

Global Equity Observer

Compounding in Health Care

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Given our increased weighting in health care, we thought we would share how we think about the sector. In health care companies, as in other sectors, we are ideally looking for high sustainable returns on operating capital and predictable long-term growth.

There is no shortage of health care companies generating high returns on capital. Given the generally nondiscretionary nature of the products, on top of structural growth drivers such as ageing populations and improving access to health care in emerging markets, there should also be plenty of companies able to grow in a predictable manner. As the charts below show, health care currently has the second highest return on operating capital employed (ROOCE); it has also grown the fastest and with the lowest drawdown in earnings per share (EPS) over the last 20 years.

While this is an auspicious starting point, inevitably there are some complications, as we discuss in greater detail below.

Patents and generics:

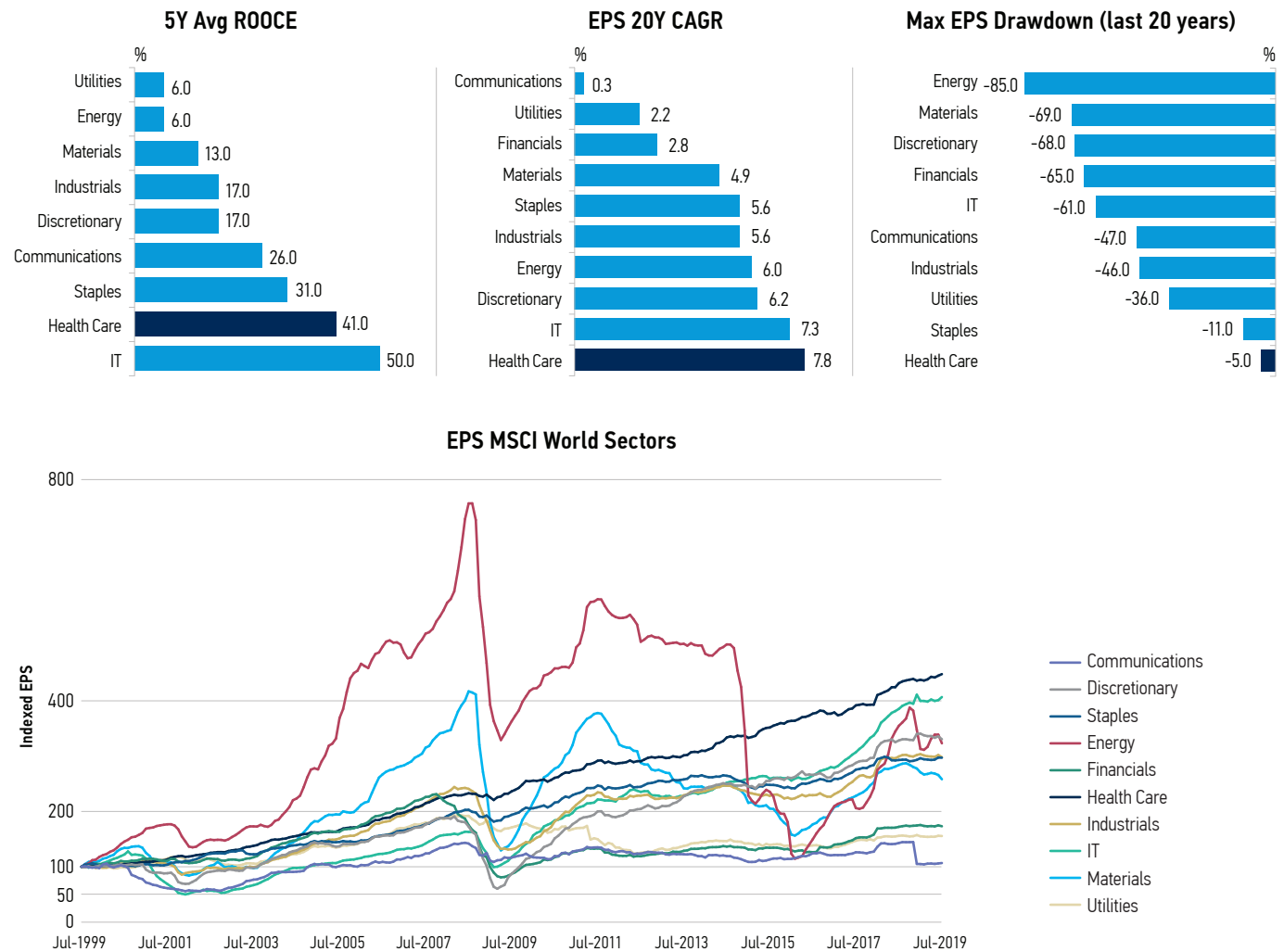
Over half of the MSCI World Health Care Index consists of either pharmaceutical (pharma) or biotech companies where high returns are usually a result of patent protection. A company can generate significant profits on a patented drug for around 10 years, but once this patent expires, sales and profits are generally decimated by generic competition. Without a pipeline of products to replace these lost sales, a company will struggle to grow and its returns will fade. Pharma companies may spend a good proportion of their sales revenues ensuring a productive pipeline, but drug development is a lengthy process and inherently unpredictable. While some companies have more productive research and development (R&D) engines than

AUTHORS



MARCUS WATSON
Executive Director

“Health care has grown the fastest and with the lowest drawdown in EPS over the last 20 years”



Source: Morgan Stanley Investment Management, FactSet, 31 August 2019.

others, it is very hard to assess whether a company that has been productive over the previous 10 years will be productive over the next 10 years.

Single-product companies:

The above issue is exaggerated when a company is reliant on a small number of drugs, a problem affecting a large number of pharma companies, particularly high-growth biotechs. Unexpected competition or safety issues can have a devastating impact on individual drugs. Without suitable diversification, the impact can be disastrous.

Government intervention:

Drug prices are a hugely controversial topic, most notably in the U.S. For years, politicians have tried to find a way to bring prices down to levels seen elsewhere in the world, with very limited success. We are of the view that without moving to

a prohibitively expensive single-payer system it is difficult to achieve anything dramatic. Nonetheless, selling drugs in the U.S. is not getting any easier. We anticipate that a combination of government and private market initiatives will ensure that this continues.

Pricing pressure:

Outside pharma, the patent/pipeline risk is significantly diminished, but other issues exist. Single-product companies can still be at risk. Most notably, pricing pressure is often rife. The trouble with pricing pressure is you have to run to stand still. Small changes in price or volume can quickly reduce an acceptable level of organic growth to stall speed, impairing the potential for compounding. We seek companies reasonably immune from pricing pressure or at the very least where the volume/price dynamics are such that we are highly confident in the long-term organic growth outlook.

“We have a strong preference for companies selling consumables rather than potentially cyclical equipment”

Cyclicalities:

Given the likelihood of predictable recurring revenue streams, we have a strong preference for companies selling consumables rather than potentially cyclical capital equipment, and we keep a close eye on the specific type of consumable that they sell. Some hospital procedures are far more elective than others, and as a result the volume of consumables might be more prone to cyclicalities. For example, one might expect cosmetic surgery volumes to be more impacted by a recession than those for heart surgery.

Our strategy:

We look to avoid, as much as possible, the pitfalls outlined above while benefitting from the previously mentioned prevalence of high and sustainable ROOCE and predictable growth. As is often the case, we spend most of our time assessing what can threaten the sustainability of returns and the predictability of the growth. As always, we insist on good management and a reasonable valuation.

As one might expect, the pool of companies that meet our strict investment criteria is limited, but it has fortunately expanded over the last few years. Four of the health care holdings in our global portfolios have been transformed over recent years by spinoffs. In one case the spinoff was the desirable asset, in the three other cases weaker businesses were spun off, leaving behind three potentially wonderful companies. Even after this, in one case we patiently waited for a reasonable valuation, another required a change in management to transform the returns, and another one finally became investable after an acquisition improved the level of diversification within one of its businesses.

To avoid being too abstract, below are some examples of industries where we have found great businesses:

Animal health – selling medicines for animals has all of the virtues of selling conventional pharmaceuticals, such as high returns and predictable growth. Furthermore, the companies can be very well diversified. R&D output is actually much more predictable than in conventional pharma, but the biggest advantage is that there is very limited exposure to patent expiries and generics – crucially this seems likely to remain the case.

Diagnostics – these businesses sell large bits of equipment to perform diagnostic tests of various kinds. The equipment costs relatively little for customers, meaning there is limited

scope to compete on price. The profitability comes from the consumables required for each test, which are generally supplied on long-term contracts, and as a result is highly predictable. Given the importance of the installed base of equipment, market shares also tend to be very stable.

Hospital supplies – selling syringes and intravenous fluids may not sound like great business, but the barriers to entry are very high. The quality of the product and the reliability of supply is absolutely essential to hospitals, and obtaining a reputation for this is very hard to achieve. Without a strong reputation, persuading a hospital to take your product is extremely challenging. In turn, this makes it nearly impossible to achieve the scale required to compete on price.

“Governance around product quality and business practice is critical to this sector”

Governance around product quality and business practice is critical to this sector. Issues such as device safety, drug pricing or the pollution of water systems with antibiotics or other environmental hazards can quickly become reputational, operational and regulatory challenges for health care companies. Our ESG (environmental, social, governance) integrated approach seeks to identify the key risks and opportunities that health care management should be focused on addressing. Increasingly, society demands that such organisations operate with a sense of social responsibility and use their R&D, science and technology to address the world’s health and hunger needs.

A broad observation is that there is a higher concentration of high-quality health care businesses in the U.S. than elsewhere in the world and that they are far more reasonably priced. While we have found great businesses outside the U.S., they are fewer in number and we generally struggle to find valuations that offer an appropriate margin of safety.

Investing in pharma

Given the above discussions of patents and pipelines as well as our anticipation of an ever-tougher environment for drug pricing in the U.S., it may be surprising to see so many well-known pharmaceutical companies in some of our global portfolios.

These companies do sell pharmaceuticals but they also derive a significant portion of their sales from businesses such as consumer health, vaccines, animal health, crop science and diagnostics. One of our larger holdings generates almost 50% of its sales from a combination of consumer health and vaccines. Furthermore, by having mature drug portfolios, even

in the pharma business it is possible to avoid the twin risks of patent expiries and U.S. pricing. For example, another of our holdings sells a blood-thinning drug where the patent has long since expired but was still generating over one billion euros of sales in emerging markets, growing at 8.8%. There are also certain types of drugs such as those used to treat certain rare diseases where, for idiosyncratic reasons, sales should prove relatively resilient after the patent expires. While our strategy limits the risks typically associated with pharma companies,

we could not claim to avoid them entirely. Nonetheless, the valuations are such that we feel more than compensated for the risks we take on.

Our increased weight in health care reflects that some companies have reached our demanding standards for inclusion. That is, they have the essential characteristics required to generate the high and sustainable returns on operating capital we look for, and in so doing qualify as high-quality compounders.

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