Taking Stock: Two drug makers are in need of a better prescription

by Malcolm_Berko

Dear Mr. Berko: I own 150 shares of Lilly at $42 and have a five-point loss. I like the stock because of the good dividend but I need more dividend income. So my broker recommended I sell Lilly, which only yields 4.5 percent, to buy Biovail at $12, which yields13 percent. Please give me your opinion on Lilly and Biovail, and tell me if you think this change would be a good move. Both are in the drug business, as you know. â€” C.R.: Aurora, Ill.

Dear C.R.: Eli Lilly (LLY-$32.10) concerns me. So, unless you know for certain that the FDA will grant LLY an exclusive patent for its new generic placebo, I'd not own this stock. Even though LLY recently raised its dividend to yield a 5.1 percent current return, even though long-term debt represents 23 percent of capital, even though its once-weekly diabetes drug Byetta has good promise, even though its Effient may have better efficacy than Plavix, even though LLY has a huge cash position, even though LLY's pipeline was enhanced by its acquisition of Imclone, I believe LLY's long-term potential is unattractive.

Once one of the darlings of Wall Street, LLY's stock price has been trending lower during the past decade when its high price exceeded $100 and its low price held firm at $60. Near-term profitability will be hurt by its $6.5 billion purchase of ImClone Systems Inc. in November; there seems to be a continued diminution of LLY's net profit margins to less than 19 percent; a continued decline if LLY's return on total capital to under 17 percent; and a continued drop in LLY's return on shareholder equity to less than 20 percent. Several analysts believe that LLY's earnings may come to a standstill. Wall Street is looking for a 2.5 percent earnings growth this year and flat earnings â€” perhaps to $4.25 â€” in the coming three to four 4 years.

For 2009, LLY expects revenues to come in at $22.1 billion and perhaps rise to $23.2 billion by 2013. That's not good, but it is the result of some very serious patent expirations. Zyprexa, the current flagship drug for the treatment of Schizophrenia with $5 billion in expected 2009 revenues, loses its patent protection in 2011. Then Cymbalta (depression) Gemzar (chemotherapy) and Evista (Osteoporosis) will soon lose patent protection, too. These three drugs plus Zyprexa provide LLY with $10 billion in revenues, or nearly 50 percent of the company's gross revenues.

While ImClone will modestly improve LLY's weak pipeline and assist earnings, pending patent expirations guarantee a precipitous crash in revenues a few years out. There are no drugs in the LLY pipeline that will create a commercial success significantly enough to replace $10 billion in lost revenues.

I wouldn't go near Biovail Corp. (BVF-$11.90) with a Komodo dragon. BVF's shtick is to develop drugs using advanced delivery and or controlled release technologies. This technology provides regulated and consistent delivery, fewer and reduced side effects and more convenient dosing schedules. Yep, the $1.50 dividend yields a swell 13.9 percent, but BVF's earnings are only 80 cents a share. So, management is basically taking 70 cents from Peter's cash flow to pay Paul's dividend. And while BVF may continue to pay $1.50 for a couple of years, this is a dippy decision by a daft board of directors and definitely not sustainable.

I believe revenues will soon begin to decline, that book value will fall and earnings are certain to suffer. Please, please stay away from this piece of junk. If management has an opportunity to make an acquisition, they will certainly use cash flow to pay for the purchase, which will probably eliminate your dividend. Meanwhile, I can't imagine that a viable competitor would consider a merger with BVF.

I agree with your broker's recommendation to sell LLY. But this guy must be in another time zone recommending BVF as an income and growth stock. I think it's time for you to look for another broker.

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