

# Evenlode Global Investment View

January 2019

## The Global Healthcare Industry – Course of Treatment

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Healthcare companies make up a fifth of the Evenlode Global Income portfolio. Our most recent addition to the portfolio in December was US medical testing provider Quest Diagnostics. An opportunity has arisen in the diagnostics space due to changing regulation around the price paid for tests from government-funded scheme Medicaid. Also in the medical arena, portfolio company GlaxoSmithKline announced a restructuring of the business, combining its consumer health division with that of Pfizer with the aim of separating out its consumer and pharmaceutical franchises. These are just a couple of examples of various developments across the global healthcare industry that are reshaping the corporate landscape and the investment propositions available in the sector. As the Evenlode Global Income fund has holdings across diagnostics, medical devices, pharmaceuticals and consumer health, we will take a little time in this investment view to highlight some of the developmental themes.

### Research & development focus

Rewind twenty years and things were rosy for pharmaceutical companies. They had a swathe of small molecules to develop into medicines, large addressable patient populations, and equity prices reflected an easy runway of blockbuster drugs to come. By ten years ago things were different. The low hanging fruit had been picked, and research departments were realising that they couldn't just chuck any new compound at the problem and expect to get a satisfactory number of commercially-viable drugs out at the end of the process. US academic Professor Kenneth Kaitin, an expert on pharmaceutical R&D, wrote in 2010<sup>i</sup>:

*"Few who work in or follow the activities of the pharmaceutical industry question whether change is coming. They know that the pharmaceutical sector, as currently structured, is unable to deliver enough new products to market to generate revenues sufficient to sustain its own growth. Nearly all major drug developers are critically examining current R&D practices and... considering a radical overhaul of their R&D models"*

Things had to change. Anglo-Swedish pharma company Astrazeneca, struggling with low research productivity and facing a patent cliff in the drugs it already had on sale, decided it needed to focus if it were to survive. From chasing prospects addressing virtually any illness, the firm focused on three core disease areas. By focusing on the right target molecules in those areas, the number of projects started in the early stage portfolio was reduced from 287 between 2005-10 to 76 between 2012-16<sup>ii</sup>. Other improvements as part of the firm's '5R' methodology meant significant improvements in the hit rate of the early stage pipeline, producing less wasted effort and better specified drugs at the end of the process. Successful recent launches of oncology therapies such as Lynparza and Tagrisso, amongst others, suggest that this is more than just a nice idea. The resulting improvements in Astrazeneca's top line, profitability and cash flow show why it matters to investors, the latter being particularly important in our search for sustainable and growing dividends.

Other firms have also recognised the need to improve productivity, and we have heard similar stories when we have spoken to Roche, Sanofi and GlaxoSmithKline (on which more later).

## Precision medicine

Helping with the research effort are new data resources and computational tools, from both traditional methods and genetic techniques. Roche are able to simulate medical trials (aided by the recent acquisition of Flatiron), removing some of the need for patient control arms and speeding the early stage development process. Combining with molecular design and genomic profiling, the entire discovery, trial, prescription and therapeutic targeting cycle can be enhanced and provide more patient-specific treatments. Currently this is best suited to oncology, due to relative ease of genomic profiling in naturally focused patient populations, but this seems likely to be expanded into many different diseases in time.

More specific patient diagnoses and treatments are a ‘win-win-win’ for pharma companies, the patients they serve, and the entity that pays the bill. The patient gets a tailored treatment with greater efficiency, and the pharma firm gets to supply the treatment exclusively for a period of time, compensating for the investments made and risk taken in bringing that therapy to market (it is estimated that the entire research and development cost for a new drug averages \$1.4bn<sup>iii</sup>). The payer, be it a government or an insurer, clearly has an interest in getting the right medicine to the patient efficiently, keeping that person out of expensive longer-term care. Precision medicine, assisted by greater testing up-front, allows governments to price treatments on an outcome based model. This allows the government to demonstrably get value for money from the therapies used.

## Operational clarity and efficiency

Some of our investee companies, notably Sanofi, Johnson & Johnson and GlaxoSmithKline, are healthcare conglomerates covering (between them) pharmaceuticals, vaccines, medical devices and consumer/over the counter healthcare. The justification for such a model is that the relatively stable businesses (vaccines, consumer health and medical devices) provide a buffer of stable cash flows for the more variable pharmaceutical businesses, particularly in a cycle low. We believe that there is merit in this argument. However, some argue, conglomerates lack focus and that the underlying business models are sufficiently different to benefit from different capital structures and investor bases.

GlaxoSmithKline has taken the plunge under relatively new CEO Emma Walmsley and is aiming to separate off its pharmaceutical divisions from its consumer health business. By combining Glaxo’s consumer health business with Pfizer’s in a joint venture, the hope is that scale and operational clarity will lead to increased margins and cash flow. This is much needed at Glaxo given its relatively weak cash flow in recent years, and a balance sheet that has been stretched by restructuring and drugs coming off patent. Things have slowly turned around, and time will tell whether the consumer joint venture and ultimate separation of the company accelerates that process. We think it has a reasonable chance of success given new hires into the pharma business and Ms Walmsley’s track record in the first phase of turning around the firm’s consumer division.

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## Market structure & pricing

Away from pharmaceuticals, Evenlode Global Income has holdings in the diagnostics space, both in those that make the tests (Roche), and in those that operate them for patients (Sonic Healthcare and recent addition Quest Diagnostics). Diagnostic testing is important to ensure that the right malady is identified and the correct treatment prescribed. It is vital to patients and providers that testing must be accurate, timely, and affordable. It is in the delivery of those characteristics that lies the competitive advantage of diagnostics laboratory operators like Quest and Sonic, but there is another critical component: Scale. With increasing use of testing as noted above, firms must be able to deliver the volume of tests required at a price that makes sense.

The US diagnostics market (the world's largest) is being affected by the Protecting Access to Medicare Act, or PAMA, which aims to harmonize and reduce costs for the US government, which foots the bill under Medicare. The US is a mainly insurance-based market, and PAMA-related revenues make up only 12% of Quest's revenues, but clearly a fall in pricing in any part of the business is not welcome. There is an unintended consequence of PAMA though, which is that smaller labs, typically 'outreach' laboratories in the community or attached to hospitals, lack the scale to remain profitable and generally have a larger exposure to these Medicare patients. As the biggest player Quest can provide diagnostics services profitably, and the industry seems likely to consolidate under the largest operators. Even in the absence of PAMA, the drive towards quality services delivered at scale is there in what is a fragmented market, and Sonic have recently acquired Aurora Diagnostics (which has little PAMA-affected revenue), cementing its number three position in the US behind Quest and Labcorp.

The US administration has backed itself into an unfortunate position, maintain the PAMA price decreases (which are being challenged on the basis of improper data gathering to set them) and reduce competition in the testing market, or soften the price declines. Either way, the large providers will be able to deliver a high-quality service and benefit from enhanced market share or revenue.

The United States' insurance-based market is maligned by some (especially us in the UK who are used to the NHS), but providers of testing equipment note that it is this structure of the US market that leads to it being the most demanding of the latest technology. To put it another way, Americans want and are willing to pay for the best. In another contrast with the UK, even where NHS-like systems exist like Australia, there is much more use of outsourcing to providers like Sonic. The combination of some global markets driving the new technology forward, and others where it can be deployed to make systems more effective and efficient, provides a good runway for healthcare service providers.

## Innovation and outcomes

Having a blockbuster drug or large diagnostics business is clearly important for a pharma company or testing firm at any given time. But the pharma company needs to deal with the patent cycle and the diagnostics firm must deal with the market's structure, indicating something else that is key to *maintaining* a leading position in the healthcare sector. The institution must have the capacity to innovate, either its products, its service, or both. This is where we feel the real strength of the businesses in the Evenlode Global Income fund lies. Ultimately, if these businesses deliver good

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outcomes for patients and payers, they will be able to prosper and help more people into the future. Only if that happens first will the firms be good for investors too.

**Ben Peters & Chris Elliott**

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*Please note, these views represent the opinions of the authors at January 2019 and do not constitute investment advice.*

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<sup>i</sup> *Deconstructing the drug development process: The New Face of Innovation*, Clinical Pharmacology & Therapeutics, February 2010

<sup>ii</sup> *Impact of a five-dimensional framework on R&D productivity at AstraZeneca*, Nature Reviews: Drug Discovery, March 2018

<sup>iii</sup> *Drug repositioning: Concept, classification, methodology and importance in rare/orphans and neglected diseases*, Journal of Applied Pharmaceutical Science, August 2018