McTort insists—is enthralled with biotechnology companies. Members revere the first companies to successfully turn new biotechnologies into new drugs and profits. Genentech (S. San Francisco, CA), Amgen (Thousand Oaks, CA), and its prospective merger partner Immunex (Seattle, WA), MedImmune (Gaithersburg, MD), and Genzyme General (Cambridge, MA), among others, have rewarded patient shareholders many times over.

Sitting Pretty members earnestly wish to be rewarded many times over, too, but are wary after the painful experience of buying companies at too high a price, then watching them crash when business performance did not match the exalted, unrealistic expectations. The Club may admire these great companies, but it is not sure that they are good stocks to buy at current prices.

One measure of the price tag, or market value, and a Club favorite, is the venerable P/E ratio—the stock price divided by the company's past 12-months' earnings per share. The P/E ratio has now gone mass-market in Charles Schwab commercials, revealing Sarah

Ferguson, former Duchess of York, exhorting young women to arm themselves with the ratio and other investment learning in case their prince should turn into a frog. (Indeed.) Here is the principle: Over time, a growth in earnings (E) fuels a growth in stock price (P), because as investors learn about the increasingly profitable business, demand for stock increases, sending the share price soaring. To sit pretty, investors want to own stocks when P/E is low *before* they become popular and the price is bid beyond reasonable expectations for the company's future profits.

However, Sitting Pretty members have now started to look past P/E ratios to more reliable measures of a company's true market worth, by inspecting how much cash the company's business—whether selling tires, drugs, software, or online travel—generates after deducting capital expenses such as building a plant or buying equipment. This is the price-to-free-cash-flow (P/FCF) ratio, or the company's market capitalization (i.e., the number of shares issued multiplied by the share price) divided by the amount of cash generated by its business operations, minus any capital expenses.

A more precise value than market capitalization is enterprise value (EV), or what, in theory, it would cost you to buy the business—the market capitalization minus cash, equivalents, and short-term investments, plus debt. EV/FCF thus provides the most accurate measure of the current worth of a company and one that the Sitting Pretty Investment Club is now adding to its toolbox.

So, investors are well advised to follow the Club's lead. Go ahead and check a company's EV/FCF ratio, then compare it to the company's growth rate in free cash flow (FCF) before you buy. If the EV/FCF substantially exceeds the growth rate in FCF, an investor at current prices pays for increased future growth today, risking mediocre long-term returns should the company perform anything less than perfectly. For example, as of market close on February 1, 2002, here are the EV/FCF ratios for Amgen, Genentech, Genzyme, and MedImmune, along with the growth rate in FCF for 1999 to 2000, and for 2000 to the past four quarters treated as a year, which investors refer to as the "trailing 12 months" (ttm; see Table 1).

The only company whose EV/FCF is remotely related to its growth is Genentech, although this could be an anomaly looking

Table 1: EV/FCF vs. FCF growth for seven companies

Company	Current EV/FCF	FCF growth ttm-2000	2000-1999
<i>Biotech</i>			
Amgen	64	-25%	30%
Genentech	87	251%	n/a*
Genzyme Gen.	70	-16%	-23%
MedImmune	53	17%	251%
<i>Established</i>			
Johnson & Johnson	29	14%	27%
Microsoft	19	26%	16%
Coca-Cola	33	18%	1%

*Genentech went from negative FCF in 1999 to positive FCF in 2000.

back over a several years. That's hard to do with Genentech's financials because Roche (Basel, Switzerland) privatized the company in 1999, reissuing shares to the public again the following year. All in all, these stellar biotechnology companies' business successes have earned them not only fame, but stock prices that assume more years of perfection and fantastic future growth in FCF. Because the drug business is not perfect, investors who buy at current prices will pay in the long run when normal disappointments reverse this rosy consensus.

For some perspective, the research firm Barra (Berkeley, CA) pegs an average P/FCF for the Standard & Poor 500 companies between the high teens and low twenties from 1980 to today. Then examine the EV/FCF for three established, well-known companies (Table 1).

These EV/FCF ratios and FCF growth rates are more realistic, showing again that the four well-known biopharmaceutical companies are richly priced. Of course, every company's situation is different—a drug maker's new blockbuster could be hitting the market next year—so you need to know whether a particular business is doing better or worse than its peers to justify a higher or lower EV/FCF ratio. But it takes sustained extraordinary business operations to maintain an EV/FCF ratio well above the average—especially one in excess of a company's own recent growth rate.

For now, Sitting Pretty Investment Club is going to restrain itself from accumulating first-tier biotech drug makers at current prices, content to keep looking for reasonably-priced businesses—biotechnology or otherwise.

Until next issue, have a most Foolish month!

*At press, Tom Jacobs owned no shares of companies mentioned in this column. He welcomes roses and spitballs at TomJ@Fool.com, but cannot give individual investment advice. (For links to free, easy-to-understand, step-by-step instructions to figuring out EV/FCF, send him an email or visit <http://www.Fool.com>. He means it: every Fool can do this.)*Nature Biotechnology does not guarantee the veracity, reliability, or completeness of any information provided on this page; it is not responsible for any errors or omissions or for any results obtained from the use of such information; it will not be liable for any loss, damage, or investment decision arising from a reader's reliance on the information provided.*