

Biotechnology stock prices have lost some ground relative to the market in the past three months, and a sub-par Timeliness rank suggests more of the same in the year ahead. Yet, new products should render many of these equities rewarding long-term investments.

In our December report, we looked at private-sector efforts to handle rising health care costs and the effects on biotech companies. With this Issue, we consider President Bush's Medicare proposal and its implications for the industry.

Medicare Reform

President Bush has proposed a three-tiered system for providing government-sponsored health care insurance for the elderly. Two of the tiers are in place. One is the fee-for-service plan that was enacted in 1965 when Medicare was first instituted. Drug coverage would be added via discount cards that would lower pharmaceutical costs by 10%-25% for all enrollees and provide a \$600 prescription-drug stipend for low-income seniors. A cap would be placed on elderly patients' out-of-pocket drug costs to protect against catastrophic illnesses. The President also aims to offer two new Medigap policies that would include outpatient drug coverage. (Medigap policies supplement Medicare coverage, but are bought directly by enrollees upon entry into Medicare.) The second tier consists of Medicare+Choice plans, which insure five million seniors today via private HMOs. These plans have a prescription drug benefit and would change little under Medicare reform. The third, newly proposed, tier is dubbed Enhanced Medicare. It would rely on private, preferred-provider networks to care for the elderly, much like the employer-sponsored health care plans that have become widespread over the past decade. To entice the 35 million elderly who rely on the fee-for-service coverage today to switch, this tier would include outpatient drug coverage.

The President's plan has several goals. One aims to address an unmet need, providing outpatient prescription drug coverage. The new benefit is projected to cost \$400 billion over the first ten years. Another goal is to improve Medicare so that it covers preventive medicine and provides better protection against catastrophic illnesses. A third goal is to use the fiscal restraints of managed care to lower medical costs by the time baby boomers are eligible for Medicare.

Limiting Health Care Expenditures

Medicare reform is one of three initiatives proffered by

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President Bush to cut future medical costs. His proposal would help by standardizing medicine via managed care. Today, health care still retains much of its experimental foundation, as evidenced by the variety of therapeutic approaches taken to address a given medical problem. Standardization should increase the use of the most cost-effective alternatives in treating the elderly, who are the demographic group least influenced by managed care thus far. Moreover, by relying on private insurers for the Enhanced Medicare option, the proposal relies on competition among insurers to minimize their prices.

The second initiative is a limit on medical malpractice liability, embodied in legislation recently passed by the House. Lawsuits, which have added to medical costs via extra tests and spiraling liability insurance premiums, are a threat, as evidenced by doctors' abandonment of their practices lately. A cap on malpractice awards would be consistent with standardized medicine, since patients should be at less risk under this paradigm.

Finally, we note that President Bush wants to improve the nation's health care infrastructure by increasing by 53% federal funding of information technology for hospitals. This would complement efforts to upgrade the government's own computer system for Medicare data and to lower medical errors via bar codes on drug packaging and through electronic prescriptions.

One last initiative merits consideration, in our opinion. Separate from his Medicare reform plan, President Bush has proposed eliminating the tax on stock dividends to aid the economy. We think it would have broader ramifications. By rendering dividends tax-free, the government would give seniors more income since it is this demographic group that owns most stock in publicly traded and private companies. That's important because income levels of the elderly will likely affect the government's future health care expenditures.

Investment Implications

We think Congress will pass Medicare reform legislation in the near future. But it is unlikely to have an immediate impact on the biotech industry, as most changes probably won't be felt until 2006, when the new program would likely begin. Even then, the impact on the biotech sector would be minor. Further out, reform probably would hurt pricing by favoring generic and other low-priced medicines. We think it thus would gradually restrict the industry's R&D focus.

Keith A. Markey

Composite Statistics: BIOTECHNOLOGY INDUSTRY

1999	2000	2001	2002	2003	2004		06-08
6591.5	7928.5	9533.0	11075	13050	15250	Revenues (\$mill)	23750
34.0%	30.2%	29.0%	28.0%	28.5%	29.0%	Operating Margin	32.0%
576.3	962.3	1226.8	800	915	1025	Depreciation (\$mill)	1400
865.8	1146.4	1297.9	1700	2070	2440	Net Profit (\$mill)	4475
42.6%	37.2%	42.3%	36.5%	35.0%	34.0%	Income Tax Rate	33.0%
13.1%	14.5%	13.6%	15.3%	15.7%	16.0%	Net Profit Margin	18.8%
4655.4	10279	11820	12000	11750	11900	Working Cap'l (\$mill)	14000
1334.9	1743.1	2278.3	2400	2500	2600	Long-Term Debt (\$mill)	4000
10954	18746	20804	21000	22500	24500	Shr. Equity (\$mill)	32000
7.3%	5.9%	5.9%	8.0%	8.5%	9.5%	Return on Total Cap'l	12.5%
7.9%	6.1%	6.2%	8.0%	9.0%	10.0%	Return on Shr. Equity	14.0%
7.9%	5.9%	6.2%	8.0%	9.0%	10.0%	Retained to Com Eq	14.0%
--	--	--	--	Nil	Nil	All Div'ds to Net Prof	Nil
97.3	NMF	NMF	46.0	Bold figures are Value Line estimates		Avg Ann'l P/E Ratio	25.0
5.55	NMF	NMF	2.50			Relative P/E Ratio	1.65
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