Milwaukee Sentinel

Your Money

MILWAUKEE SENTINEL Monday, February 8, 1993 8B

Drug stocks are a downner

While sector is in withdrawal, analysts high on some firms

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Until a year ago, an investment in a major pharmaceutical company was almost like shooting fish in a barrel.

For much of the latter half of the 1980s until January 1992, drug stocks led the market with the promise of rising profit margins and new products entering the pipeline.

But recently, investors riding the high of the drug stocks' extended ride are going through withdrawal as drug stocks continue their extended decline in anticipation of the Clinton administration's health care reform package.

Not even the king of the drug stocks has been immune.

After leading the charge and splitting its ever-increasing stock several times, Merck & Co. stalled last year and now is headed in reverse. After reaching a post-stock split high of $60, Merck hit a new low of $37¼ recently.

Most of the drug sector has been part of the accelerating nose dive.

Bristol-Myers Squibb Co. is trading at $58, down from its January 1992 high of $89. Shares of Glaxo Holdings PLC recently hit a new 52-week low of $18.625, down from its early 1992 high of $35.

Several area drug stock analysts say shares of the major drug companies will remain under pressure until the new health care policy is revealed in April. While the party could be over for the sector as a whole, the decline in value represents a buying opportunity for shares in selected companies, say two analysts for Vector Securities International in Deerfield, Ill.

"We're not very positive on the group right now," says Vector analyst Craig Baskin. "We're concerned that any new health care plan that comes out of Washington (D.C.) will somehow limit the pricing of pharmaceutical drugs. We're worried that managed health care will mean that large buying groups like hospitals and HMOs will seek ever-increasing discounts from drug makers in exchange for their business."

The theme running through concerns over government price controls and increasing cost sensitivity is reduced profit margins, as drug price increases may not match the rate of inflation under this scenario, Baskin says.

Even less encouraging is that most of the research-based drug companies are not bringing a lot of new promising drugs to market in the coming year, says Vector analyst Patricia Padgett Lea.

But, there are some exceptions.

Glaxo will launch Imitrex, a new drug for treating migraine headaches. It appears to be more effective than other competing products on the market, but with fewer side effects. Imitrex should add $155 million in worldwide sales for 1993, and should exceed $1 billion in sales by 1996, according to Baskin.

Another British drug company, SmithKline Beecham PLC, is introducing an anti-nausea drug Kytril that could see $385 million in sales by 1996. The company also is launching the anti-depressant drug Paxil, which could post similar sales as Kytril by 1996, Baskin says.

Padgett Lea is recommending her clients take a position in Pfizer Inc., which has a highly regarded cycle of new products and is trading at less than 17 times its 1993 earnings estimates. Padgett Lea recommends buying Pfizer stock in the low $60s, and trading it once it reaches the low $70s. She says the stock price of Pfizer is depressed because the entire sector is unpopular now.

Padgett Lea also likes Bristol-Myers as a pure yield play, with some growth potential once the drug sector hits bottom. Trading recently at about $58 per share, Bristol-Myers provides investors with a 5% yield.

Louis Webb, a drug stock analyst for Robert W. Baird & Co. Inc., says the market is discounting the inherent strength of the drug sector. The top 10 U.S. pharmaceutical companies maintain strong balance sheets, positive cash flow generation and have diverse operations, Webb says.

"While the research-based companies have been under pressure, investors shouldn't overlook the power of research, the potential for medical breakthroughs and the potential returns derived from innovation and proprietary intellectual property (drug patents)," Webb says.

One benefit of a Clinton policy that provides health care for every American could be increased access to prescription drugs from what currently exists, Webb says.

Gonn: Likes Schering-Plough

Further, drug therapies can eliminate the need for the more costly alternatives of surgery and hospitalization, Webb says. And, by spending a combined $10 billion annually on research and development, the U.S.-based drug makers represent 50% of future innovation in the health care field, Webb says.

Another drug stock worthy of consideration is Schering-Plough Corp., says Craig Gonn, an investment consultant for Kemper Securities Inc. in Mequon.

For the last five years, Schering-Plough has grown at a 20% clip, and pays a 2.7% dividend. The stock tends to run up on its own independent of the rest of the drug group, Gonn says. He points out that it hit a new high of $70.50 two months ago while the rest of drug stocks languished.

The stock has since fallen back to about $58, making it more attractive, Gonn says.

Schering-Plough is awaiting FDA approval of a new antihistamine drug Claritin, which is the leading seller in Canada after just 10 months on the market, Gonn says. Schering has a number of other drugs that are market leaders, and should keep share earnings expanding by 17% annually through 1995-'97.

As for the short-term direction of the drug sector, Baskin says the market valuation of drug companies could drop another 5% to 10%.

Webb believes the drug stocks as a whole already have hit the bottom.