BARRON'S Online

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# A Little Respect

*Drug stocks are the cheapest in 10 years. Some savvy buyers smell a rare opportunity*

**By ANDREW BARY**

**THE BIG DRUG STOCKS TODAY** trade for just 12 to 14 times projected 2004 profits, valuations last seen in 1993 and '94 when Wall Street feared President Clinton's health-care proposals would lead to industry price controls.

The sector's problems are at once similar and very different, ranging from looming patent expirations on major drugs such as **Merck**'s Zocor to an uninspiring pipeline of new drugs, the threat of cheap imports from Canada and potentially greater government influence over drug pricing, especially if Democratic contender John Kerry is elected president next month. Merck's recent decision to discontinue sales of Vioxx, one of its biggest sellers, because of health concerns, has only heightened investors' disdain for the group, not to mention the company, which has seen its shares plummet 32% to 30 in the past three weeks.

In a rare development on Wall Street, investors are treating even slow-growth utilities with more respect. As the table nearby shows, two leading phone companies, **Verizon Communications** and **SBC Communications**, as well as two big electric utilities, **Dominion Resources** and **Southern Co.**, now sport higher price-earnings multiples than many drug companies. The Street expects the drug industry to produce no more than mid-single-digit earnings growth in the next decade, well below its 20-year annual record, and many skeptics regard the stocks as "value traps" -- cheap and likely to stay that way, given their seemingly poor prospects.

Yet some investors don't buy this gloomy talk, and see striking parallels to the post-Clinton fiasco. Shrewd investors who snapped up drug-company shares 10 years ago profited handsomely thereafter, because the so-called Hillary-care health plan died and the industry went on to produce blockbusters like Lipitor and Zyprexa.

M. E. Cohen for Barron's

"**Pfizer** looks very cheap," says David King, manager of the **Putnam New Value** Fund, who added Pfizer to the fund for the first time when the stock recently fell below 30. That drop occurred amid concerns that the same problems that prompted Merck to pull Vioxx -- the heightened risk of heart attacks and strokes -- also could affect people taking Pfizer's COX-2 pain reliever, Celebrex, which the company has said is safe. Pfizer's 2004 P/E of 14 is below the P/E of 17 on the Standard & Poor's 500 stock index, and the company's 2.3% dividend yield is above the 1.8% yield on the S&P.



One notable investor who might be eyeing the drug sector is **Berkshire Hathaway** CEO Warren Buffett. At Berkshire's annual meetings in recent years, Buffett has spoken favorably of the industry, saying in 1999 that "pharmaceutical companies have enough going for them that they should not sell at depressed multiples for very long," according to one attendee's notes from that meeting.

Buffett added that if Berkshire were to invest in the group, it likely would buy shares in a "basket" of leading companies because of the difficulty of handicapping prospects for individual drugs.

In a *Barron's* interview a year ago, Buffett said the drug industry "in aggregate" is better than technology because of higher returns and patent protections ("The Waiting Game[1]," Oct. 27, 2003). "If you look at the top 10 drug companies ranked by sales, the No. 2 or 3 company from the bottom is still earning a good return," he said. Berkshire has plenty of money to invest; it is sitting on $35 billion of cash.

There's no evidence, to date, that Buffett has plowed any money into drug stocks, and Berkshire historically has had little exposure to the sector. Buffett now has very demanding investment criteria, and the drug stocks might not meet his test. Indeed, Buffett has made no major investment moves in the past year, save for a big bet against the dollar.

Shares of Pfizer and many other drug firms are way below their peaks of 1999-2000, demonstrating the drugs no longer are the "safe" stocks of yesteryear. Pfizer, at 29, is down 44% from its peak, while Merck and **Bristol-Myers Squibb**, now 23, have lost two-thirds of their value. **Schering-Plough** has plunged 72% from its all-time high.

**Tables:** Back to the 1990s | Cheap Medicine[2]

*Barron's* has been bullish in the past few years -- and wrong so far -- on Merck, Pfizer and **Eli Lilly**. Lilly arguably has the industry's strongest pipeline of new drugs, but its stock is down 17% this year to 56.

The main fear about Pfizer is earnings growth, which may slow markedly in coming years, owing to patent expirations on such big sellers as the antibiotic Zithromax and antidepressant Zoloft. Pfizer's drug pipeline, moreover, is looking less impressive than it did a year ago. But the company has a low stock-market valuation, a strong balance sheet and high levels of free cash flow.

"We've been adding to Merck," says Tom Kahn, co-director of investments at Kahn Brothers, a New York investment firm. Kahn is attracted to Merck's 5% dividend yield and comforted by Merck's vow to maintain its payout. "Yes, Merck will be sued over Vioxx, and yes, they may have to pay a lot of money, but it's not going to sink the ship," he declares.

Diet-drug liabilities have cost **Wyeth** $16 billion, and Wyeth is still standing. Kahn doubts Merck will face anything near the Wyeth liability. Merck's Vioxx liability could total $11 billion, according to a research note by Sanford C. Bernstein analyst Richard Evans.

Merck trades for 11 times projected 2005 profits of $2.65 a share, reflecting a reduction of about 65 cents for the Vioxx withdrawal. The bear argument is that Merck's problems go beyond Vioxx because the company faces the 2006 patent expiration of its top drug, Zocor, which has $5 billion in annual sales. Merck's profits could decline in both 2006 and 2007.

Kahn says Merck's annual earnings might bottom at $2 a share in a worst-case scenario. This assumes no growth for key drugs such as Singulair, Fosamax and Cozaar, and it gives Merck little credit for a joint venture with Schering-Plough involving Vytorin, a cholesterol-reducing drug that combines Merck's Zocor and Schering's Zetia. Vytorin is off to a strong start and could hit $4 billion in sales by 2008.

The two highest-yielding drug stocks, Merck and Bristol-Myers, probably are good bond alternatives, because both yield more than the 10-year Treasury note, now at 4.05%. Bristol-Myers appeals to value investor Rich Pzena, head of Pzena Investment Management in New York. He argues that investors effectively are giving Bristol little credit for its drug pipeline.

Ironically, Schering-Plough has been the group's top performer in 2004, even though it might lose money this year. Schering bulls point to Vytorin's sales potential and Schering's takeover appeal. Yet Schering shares look rich because the company might earn no more than $1 a share in 2008. The stock's 2008 P/E is higher than the rest of the group's 2005 P/E. Merck is the most logical buyer for Schering but probably is loath to issue stock for such a deal given its depressed valuation and Schering's high valuation.

With Wall Street sentiment on the drug sector at its lowest point in a decade, the industry could confound the naysayers again. Indeed, that seems a good bet, given the drug makers are some of America's best companies.

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# Back to the 1990s

**Table:** Cheap Medicine[0]

The price/earnings ratios on the major drug stocks aren't much higher than they were 10 years ago. The shares are down sharply from 1999-2000 highs.

| | Recent | 1993-'94 | 1993-'94 | 1999-'00 | Change |
|---|---|---|---|---|---|
| **Drug Stocks** | **Price** | **Low Price** | **P/E** | **High** | **From Peak** |
| **Bristol-Myers** | $23 | $12 | 10 | $74 | -69.% |
| **Eli Lilly** | 56 | 11 | 10 | 108 | -48 |
| **Merck** | 30 | 13 | 12 | 90 | -67 |
| **Pfizer** | 29 | 5 | 13 | 50 | -42 |
| **Schering-Plough** | 17 | 7 | 12 | 61 | -72 |
| **Wyeth** | 37 | 14 | 11 | 70 | -47 |

*Source: Bloomberg*

**Cheap Medicine**

Most drug stocks trade for 11 to 14 times projected 2004 profits, below the price/earnings ratio of the S&P 500 index and slow-growing utilities. With solid dividends and strong free cash flow, the out-of-favor drug stocks could be good values.



| | Recent | Price | Earnings Per Share | | P/E Ratio | | Mkt. Val | Dividend |
|---|---|---|---|---|---|---|---|---|
| **DRUG STOCKS** | **Price** | **Change YTD** | **2004E** | **2005E** | **2004E** | **2005E** | **(bil)** | **Yield** |
| **Bristol-Myers** | $23.00 | -19.6% | $1.61 | $1.40 | 14.3 | 16.4 | $44.73 | 4.9% |
| **Eli Lilly** | 56.03 | -20.3 | 2.81 | 3.23 | 19.9 | 17.3 | 63.35 | 2.5 |
| **Merck** | 30.19 | -34.7 | 2.58 | 2.66 | 11.7 | 11.3 | 66.98 | 5.0 |
| **Pfizer** | 29.08 | -17.7 | 2.12 | 2.36 | 13.7 | 12.3 | 219.57 | 2.3 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Schering-Plough** | 17.24 | -0.9 | -0.01 | 0.23 | NM | 75.0 | 25.38 | 1.3 |
| **Wyeth** | 36.58 | -13.8 | 2.66 | 2.87 | 14.1 | 12.7 | 48.79 | 2.5 |
| **UTILITIES** | | | | | | | | |
| **Dominion Resources** | 65.08 | 2.0 | 4.82 | 5.19 | 13.8 | 12.5 | 21.49 | 4.1 |
| **Southern Company** | 30.15 | 0.3 | 1.99 | 2.06 | 15.2 | 14.6 | 22.26 | 4.7 |
| **BABY BELLS** | | | | | | | | |
| **SBC Comm** | 26.35 | 1.1 | 1.51 | 1.35 | 17.5 | 19.5 | 87.31 | 4.7 |
| **Verizon Comm** | 40.77 | 16.2 | 2.49 | 2.65 | 16.4 | 15.4 | 112.87 | 3.8 |

NM=Not Meaningful E=Estimated

*Source: Thomson Financial/Baseline*

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