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2006 INVESTMENT OUTLOOK -- THE BEST PLAYS

Biotech Bets

For risk-takers, these companies could bring big payoffs

Just six months ago gloomy biotech executives used terms such as "nuclear winter" at an industry conference to describe how poorly their stocks were performing. But soon after, major players such as Genentech Inc. () and Amgen Inc. () began reporting good news, ranging from strong sales of current products to promising data on experimental drugs. Their fortunes boosted the entire sector: The Amex Biotechnology Index soared 20.1% from July 1 through early December. In that same period the Standard & Poor's 500 Health Care Index () crept up just 1%.

Despite the bounce, the sector's leading analysts say bargains are out there for those willing to take on a lot of risk. Most biotech companies are still racking up losses as they struggle to get their first products approved by the Food & Drug Administration. Without profits, it's impossible to judge a stock on such tried-and-true measures as price-earnings ratio. Even a hint of bad news can send a company's shares tumbling.

To vet the sector, start with the biotechs that are profitable. Analysts are especially high on giant Amgen. Despite a 27.3% runup in the stock since July, it trades at about 77, or 21 times its expected 2006 earnings. The Thousand Oaks (Calif.) company is ringing up double-digit sales growth on its drugs to treat anemia and rheumatoid arthritis, and its pipeline includes potential blockbusters for cancer and osteoporosis. Yet the ratio of p-e to its estimated long-term growth rate (PEG) is 1.51 -- a steal compared with Genentech, which is trading at a PEG of 2.27. Another biotech large cap, Genzyme Corp. (), is slightly more pricey than Amgen but could pay off for long-term investors. Analysts expect the Cambridge (Mass.) company to continue to bolster its lead in treating enzyme disorders.

When it comes to finding values among smaller biotechs, one strategy is to look for companies whose share prices seem out of whack with their revenue prospects. Tercica Inc. (), for example, is about to launch its first drug, which treats a form of short stature in children. A Dec. 12 approval of Insmed Inc.'s () competing drug sent Tercica's shares down 29%. Still, analysts estimate Tercica's sales could peak at $200 million. Even though the Brisbane (Calif.) company has nothing in the near-term pipeline, "a one-product company is less risky than a no-product company," says Eric Schmidt, an analyst for SG Cowen & Co. With the stock trading at about 7, Tercica's market capitalization is just $222 million, or 1.1 times expected sales. Most biotech stocks trade at four times sales or more, and Tercica's could catch up.

SLEEPER STOCKS

Analysts also are enthusiastic about biotechs that are developing drugs for under-treated diseases. Threshold Pharmaceuticals Inc. () of Redwood City, Calif., is working on a treatment for pancreatic cancer and a drug to treat enlarged prostate -- which affects nearly all men over 60. Yet it's trading 17% below analysts' mean price target.

Among the biotechs that recently made their debut on the Street, a handful may be below-the-radar winners. Many biotech initial public offerings have flamed out of late, causing other new -- but more worthy entrants -- to fall, too. One example is Inhibitex Inc. (), an Alpharetta (Ga.) company that went public in 2004 and is in the late stages of

developing a drug to treat infections in premature infants. Christopher Raymond, an analyst for Robert W. Baird & Co., estimates that if the drug hits the market in 2007, it could pull in $150 million in sales a year by 2010. That makes the stock, which trades at 8.13, worth 15, he says.

While biotech's dreary days are past, the potential for bad news from any one company always looms large. Still, for an investor with a penchant for risk, the sector offers rich returns.

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