# Bargains in the basement

**Tom Jacobs**

Let me seduce you this month with an enticing thought: you can buy shares in a business for free. Once in a great while, the market will actually value a cash-generating company less than the cash in its checking account. If you can spot the opportunity, risk of loss is very low against potential rewards. How is this possible?

Biotech investors know well that the market often disfavors certain companies or sectors, and that in the short term it may do so with violent emotion. Sometimes, particularly when fear drives investors to desert the stock market in droves, a business may find that its enterprise value is close to, or less than, its cash net of debt. When selling has driven down the stock price to such a point, the business is valued at zero or less.

Yet, if a company is not burning through its cash—spending more than it receives in revenues—its business is invariably worth *something*. At a price near or below cash, a company is a buyout target for a competitor or private equity firm happy to pay some premium for the business in excess of its cash. And even if the company stays independent, the chance that its business will improve and provide investor rewards is worth the limited downside risk.

A happy example is Internet advertising company ValueClick (Westlake Village, CA, USA; Nasdaq:VCLK), which during the 2000–2002 bear market often sold at a 15% or greater discount to its net cash per share. Meanwhile, cost-conscious management moved the company into the black. When the advertising market began to recover, ValueClick's revenues soared and the stock vaulted from < $3.00 a share to over $11.00.

*Tom Jacobs is cofounder with Jeff Fischer of Complete Growth Investor, (http://www.completegrowth.com/). He welcomes your comments at tom@completegrowth.com. Tom owns no shares of companies mentioned in this article.*

So a cash-neutral or cash-positive business whose stock price is at, or close to, net cash per share offers very little risk for the investor against some decent potential return. Does this ever happen in biotech? Rarely, but it's worth watching for.

## Why cash neutral or positive?

It is crucial that the company not be burning through cash—that it have neutral or positive free cash flow (FCF). FCF is defined in different ways, but commonly as net cash from operations minus capital expenditures, which are investments in property, plant and equipment.

> Gene Logic is a rare instance where the value investor's margin of safety may be possible in biotech.

Consider two companies that have $5.00 a share in net cash and sell for $5.00. The first one produces a little FCF each quarter. The second spends more than it generates by about $0.50 a share each quarter, meaning that the cash floor under the stock price declines fifty cents every three months. The cash per share is a source of security for an investor in the first company, but not in the second.

## Two caveats

First, you definitely don't want a company to starve capital expenditures to look good on cash, perhaps to better its chances for sale. Because most businesses have minimum cash needs to upgrade or invest in new equipment, you should view the capital expenditure trends over several years and understand any reasons for declines.

Second, note that a company's cash balance will not necessarily rise or fall exactly in line with cash burn or generation. Cash can increase or decrease for reasons unrelated to the core business, including paying for an acquisition or selling new shares.

**Table 1 Gene Logic: close to a margin of safety**

| Quarter | Net cash[1] ($ millions) | Cash burn[2] ($ millions) | Net cash/share ($) |
|---|---|---|---|
| Q1 2004 | 114 | (2.2) | 3.64 |
| Q4 2003 | 115 | (2.3) | 3.68 |
| Q3 2003 | 114 | (5.2) | 3.66 |
| Q2 2003 | 123 | (1.6) | 3.96 |

[1]Cash, short and long-term investments minus total debt. [2]Capital expenditures include license, patent and software development costs. (Source: Company SEC filings).

## The case of Gene Logic

A biotech company coming tantalizingly close to satisfying these criteria is Gene Logic (Gaithersburg, MD, USA; Nasdaq: GLGC). Starting out as a pharmacogenomics database business, the company last year through an acquisition added contract services to support preclinical and clinical testing at drug companies. **Table 1** shows its cash, short- and long-term investments for the last four quarters, cash burn and net cash per share. The company is on the edge of cash neutral or positive.

With shares selling recently at $3.85 against $3.64 in net cash, Gene Logic's enterprise value is only $6.6 million, even though its business generated $20.2 million in revenues last quarter with positive gross margins. As long as Gene Logic continues burning cash, the $3.64 is a slowly declining floor to the stock price, but if the company can close the gap, the risk-reward equation becomes very interesting.

The closer Gene Logic comes to being cash neutral and the closer the stock price to cash per share, the safer an investment in it will be. This is a rare instance where the value investor's margin of safety may be possible in biotech.