

Good Genes

Kerry A. Dolan, 06.06.05

Do you want to invest in the DNA revolution? Don't wait for customized drugs, which are years away. Buy shares in a company that is using DNA for diagnostic work.

In the hoopla that followed the sequencing of the human genome in 2000, much of the excitement centered on the promise of miracle cures molecularly tailored to each individual. That kind of medicine is still no more than a promise. But gene-based health care is here and now in another form: molecular diagnostics.

Diagnostics have long been the poor relation of higher-profile therapeutics in the health care realm. They account for just 4% of total U.S. health care spending and typically have had lower gross margins than drugs--50% versus 80%. Overall the \$30 billion U.S. clinical diagnostics market is growing at a mere 4% annual clip.

But new, patented tests created with information gleaned from genome mapping have injected new life and higher margins (near 75%) into the business. The \$2.5 billion molecular diagnostics industry is expanding at a 15% annual rate, according to consulting firm Leomics Associates of Emerson, New Jersey.

The number of patented, genome-sourced diagnostics is likely to mushroom as more disease targets are identified. Thus far, much of the molecular diagnostics field has concentrated on infectious diseases, detecting HIV, hepatitis C and sexually transmitted diseases like chlamydia. Genetic screening, including prenatal screening for cystic fibrosis and other genetic disorders, accounts for a smaller piece of the market.

The next wave of tests is likely to be for cancer. In the future we will have diagnostics to determine what type of, say, colorectal cancer a person has, which will then help in determining the proper treatment. Diagnostics will also be able to detect cancer earlier, before it has a chance to spread to the lymph nodes, says David Lewis, a partner at Thomas Weisel Partners who follows the sector.

Unlike many in the biotech realm, a handful of companies dealing in molecular diagnostics have done well, with good profits and stock prices. While their price/earnings multiples are on the rich side, the industry's promise makes the tariff acceptable.

J.C. Waller's Icon Healthcare Fund has profited with a big position in these firms (*see table*). The mutual fund has a five-year annualized return of 13% (versus a negative 2% for the S&P 500). Its expense ratio is 1.3%. Waller, 36, who served as a Ranger and a Chinese translator in the U.S. Army before joining Icon Advisers in Greenwood Village, Colorado in 2000, prefers gene diagnostic companies to the big pharmaceutical outfits, which he regards as being sluggish.

One of Waller's favorites is Quest Diagnostics, the nation's largest medical testing company, with a 12% market share. It performs all types of clinical tests but also touts itself as a pioneer in gene-oriented tests for things such as HIV resistance and cervical cancer screening. Typically the tests are developed by other companies and licensed to Quest.

Waller expects Quest's earnings to grow 14% annually for the next five years. Last year Quest's return on average equity was 21.3%. This company is available at 20 times its expected 2005 earnings.

Another Waller pick: Laboratory Corp. of America. LabCorp is the second-largest U.S. medical testing company and offers many of the same genetic tests that Quest does. Waller has owned LabCorp since late 2003. He is looking for 13% earnings growth for the next five years. At a recent \$50, the stock also goes for 18 times expected earnings. LabCorp lowered its sales, general and administrative expenses to 21% of revenue last year from 26% in 1999, enabling it to almost triple the net margin to 11.8%.

Beckman Coulter is an equipment supplier to this thriving industry. For molecular diagnostic tests Beckman Coulter has developed a nucleic-acid- sample detection instrument that separates fluorescent-dye-labeled DNA fragments for pattern recognition or further identification. Stock price: 19 times expected earnings.

Then there are the companies that develop the diagnostic tests. Here Biosite has been one of the most successful players. It came up with tests, to be used primarily in hospital emergency rooms, that determine within 15 minutes if a patient has had a heart attack; has congestive heart failure, a bacterial or parasitic infection; or has used illicit drugs. Another test, now awaiting the U.S. Food & Drug Administration's approval, can determine quickly if a patient has had a stroke. Biosite seeks to refine the test to see if a stroke is caused by a blood clot, giving doctors the confidence to quickly treat the patient with a clot dissolver. Hospitals are reluctant to do that now, because if the patient has had the other kind of stroke (caused by bleeding), the clot dissolver may hasten his death.

Waller expects Biosite's earnings to increase 17% annually for the next five years. Its gross margin is a mere 26%, and it's not controlling expenses well, says Waller. At \$60, or 22 times expected earnings, it's an okay stock but not a screaming value, he says.

Gen-Probe, like Biosite a San Diego firm, made its mark in 1985 with a test for Legionnaires' disease. It has gone on to specialize in DNA probes for sexually transmitted diseases and other microbial infections. Waller expects 20.5% annual earnings growth, justifying its steep price (36 times expected earnings).

Gene Testers

Waller expects handsome earnings growth for a number of companies in the molecular diagnostics business.

Company/business	----- Price -----		P/E 2005E
	Recent	52-Week High	
Beckman Coulter	\$66.20	\$73.35	19
BioSite	57.47	64.09	21
Gen-Probe	42.89	53.14	35
Laboratory Corp of America	50.75	51.25	18
Quest Diagnostics	106.70	107.54	19

Prices as of May 9. E: Estimate. Source: Reuters Fundamentals via FactSet Research Systems.