Never a Dull Moment

Big moves in share prices – up and down – constantly challenge investors to update the calls they're making. Here's how Atticus Lowe has managed more than his share of "excitement" over the past year.

INVESTOR INSIGHT

Atticus Lowe
West Coast Asset Management

On patience: "We make decisions on fundamentals, but share prices can move for plenty of other reasons. All we can control is the quality of our research."

Editors' Note: *Viewed collectively, the top picks of West Coast Asset Management's Atticus Lowe have performed spendidly since our interview with him just over a year ago [VII, April 30, 2007]. The picks – Noven Pharmaceuticals, Angiotech Pharmaceuticals, Contango and National Home Health Care – have risen more than 19% since the issue appeared, versus a broad market* <u>*decline*</u> *of nearly 7%. To put it mildly, however, the performances of the individual stocks have been mixed. On the positive side, Contango is up 170% and National Home ended up being acquired at a 9% premium. But Noven and Angiotech have both faltered mightily, each down around 50%. Faced with such dramatic moves, we spoke recently with Lowe to see how he has responded to all this activity.*

We're only talking about a piece of your portfolio, but has the volatility in these four stocks been representative of what you've seen lately?

Atticus Lowe: These particular stocks have been a bit unusual. In every company we invest in we prioritize margin of safety, which we thought was larger than it actually was in Noven and Angiotech. In both cases, though, we view it as a temporary loss of capital rather than a permanent one. You just can't control what the market's going to do.

Let's start with the happy news. What's happened with Contango?

AL: When we first bought the stock, Contango had three basic sources of value: a 10% interest in the Freeport liquid natural gas facility off the coast of Texas, proven but undeveloped Fayetteville Shale natural gas acreage, and a large portfolio of prospects in the Gulf of Mexico which were generated by two of the best prospectors in the world. We thought the Freeport LNG interest, Fayetteville assets and a small amount of proven Gulf reserves were worth more than where the stock was trading, providing us with huge option value from the Gulf prospect portfolio. After Contango made one of the biggest discoveries on the Gulf of Mexico shelf in the past 25 years – which keeps getting bigger – the thesis has played out better than anyone could have expected.

Have you held on for the ride?

AL: For the most part, yes. We've added to our position at times over the past year, usually when the market was slow to price in the value of new discoveries announced by the company. Overall, we've trimmed the position somewhat to pursue other opportunities, but it remains our largest investment by far.

With the shares currently around $82, is it time to take money off the table?

AL: Ken Peak, the CEO, has indicated that he plans to sell the company this year. We believe Contango has roughly 300 billion cubic feet of natural gas reserves and that a fair value for that – leaving plenty of upside for a buyer – is $5-6 per thousand cubic feet. At that value, Contango shareholders would net $90-110 per share. On top of that, the company plans to spin off to existing shareholders a new public entity, called Contango Energy, which will hold the remaining prospect portfolio, have enough cash to support it and be managed by the same team.

At today's price, we aren't planning to sell a share. We still expect to get taken out at a significant premium and we'll be in on the ground floor of Contango #2. By the way, with natural gas prices above $11 per mcf, a buyer could pay significantly more than $5-6 per mcf and hedge the relatively short-lived production while still earning a great return. We aren't counting on this, but are certainly optimistic.

What's gone wrong so far with Noven?

AL: Our investment thesis on Noven was three-pronged. The company had a large net cash balance, a very profitable joint venture with Novartis, and a best-in-class proprietary drug delivery platform with low risk and huge upside potential – all of which we got at a bargain price. Noven's transdermal patches are already used in two successful products and the technology can be applied to a wide range of drugs. That's important, because big pharma companies desperately need to find ways to extend the existing product lives of their drugs, and Noven's delivery platform can provide them with a way to do so that's inexpensive and quick to market.

Given that, we and the rest of the market were very disappointed when Noven spent $135 million in cash last summer to buy JDS Pharmaceuticals, with the rationale that they wanted to broaden their portfolio and build their own specialty pharmaceutical business. Not only did drawing down the cash position take away an important part of our margin of safety, but it also called into question our original thesis. Why would they do this when they had all the opportunity in the world – or so we thought – sitting on their plate already?

What did you conclude?

AL: What we did *not* conclude was that the opportunities had diminished. Since we last spoke, the company has separated the Chairman and CEO positions and named heavy hitters to each. The new Chairman formerly ran the $4 billion U.S. pharmaceutical business of Novartis and the new CEO, Peter Brandt, ran Pfizer's U.S. pharma operations. They clearly see the potential that we do and have a sense of urgency to bring new products to market that prior management lacked.

Given the emphasis you put on management, what did you miss here?

AL: It's hard to say. One thing we should have put more emphasis on was the fact that the prior CEO, while he had plenty of options, didn't have much real skin in the game in the form of stock ownership. At the end of the day, he didn't bring the fire that the business needed and instead of using cash to buy back stock at a good price, he used it to buy JDS and ended up losing more than twice in market capitalization what it paid.

We take it you haven't pared your stake?

AL: We have bought a ton of stock around the current price, making it the biggest position we've ever taken at cost. We own about 15% of the company.

With the shares at $12.15, how are you looking at the upside from here?

AL: Noven's primary current asset is a joint venture with Novartis, called Novogyne, which markets a best-in-class estrogen therapy patch. This business has grown significantly since some controversial studies came out about the dominant non-patch competition (Wyeth's Premarin and Prempro products) and it should generate for Noven more than $55 million in pre-tax income this year. At a reasonable 10x multiple, that business alone is worth $350 million assuming it were fully taxed.

The company also has a partnership with Shire Pharmaceuticals, which markets the first patch available for the treatment of attention deficit hyperactivity disorder [ADHD]. This is important because it serves as the proof of concept that the company can create new demand in markets that don't currently have a transdermal delivery option. Without giving this business credit for much growth, we value it at another $50 million or so.

That's $16 per share in value so far. What's left?

AL: What's left is a net cash balance of around $2 per share, the JDS assets which Noven paid $5.50 per share for, and the drug delivery platform and related prod-

INVESTMENT SNAPSHOT

Testing Conviction

The sharp share-price declines in two health care picks made by Atticus Lowe in his *Value Investor Insight* interview a year ago have done nothing two diminish his enthusiasm for the companies' long-term prospects. In both cases he has "backed up the truck" to buy more.

Noven Pharmaceuticals
(Nasdaq: NOVN)

Share Information
(@5/29/08):

Price	**12.14**
52-Week Range	8.49 – 26.151
Dividend Yield	0.0%
Market Cap	$301.4 million

Original Thesis: The market was undervaluing dramatic potential from applying the company's leading transdermal patch technology to deliver a broader range of drugs.

What's Happened: A cash-draining acquisition spooked the market and new-product breakthroughs have yet to bear much fruit. New management now in place.

Response: Bought "a ton" of stock around the current price, believing that the market is vastly underestimating both current operations and still-vast new-product potential.

Angiotech Pharmaceuticals
(Nasdaq: ANPI)

Share Information
(@5/29/08):

Price	**2.82**
52-Week Range	1.50 – 7.90
Dividend Yield	0.0%
Market Cap	$240.0 million

Original Thesis: Concerns over declining stent royalties were obscuring significant value in other current business lines and in dramatic new-product growth prospects.

What's Happened: New-product revenues haven't yet offset declining stent royalties enough to quell concerns about the company's large debt load.

Response: Bought more shares, raising stake to 13% of the company. Still see growth prospects eventually resulting a share price of "multiples" the current level.

uct development pipeline. Management fully expects to make a killing on the JDS acquisition over time. JDS has two branded products in the psychiatry area and recently received approval on a third, but the big potential homerun is a non-hormonal treatment for menopause symptoms that should be entering Phase 3 trials soon. That drug alone is a monumental call option, which could add multiples to the current share price if it hits. To fund further development for it, I'd love to see Noven find a partner who would be willing to pay them a large upfront bonus and share the development costs. This would fit nicely within Novogyne, and it could actually make a material impact for Novartis if successful. There aren't many late-stage products in development with blockbuster potential and a low risk profile, so we imagine Noven could strike a nice deal here.

Regarding the drug delivery business, we know Noven has a number of products in development, but for competitive reasons we don't know what they are, how big the potential is, or when they are expected to reach market. This is frustrating as an investor, but the prior CEO has stated on conference calls that one or two products could reach the market in 2009. We doubt Noven has been casting for minnows, so we expect to see products that will have a material impact.

Is your conviction still equally high for Angiotech?

AL: As we discussed last time, Angiotech helped develop Boston Scientific's paclitaxel-eluting Taxus stent, on which they receive a roughly 6% net royalty. They parlayed this fortune and their drug-coated medical device concept into an $800 million dollar acquisition of American Medical Instruments [AMI] at the end of 2006. AMI sells thousands of high-margin niche products like biopsy needles, sutures, and surgical knives.

The main issues from the market's perspective are the company's high leverage – it currently has $500 million in net debt – and the fact that a decline in Taxus royalties isn't yet being offset in a meaningful way by new products out of their pipeline. Our view, though, is that the company is rapidly turning the corner on new-product revenues and that they have plenty of flexibility in servicing their debt.

Explain first your optimism on revenue.

AL: The big story there is Angiotech's knotless suture, which is gaining market traction at a rapid pace. Sutures are a $2 billion business for Johnson & Johnson's Ethicon division, which basically has a monopoly in the market. But we believe Angiotech's "Quill" technology is a game-changer, saving time and money while providing a stronger hold and better aesthetic results. The sales process is a drawn-out one, but we expect to see very material revenue increases in coming quarters.

Another product we expect big things from is the 5-FU platform, which is a non-traditional antibiotic drug coating that helps prevent infection. The trial results for a 5-FU central venous catheter were spectacular and they just got FDA approval to market it in the U.S. While that's probably a $50 million annual revenue opportunity, we think they can take the platform far beyond that to other implantable devices – in some cases without the need for additional clinical trials.

What about the debt load?

AL: The company has no debt covenants of concern and the earliest any of it is due is five years from now. They're already on the verge of being cash-flow positive on an operating basis and they also have nearly $100 million in cash. Everyone's understandably concerned about leverage these days, but we think the debt here is completely manageable. Given that, we actually like the leverage to equity here and appreciate management's unwillingness to dilute shareholders at the current price through some sort of capital raise.

How are you valuing the shares, currently trading at around $2.80?

AL: Adding back net debt to the company's $240 million market value gives an enterprise value of around $725 million, which is less than they paid 18 months ago for AMI. But the AMI business has actually improved and should earn $50-60 million in EBITDA on $175 million or so in sales this year. Using market comparables on either sales or EBITDA, we believe today's AMI business is worth $550 to $800 million.

That means we're getting the Quill suture business, the 5-FU drug coating platform and the rest of the company's entire product pipeline for free. On top of that, the Taxus royalties will keep coming and we believe the present value of those payments is between $200 and $350 million.

Have you backed up the truck here also?

AL: Yes – we now own around 13% of the company. We see a clear path for Angiotech to become a major medical-device player. They've recently added two world-class leaders from J&J to the management team and named Hank McKinnell, the former Chairman and CEO of Pfizer, to the board. We believe they have the right business strategy in place and just need to keep doing what they're doing.

We wouldn't be at all surprised to see them do something this year to unlock value. They could sell the Taxus royalty interest. They could sell pieces of the AMI business – I would imagine J&J would be very interested in the Quill suture business, for example. If the market isn't giving them credit for the value in place, it might make sense to do something that makes the market take notice.

We admire your enthusiasm.

AL: Nobody enjoys watching one of their stocks go from $6 to $2 when you think it's worth multiples of that. We make our decisions on fundamentals, but share prices in the short term can move for plenty of reasons other than fundamentals. All we can control is the quality of our research. With patience, we think over time we're going to make a lot of money on these companies. VII