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My worst biotech investment

Tom Jacobs

No one enjoys investing losses, but no investor picks only winners. Even Warren Buffett had his US Airways and Peter Lynch the fraudulent Belgian car exporter ACLN. To deny losers is to pretend you can avoid losing money in the stock market. You can't. Every successful investor's record is an average of winners and losers, and losses often teach more than profits. On this happy note, today I stand first in the confessional line, inviting all *schadenfreude*.

My worst biotech investment, drug maker QLT (Vancouver, BC, Canada; Nasdaq:QLTI), appeared in this column in October 2004 (*Nat. Biotechnol.* **22**, 1221). Its history illustrates four simple truths. First, every investment is a wager on the chance of potential events, which no matter how certain you are, may not occur. Second, neither you, nor alleged experts, nor professionals have any control over the course of events. Third, because of these two truths, you will have losses. And fourth, as a result, accepting the occasional but inevitable loss ensures a longer, happier and less stressful investing life.

Setting the stage

In the fall of 2004, QLT was a huge success story, with its proprietary photodynamic drug Visudyne (verteporfin), the leading treatment for wet age-related macular degeneration (AMD), offering improvement, though not a cure, to millions. The company was drowning in cash. True, Visudyne faced competition, but the expected first competitor, a pegylated aptamer Macugen (pegaptanib sodium), seemed unable to meet investors' lofty expectations. Genentech (S. San Francisco, CA, USA; NYSE:DNA) was testing the promising Lucentis (a humanized antibody fragment; ranimizumab), but that wasn't expected on the market, if at all, for a couple of years—lifetimes in biotech.

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But competition would come, so QLT planned ahead by purchasing Fort Collins, Colorado-based Atrix, a promising biotech that offered three key benefits: an approved peptide drug against prostate cancer, Eligard (leuprolide acetate), about to appear in a new version; a dermatology line led by acne drug Aczone (a gel combining solvent microparticles with 5% dapsone), all but certain to be approved in 2005; and Atrigel, an advanced lactide/glycolide copolymer dissolved in *N*-methyl-2-pyrrolidone used for transdermal drug delivery. Atrix would bolster QLT's pipeline which, though thin, was far from valueless. Investors reasonably hoped for good phase 2 trial results from QLT's photosensitizer drug lemuteporfin for nonmalignant prostate enlargement, leading to phase 3 trials and a better-than-even chance of approval and marketing success.

At the time, little had to be right for QLT to reward, and everything had to sour to bring losses. With QLT selling at a mere ten times enterprise value to free cash flow (or EV/FCF, my preferred measure of snapshot valuation as opposed to the price/earnings or P/E ratio), I wrote that it was a bargain, and Macugen's maker, Eyetech Pharmaceuticals (now owned by OSI Pharmaceuticals, Melville, NY, USA; Nasdaq:OSIP), the stock to short. Unfortunately, that proved only half right. Eyetech crashed almost 75% (profiting those who shorted), but unfortunately, QLT fell too. One by one, every single thing went terribly, terribly wrong.

The parade of horribles

Though Macugen, once approved, proved no threat, the respite was brief. Genentech's Lucentis started showing excellent, though not unblemished, trial results, bringing possible approval and marketing closer than expected. But worse and completely unexpected, retinal specialists in significant numbers started prescribing Genentech's blockbuster Avastin (bevacizumab) off-label for AMD. Visudyne sales and QLT stock began dropping.

Then, QLT's partner Sanofi-Aventis (Paris; NYSE:SNY) botched the launch of Eligard's six-month formulation, and prescribing doctors faced uncertain reimbursement. And QLT may have to forego some Elligard revenues in the near-term due to a patent dispute. Even though the patent at issue only runs until May 2006, any revenue loss hurts.

More pain ensued. Aczone did indeed secure FDA approval, but on a far more limited basis than would bring profits. The company delayed launch for a year or so to conduct more tests to secure a broader label. It's a positive that QLT reacquired full worldwide marketing rights to Aczone, but you wonder why former partner Astellas (Tokyo) would give up a drug if it were promising. Worse, to extinguish the last hope, the company announced on February 14 that phase 2 trials of lemuteporfin had not reached their primary endpoint.

No margin of safety

Eligard sales are moribund, Aczone speculative and lemuteporfin apparently dead. Visudyne sales declined 13% year over year in the last quarter and the company projects a 17% or higher decline this year. Potential royalty revenue from QLT's Atrigel technology cannot make up for these.

With shares in the high $6s in early February 2006, QLT did indeed sit astride piles of cash and sport a valuation cheaper than any profitable biotech on the planet, but its margin of safety had evaporated. I thus sold and, with an average purchase price of $10.38, endured a 38% loss. It was highly unlikely that all positive potential events for QLT would fail, and if even just one of them had turned out differently, I would still own the stock and probably show a profit. But every door had shut.

The long view

You will endure losses like this. But if they are few, you are on the right track. Never cling to losers hoping that a stock will 'come back.' Sell and buy solely on whether the potential return compensates for the risk. And even if losses are as infrequent as rain in the desert, when the freak storm comes, as it surely will, accept it.