Courtney Smith & Co

Company Commentary: Covance, Inc

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Courtney Smith & Co., Inc is an independent research and management firm based in New York. The Company produces research on global macro investments and on specific companies and investments. The Company manages money for high-net individuals and institutions.

The Outlook for Covance, Inc.

The underlying fundamentals are bullish for Covance, Inc. (CVD). This is a solidly profitable company that is in a growing industry and well run.

Our expectations are for the company to outperform the market over the long run as well as do better than most Street analysts.

However, much of the good news is already priced into the market for the stock so we are not as excited about the stock as we are of the company.

Detailed strategies are below but generally we recommend long term investors to wait for a price set back to create value in the stock before entering on the long side.

Covance Description

Covance is mainly a contract research organization. They help pharmaceutical companies to develop new drugs, run clinical trials for them, and even help in the sales of drugs.

We believe that the outsourcing of these functions will continue as the large pharmaceutical companies look to focus more on their core competencies rather than these functions.

According to the Company, these are key factors driving outsourcing:

"Factors Driving Drug Development Outsourcing

It can take up to 12 years and $800 million to develop a new major therapy.

Pharmaceutical companies have more promising compounds in the R&D pipelines than ever before, due to new drug discovery technologies.

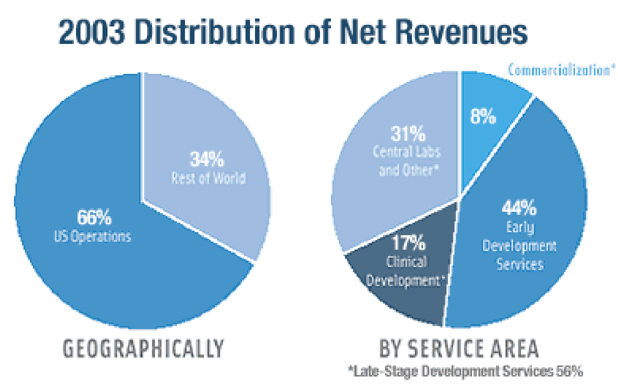
Pharmaceutical companies need to develop drugs faster to maximize patent protection and secure marketplace advantage.

Sophisticated therapeutic and regulatory expertise is needed to successfully develop a compound.

Companies must market globally to sufficiently recoup their R&D investments.

It is risky for pharmaceutical companies to increase their R&D overhead and infrastructure due to the inherent uncertainty of R&D pipeline results."

The company has effectively been in existence since 1997 and has since grown rapidly to just under $1 billion in revenues. The Company shows the current breakdown in earnings:



Fundamentals

The underlying fundamentals for CVD are bullish. The outlook for earnings is positive. Analysts expect earnings of $1.52 this calendar year, $1.85 next year and 19% average for the next five years. We look for $1.56 this year, $1.91 next year, and 20% growth going forward.

We are on the high end of estimates because we are looking for a rebound in the economy and for large pharmaceutical companies to increase outsourcing.

The economy slowed down in the middle of this year due to higher energy prices. We are not looking for a sharp decline in energy prices but are looking for a stabilization at levels below the recent highs. This will have the effect of releasing buying power from energy consumption to everything else. This will lead to higher investment into outsourcing.

We also look for the move for Big Pharma to outsource to accelerate. Big Pharma has been under pressure for the last year or two. Their profits have been under pressure as blockbuster drugs go off patent and little has replaced it.

At the same time, investors have punished Big Pharma stocks also because their cost structure is too high for the returns on those costs. Big Pharma is investing huge amounts into drug research yet showing little return. A move to outsourcing cuts their costs yet still allows management to control the research process. It allows companies to cut off dead end research without having to write off a large investment. In effect, they can cut costs yet have the ability to be more nimble in their research efforts.

So we look for a slightly higher growth than the market does.

The stock has done very well recently largely because earnings have been strong recently. Year over year growth is expected to be almost 26% for the next reported quarter. Clearly, the market and we look for a slowing.

One factor that is bullish is that earnings estimates are increasing which shows that the current surprises still remain to the upside.

CVD's return on equity is 15.52% which is good but not the end of the world.

Total cash per share is $2.44 which we like. There is no debt on the balance sheet. Also a plus.

Free cash flow is a key indicator for us and is running about $106 million. This means that the price/free cash flow ratio is 22 times. We believe this is too high.

One way to look at this is to look at the inverse of this which shows a free cash flow yield of only 4.4%. Remember, a company can only deliver its free cash flow to its shareholders and this is suggesting that it makes more sense to buy ten year treasury notes than CVD stock.

Right now, margins are increasing, operating cash flow is increasing, and the balance sheet is getting stronger.

Insiders only hold 1% of the stock. We believe this is too low and shows that there is not enough incentive on the part of the company insiders to identify with shareholders. Insiders are small sellers of the stock.

Institutions own almost 87% of the company. We view this as a negative because it shows that institutions have already bought all they want and will not be marginal buyers in the future. In fact, institutions are net sellers of the stock over the last three months. They have sold about 1.3 million shares.

Our overall fundamental outlook is bullish but tempered by valuation concerns. The company is growing earnings well and has a good and improving balance sheet. But the stock price is at the high end of valuation metrics.

Technicals

The technical picture is mixed. The price had marched to new highs at $40 per share but then took a nose dive down to $34. It has since recovered to over $38.

The sharp drop suggests that this is a stock nearer to the end of a bull move than at the beginning of one. Prior to this, all retracements were trivial. The bull shrugged them all off.

The Bottom Line/Strategy/Tactics

Our feeling is that Covance is a quality company with a solidly bullish future. However, the price of the stock is no longer cheap and may be overvalued for the tiem being. The technical picture is also suggesting a weakening picture.

For the long run, we suggest holding if you are already long but waiting for a significant dip in price before buying. We need to build in more value before long term investors should consider buying.

Traders should stay long if they are already long but move stops up to the previous lows at about $34. If not long, we suggest looking elsewhere for opportunities.

We are currently long for our money management clients.


CVD Daily
9/03/04
40
38
36
34
32
30
28
26
24
22
20
Volume
©BigCharts.com
3
2
1
0
Millions
Oct
Nov
Dec
04
Feb
Mar
Apr
May
Jun
Jul
Aug

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