Bugs or drugs, tortoises or hares?

Tom Jacobs

In biotech, most investors have favored drug-makers over companies using advances to create better protein catalysts—enzymes—and microorganisms. After all, drugs are high-profile, high-margin products, offering patent-protected profits in markets that are theoretically unlimited. New enzymes and microorganisms are low-margin products that require huge volume (think supermarkets) in unproven markets. The choice appears easy.

It's not. With few exceptions, investing in a biotech drugmaker means waiting 10 years or more for a first drug and then, if the drug is approved and successful, enjoying some nice returns. But if you invest in a tortoise instead of waiting for the biotech hare to run its race, the steady annual return for ten years could add up to the same or much greater return with lower risk of loss. (If you e-mail me I'll send you a brief Excel spreadsheet showing this.) The biotech enzyme and microorganism world offers one such opportunity.

The leaders

At one time, biotech seers foretold large, integrated companies where applied molecular evolution would create not only drugs and components, but also industrial, chemical and agricultural products under one roof. In practice, the businesses proved too different and led to spin-offs and outside joint ventures, as the two industry leaders, Novozymes (Bagsvaerd, Denmark; OTC:NVZMF; CSE:NZYMB) and Genencor (Palo Alto, CA, USA; Nasdaq:GCOR), show.

In 2000, Danish pharmaceutical power Novo Nordisk (Bagsvaerd, Denmark; NYSE: NVO) spun off Novozymes, a long-time in-house business. In 1982, Genentech (S. San Francisco, CA, USA; NYSE: DNA), and Corning (Corning, NY,

USA; NYSE: GLW) put their nondrug efforts into a joint venture, Genencor. Both parents were gone by 1990, and after a number of ownership changes, 40%-owner and food ingredient maker Danisco (Copenhagen, Denmark; CSE: DCO) made an offer in January to buy the rest it didn't already own.

Newer entrants

Along the way, the genomics boom allowed at least three other companies to go public and call attention to their own directed molecular evolution techniques. Of these, two are still independent—Diversa (San Diego, CA, USA; Nasdaq:DVSA) and Maxygen (Redwood City, CA, USA; Nasdaq:MAXY)—whereas in 2003, Eli Lilly (Indianapolis, IN, USA; NYSE:LLY) bought the third, Applied Molecular Evolution (San Diego, CA, USA).

Each of these companies started out focusing on nondrug applications, but like the genomics data companies of the boom, they have returned at least in part to drug and drug component development. Lilly bought Applied Molecular Evolution for this, and Maxygen shed its agricultural business and now refers to its 50%-owned chemical unit as “future cash value for the therapeutics business.” Only Diversa appears committed to the entire spectrum.

Speculations at best

With Applied Molecular Evolution under the Lilly pad and Genencor slated to become Dansico, this leaves Novozymes, Diversa and Maxygen. The last two are speculations at best, despite their piles of cash and lack of debt. Both companies are burning through \$37–\$38 million a year, giving Diversa about two-and-a-half years and Maxygen seven before they will need other resources on possibly onerous terms. That may favor Maxygen, except that its sales are declining whereas Diversa's are rising through product, grant and collaborative revenues. Yet the steady cash burn makes it impossible to guess when, if ever, either company will turn to cash-printing. A savior might buy them, or perhaps the cash will just slowly drain.

That leaves Novozymes, a happy tortoise

Novozymes shows steadily rising revenues from a range of enzyme and microorganism product programs. This alone makes it a biotech stand-out, but if high single-digit growth doesn't make your heart quicken, other features should.

The business produces very high free cash flow, the sweet nectar investors covet. For every dollar in revenue, about 16 cents are left after expenses and capital investments—not high for a profitable drugmaker, but top-drawer for any biotech nondrugs business. Novozymes reinvests the free cash flow in its business and then pays some out in two positive ways.

First, the company returns some cash to investors as a dividend. The current 1.5% yield is just half what many large pharmaceutical companies pay, but it's extremely rare among biotechs of any stripe. Plus, as it rises—as it appears likely to—the yield increases for existing shareholders who, instead of having to sell shares to capture any gain, secure a small but rising income.

Second, Novozymes also uses some of the cash to buy back shares. As long as the shares aren't inflated, the buybacks don't mask profligate stock options grants, and the company has its debt well in hand—all true for Novozymes—buybacks offer two other benefits.

With each share repurchased, the company retires the obligation to pay the future dividend. That means more cash to invest in the business, pay a higher dividend or buy back more shares: a virtuous cycle! Also, buybacks reduce the share count, which increases earnings per share, because they lower the denominator in earnings/shares. Rising earnings attract investors, raising the stock price, causing much happiness.

Calculated risks

Taking risks with a little money can be fun and profitable, but for any money you need to count on, greater confidence in steady returns wins every time. Novozymes shares are not that cheap at 20 times enterprise value to free cash flow, but management's prowess makes the company a good candidate for biotech investors who prefer to sleep at night.

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