PEGging biotech growth

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Biotech investing most often is nail-biting, white-knuckle, roller-coaster gambling—all-or-nothing bets that a developing company's lead drug candidate will succeed. But each year, there are more opportunities for growth investing—buying shares that reflect lower growth expectations when you think the future is brighter. The latter is still high risk, but, as with drinking alcohol and buying on credit, as we are going to do it, let's examine how to buy growth responsibly and find an interesting investment candidate along the way.

Growth investing

In traditional growth investing, you pay a price today that reflects expectations of future growth. The rule of thumb is to buy estimated growth that exceeds the market's current estimate of that growth over the period you plan to hold the stock—you want to back the horse that everyone thinks can go only so fast, but you believe will go faster.

The traditional means of measuring whether now is a good time to buy a stock is the price (P) to earnings (E) ratio (the stock price divided by the last four quarters'–worth of earnings); estimating a stock's potential future value can then be calculated by dividing the P/E ratio by the earnings-per-share growth. The result is the PEG ratio. As I have explained previously (*Nat. Biotechnol.* **20**, 219; 2002), however, enterprise value (EV; what you would theoretically pay to buy the business—the market capitalization minus cash, equivalents and short-term investments, plus debt) and free cash flow (FCF; how much cash a company generates after deducting capital expenses) are more reliable measures of a company's market worth than P and E, respectively. Thus, I prefer to first take a company's five-year historical average FCF growth per year and then project it forward. Divide the last four quarters' FCF by the per-year FCF growth to find the FCF PEG ratio.

If we project 20% growth a year and the company's current EV/FCF ratio is 20, the FCF PEG ratio is 1.0 (20/20). This means that the current valuation reflects growth expectations of 20% a year for at least some time going forward. If growth is 25%, the ratio is 0.8 (20/25), meaning the stock is undervalued for its growth. If you think growth will be less than 20%, the ratio exceeds 1.0, and the stock is overvalued. All else equal, you want to buy at a ratio less than 1.0 and sell when it exceeds 1.0.

The inevitable catch

The problem is that we are valuing a company today on the basis of historical rates projected forward, whereas historical growth is simply not logically correlated to growth tomorrow. If growth or expectations for it slow, your stock is overvalued and likely will tank. If the overall market slumps and multiples of FCF or earnings contract—which happen in every recession—your stock also tanks. Of course, if growth and/or the economy expand, multiples usually expand, too, rewarding you.

Thus, FCF PEG ratio is a blunt instrument and best used as a screening tool only. You still need to dig through company reports and industry sources to determine whether the growth rate will continue, remain stable or decline for the particular company. There may be a sound reason why one company sells for a FCF PEG ratio of say, 6.0, and another sells for 0.50. The former may be odds-on to receive approval for a billion-dollar-a-year drug and the latter may have run out of pipeline.

With these caveats in mind, I have searched for favorable FCF PEG ratios in the 'Biotechnology & Drugs' grouping—a broad net of biotech stocks—in the American Association of Individual Investors' Stock Investor Professional (SIP) affordable database for individual investors (http://www.aaii.com).

Biotech PEGylation

Most biotechs turn out to be fairly valued or overvalued, showing FCF PEGs greater than or equal to 1.0. Amgen (Thousand Oaks, CA, USA; Nasdaq:AMGN), with an impressive five-year average annual FCF growth of 24%, sports a 1.12 FCF PEG, putting shares today at a little more than fairly valued. On the pricier side, venerable innovator Genzyme (Cambridge, MA, USA; Nasdaq:GENZ), with 7% five-year annual FCF growth, shows an astronomical FCF PEG of (gulp!) 6.8, or a valuation almost seven times the FCF growth rate. Unless Genzyme is about to absolutely bust open with sales such that its trailing 12 months' FCF of $367 million explodes, Genzyme shares offer great valuation risk today. Ditto Genentech (S. San Francisco, CA, USA; NYSE:DNA), with 63% five-year average annual FCF growth and a FCF PEG of 1.5. Though Genentech growth is projected to increase, PEG tells us that in the absence of other factors, the stock offers more potential pain than gain at this price.

A favorable FCF PEG is not necessarily so. With a paltry 0.56 FCF PEG, Gilead Sciences (Foster City, CA, USA; Nasdaq:GILD) looks cheap, but that's only if you think the 63% growth rate can continue.

Growth has many friends

It's extraordinarily hard to find any biotech company with a FCF PEG under 1.0. Growth attracts investors like paparazzi to the Queen, and thus it's rare to find a Cinderella sitting alone, undiscovered. But there is one. Biomaterials company Lifecore Biomedical (Chaska, MN, USA; Nasdaq:LCBM) sports a FCF PEG of only 0.35 based on 28% five-year average annual FCF growth. The catch is the last two quarters of negative FCF, but this may not be an issue if management's conservative growth projections for 2006 pan out. It is small, overlooked companies like Lifecore that I find most attractive. They offer the most potential gain for the work involved in finding—rather, PEGging—them.

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 in this article at time of writing. He welcomes your comments at tom@completegrowth.com.