Stocks look better now than earlier this year

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Stock prices in the Alex Brown & Sons (New York) biotechnology universe of 81 companies rose 3 percent on average during this year's third quarter, with 41 stocks registering increases. Yet as the quarter ended, the market value of these stocks was down 13 percent from the beginning of the year and 45 percent from the all-time high of mid-January 1992, on average.

We think that the key forces that created and sustained the bear market in this sector are now losing momentum or beginning to move in reverse.

• Product-development setbacks are finally being leavened with successes. A string of setbacks marked 1992-1993, including the disintegration of Centocor's (Malvern, PA) Centoxin, the mediocrity of the phase III data for Synergen's (Boulder, CO) Antril, the controversy regarding Gensia Pharmaceuticals' (San Diego, CA) phase III data for Arasine, and the relative unimpressiveness of Immune Response's (San Diego, CA) HIV Immunotherapeutic. The third quarter brought some successes, however. Chiron's (Emeryville, CA) and Berlex Laboratories' (Wayne, NJ) Betaseron for multiple sclerosis was approved by the Food and Drug Administration (FDA, Bethesda, MD) in July. And Genentech's (S. San Francisco, CA) Pulmozyme for cystic fibrosis was recommended for approval by an FDA advisory panel in August. Approaching 1994, a more crowded calendar of upcoming, significant milestone events for various biopharmaceuticals lies ahead. One of the reasons the recent setbacks loomed so large was perhaps the relative emptiness of the landscape in which they occurred. A fuller calendar should bring more positives to help offset any negatives.

• Fear of price controls may be abatting. The possibility of government review and control of the initial pricing of newly approved drugs is a dagger aimed at the heart of the biopharmaceutical industry. Without premium product pricing, biopharmaceutical companies would mostly be unable to generate earnings growth great enough to attract adequate investment. Hence, there is concern about provisions in the Clinton administration's draft proposal for health-care reform that would give the government the power to negotiate prices of new, breakthrough drugs with companies and to deny Medicare coverage if unsatisfied with the "reasonableness" of the price. Although this power would frighten investors, we note that premium pricing is achieved in a number of European countries where price negotiation is mandated. Finally, however, it seems likeliest that these provisions will be attenuated by Congress.

However, higher hurdles for access to financing are creating a capital squeeze that is likely to force capital-poor companies—those without enough cash to maintain core research and development (R&D) at current levels for two years—to make strategic changes in the future, a source of uncertainty that will discourage investment in these companies until the financing climate changes. For now, many companies are already streamlining research programs to dampen cash burn. Over the next year, financial prudence or necessity could drive more dramatic strategic shifts, such as out-licensing of major products, reductions in research, mergers, or acquisitions.

Still, despite such problems, the biopharmaceutical group's promise is immense and will represent very rewarding investment opportunities again.

• Although rapid technological change may shorten the life cycle of some novel biopharmaceuticals compared to drug products in the past, therapeutic advances represent a constant wave of fresh opportunities for nimble companies and nimble investors.

• The nationwide shift to managed health care could actually benefit many biopharmaceutical companies, since many are developing breakthrough products, and breakthrough products could provide the most attractive pharmacoeconomics in a Clinton health-care environment.

• Companies can succeed and reward investors without becoming fully integrated pharmaceutical companies. In fact, we see an accelerating shift away from that business model to a more flexible structure based on partnerships with large pharmaceutical companies with unmatched abilities in commercialization but great needs in drug discovery.

Indeed, we think that conditions have become more favorable for biotechnology stocks than at any time this year. We can't identify any single event so spectacular that it would have the weight to swing the entire sector back into forward motion. Nonetheless, we think a rebound is possible, because previous biotechnology bear markets have tended to end when a "critical mass" of medium-weight positive events coincided with long-depressed valuations. This was the case at the through of the 1987-1988 slump and could very well be the situation this time as well.

On the other hand, the most potent force for upward movement in this sector is FDA approvals of new drugs and subsequent sales growth. Unfortunately, the number of potential 1994 approvals of new drugs—as opposed to supplemental indications for already marketed products—is low. Hence, if the market remains suspicious about the value of milestones short of product approvals, a rally could be postponed.

We would focus during this year's fourth quarter on those biotechnology companies that have strong, attractive fundamentals and that should be able to maintain the current pace and breadth of product R&D without needing to raise funds soon. The limited liquidity of many stocks in this sector argues for accumulation beginning now. Our recommendations include Chiron, Alpha-Beta Technology (Worcester, MA), Athena Neurosciences (S. San Francisco, CA), PerSeptive Bio-systems (Cambridge, MA), and U.S. Bioscience (W. Conshohocken, PA). ///