Is there balm in Gilead?

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If ever an area of biotech exemplified the investor's mantra 'buyer beware', then anti-infectives would be it. For example, of the 16 publicly traded companies with some sort of antibiotic development program listed on p. 1478, 14 are newer and unprofitable; investors must therefore be careful not to let the science story obscure whether the money will run out before the pivotal trials are done. For the remaining profitable companies, investors must not overpay. But there are opportunities for cheaper shares and good investment candidates if you are both prepared and patient.

The importance of money

Apart from Novozymes (Bagsvaerd, Denmark; OTC:NVZMF;CSE:NZYM B), and Cubist (Lexington, MA, USA; Nasdaq:CBST), all the other companies are unprofitable and burning through cash. To even consider speculating in any of them, you must estimate how much cash the company "burns through"—spends beyond what it takes in each quarter—and determine how long its current checking account balance may last at that rate. While some companies may be able to raise money by selling more stock or issuing debt, it's not always possible to find buyers at favorable or any terms, and stock prices plummet when there is the slightest whiff of financial insecurity.

The positive side of speculating in development-stage companies is that you don't have to fret too much over the price you pay. You are making an all-or-nothing bet, pure and simple. As long as you are fairly certain that the lead drug, if approved, would be very profitable, and if you don't buy after investors have already driven up the price on emotion (just look at a one-year chart to get a sense of this), there should be enough gain to reward you if the drug succeeds.

With the exception of Vertex Pharmaceuticals (Cambridge, MA;Nasdaq:VRTX), an unprofitable company that nevertheless has a diverse pipeline, promising near-term drugs, and a whopping $752 million in the bank as of September 30, the unprofitable companies profiled on p. 1478 are going to need more cash sooner rather than later to survive. Investors should be ready for the time when their ownership shares will be diluted by new stock sales, their company will take on a greater debt load, or neither avenue will be available and worse economy may await.

The importance of valuation

Investing in profitable companies is different. The finances are stable and cash cushions sufficient to support the ups and downs of product development, so it's not about an all-or-nothing speculation, but whether you are buying growth at a reasonable price. You must *not overpay*.

Yet opportunities to obtain a good company's shares at a favorable price come rarely, usually at two times: first, when the entire stock market is depressed and everything is selling cheaply, such as fall 2002 to spring 2003, when a drunken investor throwing darts blindfolded in a British pub could pick winners; or second, when the herd overreacts to bad news, such as a drug disapproval or setback in trials, and sells a stock emotionally. You must be prepared but also patient.

Of the two profitable anti-infective companies, Novozymes and Cubist, neither presents a good opportunity. Novozymes, up 60% since I wrote about it in March 2005 (*Nat. Biotechnol.* **23**, 293), is an exciting company but currently highly valued for its growth. And with a large, diverse product base it is unlikely to face the one-time hit to profits that would lead to a large selloff. Watch it, but don't expect cheap shares.

Cubist turned profitable the first time last quarter and sales of Cubicin (daptomycin) appear able to support this for some time. However, if you project that profitable quarter forward—a risky exercise at best—shares are still selling for a nosebleed price-to-earnings ratio (P/E) of over 200. This high P/E dependent on one lead drug makes the shares too risky at even a much cheaper price—which will almost certainly come. So why buy now?

Balm in Gilead?

There is one anti-infection company that looks interesting, however. With a $28 billion enterprise value, Gilead Sciences (Foster City, CA, USA; Nasdaq:GILD) is not far behind Schering-Plough (Kenilworth, NJ, USA; NYSE:SGP) and is the third biotech after Genentech (S. San Francisco, CA, USA; NYSE:DNA) and Amgen (Thousand Oaks, CA, USA; Nasdaq:AMGN) to join the ranks of the 'big pharmas.' The company is aggressively using its financial resources to expand its research and development pipeline and product portfolio beyond its blockbuster HIV drugs and large Tamiflu (neuraminidase inhibitor oseltamivir) royalties through in-house work, alliances and acquisitions. For example, Gilead recently agreed to pay $2.5 billion for Myogen (Westminster, CO, USA), and $132 million for Raylo Chemicals (Edmonton, AB, Canada) to bolster its development and manufacturing operations.

All good, but what price to pay for Gilead shares? There is a risk that Gilead may be overpaying for Myogen, however promising its pulmonary arterial hypertension drug endothelin A receptor antagonist ambrisentan (LU 208075). What's more, a company press release states that it expects the Myogen acquisition to be dilutive in 2007 and 2008. 'Dilutive' is a polite way of saying that the acquisition will reduce earnings growth to some degree. Despite these risks, Gilead stock sports a rich P/E of 42 times trailing earnings and 27 times earnings estimated for the year ahead.

With these risks and the current high valuation, there is a very high probability that at some point in the next two years investors will sell off Gilead stock emotionally, perhaps 20% or more. If you are paying attention, and if you believe, as I do, that the long-term is bright for Gilead, that's when you buy. Put Gilead on your watch list and be patient.

Tom Jacobs is co-founder of Complete Growth Investor, http://www.completegrowth.com, a stock service for individual investors. Tom held no position in any of the companies mentioned here at time of writing.