Sand Spring Advisors LLC

Biotech Bottom

by,

Barclay T. Leib

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I am personally not one who favors messing too much with Mother Nature.

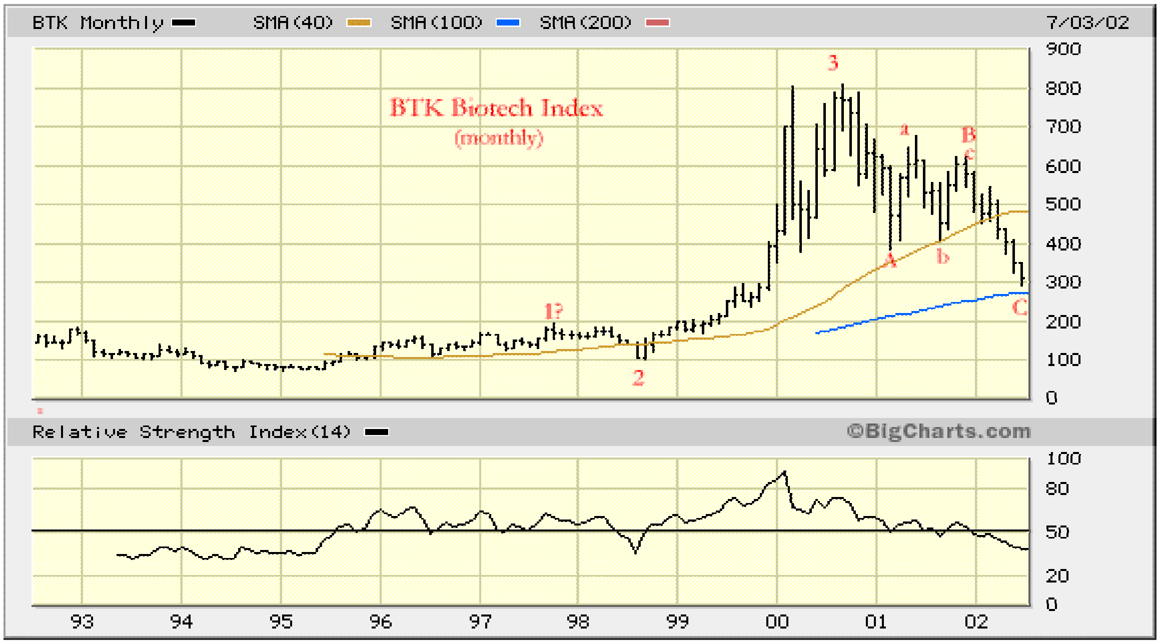
I look out my office window at rural New Jersey and often wonder how it is that "progress" and "growth" can be deemed so desirable, when the quality of life we all now live – with a more densely packed population, less farmland by the day, traffic jams increasingly in the smallest enclaves, higher taxes by the year – only tends to continuously sap our entrepreneurial energy.

On these pages I have previously bemoaned what has happened to the quality of the American food chain. We may have tomatoes, strawberries, and watermelon on our grocery shelves year round, but the hothouse farming techniques, bioengineering, and insecticides that help allow such also seem to drain the very taste from these fruits and vegetables that we so cherish. If Mad Cow disease is not already within our beef supply, the excessive use of hormones and antibiotics certainly is.

All of that said, bio-technology is not going away, and while I may question its results in our food system, the production of new medicines and treatments to address a wide range of debilitating diseases appears a clear growth area over the coming decade. While Martha Stewart still occupies the public attention in the well-publicized stock sale scandal of fallen biotech darling Implone, we think now is as good a time as any to potentially pick up some biotechnology exposure in the long side of one's portfolio. Certainly this is a sector where there is still "blood in the streets" in 2002, with the BTK Index down no less than 46.5% year-to-date. And "blood in the streets" may spell opportunity at least for a substantive bounce. Many of these stocks now trade not that far above book value, with high current ratios (plenty of liquidity), and modest cash burn rates.

Please do not get us wrong: For the market as a whole, we still see issues such as pension fund accounting, an overly extended consumer, and still lofty P/E levels as troublesome factors that will limit the extent of the major market indices to get into synch and maintain a significant and sustainable rally. Friday's 324.5 point Dow Jones advance was impressive, and certainly augers for generally healthier times until November 7, 2002 (our next major 4.3-year PEI cycle date), but not likely beyond that time.

This does not mean that narrower sector-indices such as the BTK Biotechnology Index may not be able, with time, to reach new all-time highs. Indeed, If we had to bet, while the NASDAQ Composite and NASDAQ 100 have likely just completed a fairly important Wave 1 low of a new bear market, the BTK Index (shown below on a monthly basis) is likely only completing a 4th wave low, on the path to eventual new highs. The wave count on the weekly BTK chart is difficult to interpret in the wave 1 & 2 positions, but the 1998-2000 rally certainly appears to us to have been a 3-wave, with a huge A-B-C 4th wave chop ever since. We now have strong moving average support slightly under 300, and 269.50 and 247 are two further levels of Fibonacci support.



Zooming in from a monthly perspective to a daily one, we spy a lovely "hanging man" reversal formation this past Wednesday on the BTK daily Candlestick chart. This occurred near the bottom of the Bollinger Bands, and we subsequently experienced some impressive follow-through to the upside on Friday. Like the NASDAQ indices, we also completed a "Three Thrusts to a Low" type formation. Per this chart, an ascent to the top of the Bollinger Bands near 375 would be our minimum expectation. Even from current levels, such a move would represent over a 16% rally, although much more is possible.

So with this overview in mind, we are going to delve into the chart pictures of some individual biotech stocks. But first we must post a huge warning and caveat: Biotech stocks can be very volatile and we personally have little ability to evaluate their prospects on a fundamental basis. To do the latter, you must almost be a doctor, and truly understand not only the individual disease that a company is trying to treat, but also the pharmacological side effects of the proposed new drug solutions. You must follow the clinical trials of these drugs and ensure that the trials are not flawed in some way that the FDA will reject them. You must be wary of Implone-like clinical trial sloppiness, and interview clinicians to ensure real medicine is there. Beyond this, you must then make sure that there is an actual market demand for a new drug, and that if approved by the FDA, the drug's sale will be economic vis a vis production costs. Any expected revenues must be discounted back (on both a value of money and probabilistic basis that the drug will gain approval) and compared to a company's current valuation.

Overall, biotech investing, done well, is likely only for those who love a complicated game of chess, and have the patience to really do their homework and ignore a tremendous amount of interim market valuation volatility.

Thankfully, there is a gentleman in New York named Evan Sturza who runs Sturza Medical Research – a Biotech market newsletter. Sturza is also the principal of Ursus Capital, a biotech hedge fund. While Sturza himself is not a doctor, he has several doctors among his partners, and historically this group has done a wonderful job picking the biotech "sheep from the goats." With the ability to go both long and short biotech stocks within an overall risk framework that is typically net long, the Ursus Capital hedge fund returned +26% in 1999, 111% in a very tough 2000, and 27.5% in an equally tough 2001. More notable, the Ursus hedge fund has been profitable 13 out of 16 quarters since its inception. This year, Ursus Capital is net down 17% year-to-date -- reflective in part of Sturza having established a greater long bias to the fund's mix prematurely. He clearly spies "value" (to the extent one can even use such a word with regard to biotech) within the small universe of stocks that he follows. We wish thank Sturza for his permission to post a few chart perspectives of selected longs he currently favors within our pages.

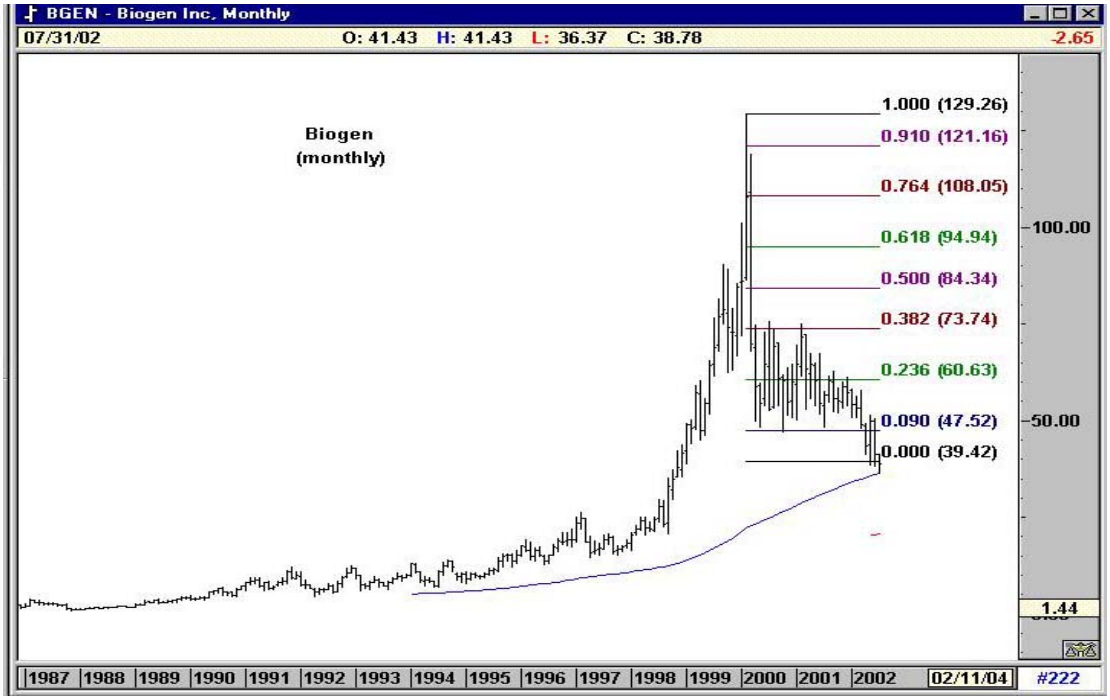
We thus consider the stocks below to have been pre-filtered for fundamentally compelling stories before our technical eye has even reached them. In each instance, we mention this fundamental story, but cannot and do not dwell upon it. We also caution that in many instances, Sturza Medical Research has been bullish these stocks from significantly higher levels.

These facts understood, if a pattern or story tweaks your curiosity, please DO YOUR OWN HOMEWORK before investing. We are temporarily bullish the market, so we deem the risks of investing in any of these stocks over the short-term to be acceptable, but over the longer-term, we hold out no promises. It is important to remember that we are traders at heart at Sand Spring. We were bullish gold at $265, but agnostic about it above $310. Similarly, we anticipate going along for the easy part of a Biotech bounce, but will likely hop off the boat long before many of these companies realize their true potential, or conversely turn into flops.

Biogen (BGEN, 38.78, 21.8 p/e ratio, current ratio=4/1)

Sitting just atop long-term moving average support, and with a complete looking rhythm on a Fibonacci basis (on bands pulled down from the Feb 2000 high), Biogen appears to us to be a reasonably low risk proposition at $38.78 – at least for a short-term rally to fill a gap on the daily chart at $47. A break of $37, however, and all bets would be off, as the next Fibonacci support does not appear until 21.

Fundamentally, in late May Biogen received a favorable FDA response to its Amevive fusion protein drug for the treatment of psoriasis. It has also recently received European regulatory approval for its drug Avonex. This latter drug is used for patients with a high risk of developing multiple sclerosis. Notwithstanding both of these announcements, the stock was weighed down in June by the overall market. We'd look for a pop here, and as long as moving average support near $37 holds, the longer-term may be quite bright.



Inhale Therapeutics (INHL, 8.05 -- Book Value 4.9; Current Ratio 6.3-1)

From an early 2000 high of $70.75 to a recent low of $5.75, Inhale Therapeutics has been trading like a huge roller coaster. Part of the recent decline is simply a function of a nasty market in tech and biotech, and part stems from product development setbacks, including uncertainty on this company's progress with Exubera – an inhaleable insulin drug supported by Pfizer, but still lacking a NDA filing. But according to Sturza, this company has much going for it, even if one assigns a zero value to Exubera.

Specifically, Sturza sees INHL's dry powder inhalation technology and small-molecule drug delivery programs to be this company's true claim to fame, and something that it will increasingly license out to pharmaceutical partners.

We have no way to gauge INHL's true value, but as beaten up as it is, a bounce to Fibonacci resistance at $12.13 or even up at $21.53 (where long-term moving average resistance exists as well) seems likely to us. Stops set under the recent $5.85 low are likely safe from being elected but prudent protection if we are wrong.

Arqule (ARQL, 6.50 – Book Value 7.89; Current Ratio 3.2-1)

Arqule is another biotech drug discovery stock that is closely allied with Pfizer, and also focused on small molecule drugs and the testing of new drugs with regard to absorption, distribution, metabolism, elimination and toxicity in pre-clinical trials. Arqule has a market cap of just $131 million, but $95 million in cash and anticipated 2002 revenues of $62 million. Its cash burn rate is running at only $10-15 mm per year. Given all this, Sturza finds this company to be an exceptional value at current levels.

We're buyers as well at current levels, with a game plan to take half of our investment off the table on a bounce to moving average and Fibonacci resistance at 12.22. The balance of our investment will then effectively be cost-free.

Medarex (MEDX, 7.30 – Book Value 6.62; Current Ratio 15.9-1)

Medarex is a company focused on creating "antibody-toxin conjugates" (whatever that is) and has a drug in phase 1 trials for the treatment of melanomas and prostate cancer. To date, this latter compound appears to have been well tolerated and effective in a variety of instances, and will soon be moving into wider Phase II trials. The company has a net cash balance of $253 million plus $124 million of separate investments in several other companies. At a current total capitalization of $533 million, and subtracting out cash and investments, this means the market is currently valuing MEDX's seven drugs in human clinical testing and 47 other parterships at just $156 million. This is another of Sturza's favorites. For us, the easy money should be between current levels and $12.50.

Guilford Pharmaceutical (GLFD, 5.99 – Book Value 5.3; Current Ratio 8.4-1)

Guilford is a pharmaceutical company with $130 million in cash, a water-soluble anesthetic agent called AQUAVAN in European Phase 1 trials that has quicker onset and is less of a respiratory depressant than current anesthetics in use today, and a product GLIADEL used in the treatment of glioma already on the market in certain countries, but yet to be aggressively marketed. At a $178 million total market capitalization, Sturza is also a bull here as well, with a one-year $15 target.

How interesting it is that both Fibonacci and moving average resistance also resides at $15.59.

Sepracor (SEPR, 9.43)

Last on our list of overly beaten-up Biotechs is Sepracor – a company that recently experienced a FDA rejection of its drug Solitara, an antihistamine used in the treatment of allergies. Certain impacts on cardiac function were cited. Solitara is likely now dead in the water, although the company may re-file its application at some point.

Notwithstanding this setback, the company also has a drug Estorra targeted for the treatment of insomnia expected to go up for FDA approval in the second half of 2002. The company plans to be more conservative in its safety database and overall approach to the FDA in handling this second drug. The company also has yet another Xopenex inhaler up for FDA approval soon, with the liquid version of this drug (useful in preventing bronchospasms) already in many global markets.

Sepracor currently has $550 million in cash, and is slowing new R&D expenses so as to cut its cash burn rate. Hanging over this company's head is $1.16 billion in convertible debt due in the 2005-2007 period.

But if Estorra and the Xopenex inhaler are approved, these products should hit the market in 2004, and allow this company to easily meet its financial obligations. Sturza estimates that 2003 sales from Xopenex liquid solution alone will be $165 million, with further royalty income of $52 million.

This situation seems a bit more speculative to us – particularly given the huge head-and-shoulders formation the stock has made on the weekly chart, but could we get a bounce-back to the neckline of that head-and-shoulders at some point? Sure we could, and such a bounce would represent an easy double of the current price level.

Broader Indices

So there will end our brief foray into predicting a biotech bounce. If long-term subscribers are disappointed that the usually bearish analysis here has suddenly become a bit of bullish "greater fools theory" at work, we apologize. Our goal at all times is simply to make money, and just as we previously paired the astute fundamental short selling expertise of Jim Chanos in our May 2001 piece "Expert Short Picks," we thought it would be appropriate at this time to combine the fundamental astuteness of Evan Sturza with our own Fibonacci band analysis.

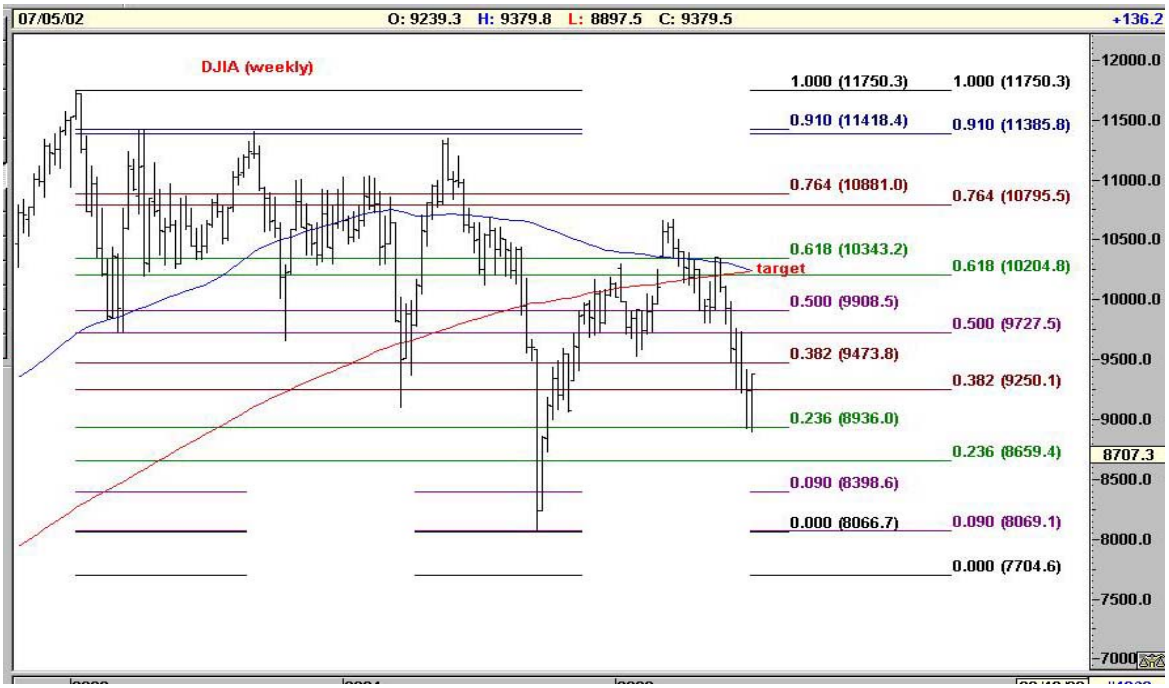
Elsewhere, in the major stock indices, we will also take a stab at setting out some preliminary targets for this anticipated bounce period into November 7, 2002.

In the S&P 500, would a clean 50% retracement of the 2000-2002 decline be possible? If so, 1254 is the target we're headed back to.

In the Nasdaq Composite, 1678 is a lay-up, 2232 likely, and we even have an outside chance at 2786. From Friday's 1448 close, this means we are calling for at least a 16% bounce, and more likely a 54% advance! Either (and particularly the latter) will be enough to convince the bulls that old times are back – but of course they will not be. Feb 2000 issued in what will in our mind be a general malaise in stock investing over the next 17.2 years. Little mini 4.3-month bull markets and even more significant 2.15- year bull markets will come and go during this period, but if the Nasdaq Composite ever broaches its March 2000 highs again, it is not likely to occur in the current cycle ending in 2017.

Even the anemic Nasdaq 100 is likely to rebound toward Fibonacci and moving average resistance near 1923.

Basis the Dow Jones Industrials, we see a far sloppier pattern, and have drawn a variety of Fibonacci bands (including ones to an extrapolated low near 7,700 – to be seen somewhere in the distant future), and our best guess would be for a bounce to 10,204 – a relative under-performer during this rally period.



The Dollar

And what pray tell does this July-November period hold for the U.S. dollar now that our previously espoused target for the euro to reach 100 has largely been fulfilled?

A retracement period for the euro, backing and filling within the various Fibonacci lines depicted below is likely the answer, but the dollar appears set up to be far more dynamic against the yen. 145.50 appears a reachable target here.

So overall, what we are calling for between now and November 7, 2002 is a very different type of market than the past two years. Doing so, ironically, represents the easiest path for us to remain longer-term bearish. For our cycle work, a rally into November 7th will almost ensure that 2003-2004 will be dour years. Conversely, should the market be making a low November 7th by some chance, it would force us to be more constructive for 2003-2004. We don't favor such a latter path at this time.

Send us your comments at information@Sandspring.com.

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