



Setanta Healthcare Sector Review

Introduction

This paper has been produced as a Q&A with Rowan Smith, Healthcare Sector Manager to provide an overview of observations that influence the management of the Healthcare portfolio.

Q: How do you value a Healthcare Business?

A: For most Healthcare businesses, the most productive assets are intellectual as opposed to physical. These include capitalised R&D/patents, brands, relationships with physicians, regulators, etc. These assets, just like tangible assets need to be maintained/replaced. Healthcare companies often replenish assets through R&D and marketing spend, which is generally expensed (although much of it should be considered “investment”). It is virtually impossible to establish in advance a value for this “investment”– some spend will prove utterly worthless, while other spend will be immeasurably valuable. Usually the most important assets are current products and related patents, which if developed internally are not represented on the Balance Sheet. Therefore in most cases, asset-based valuations are not at all useful.

Earnings-based metrics are more useful but amortisation of acquired intangibles can often unfairly depress earnings. When Company A acquires Company B, even if it pays zero goodwill, it will have to amortise the value allocated to the product portfolio acquired. This in effect represents the cost of replacing the product portfolio, as the associated revenues will usually disappear when the patents expire. However the cost of replacing these products should already be reflected in the R&D spend (which is also expensed), *if* the company is investing adequately. As such, the amortisation expense can often legitimately be viewed as double-counting the cost of replenishing productive assets. To look at it another way, an independent Company B would continue to spend on R&D at the same level that Company A now does and its success in replenishing the product portfolio would be dependent on the productivity of that R&D investment, just as is the case under the new owner, Company A. Yet Company A is now recording an additional amortisation expense, whereas Company B would not do so. Despite the economic prospects for the underlying business not having changed the reported profits are markedly different.

Q: What valuation metrics do you therefore prefer at present?

A: I prefer cash-based metrics. However these can also be misleading. One reason for this is that it can be exceptionally difficult to gauge the level of spending required to maintain the productivity of individual corporations. As such low multiple stocks may actually be overvalued due to under-investment, whereas high multiple stocks may be cheap due to significant yet highly-profitable reinvestment. As R&D output tends to be highly unpredictable it is extremely difficult to spot the traps in advance. This problem (i.e. estimating the replacement cost of assets) is not exclusive to Healthcare but is particularly evident in this sector. Most businesses within the economy possess relatively mundane assets (tangible PPE and working capital) which will produce a cost of capital return over the cycle. The value of the assets should be roughly equivalent to the cost incurred in acquiring the assets. Whilst healthcare assets can be different, this principle should still essentially hold true in aggregate for the Healthcare sector but individual cases can differ dramatically from the average. Thus it is extremely difficult to estimate how much it will ultimately cost to maintain a current profit level for many companies in my sector.

For the sector overall, the R&D to sales ratio has remained high (Exhibit 1) yet, in particular for the traditional drug companies, the return on this investment has been disappointing over the past ten years or more, with a few exceptions (Exhibit 2).

Exhibit 1: (Median)R&D as % Sales for 25 Top Healthcare Companies (data on 16 since 1991)

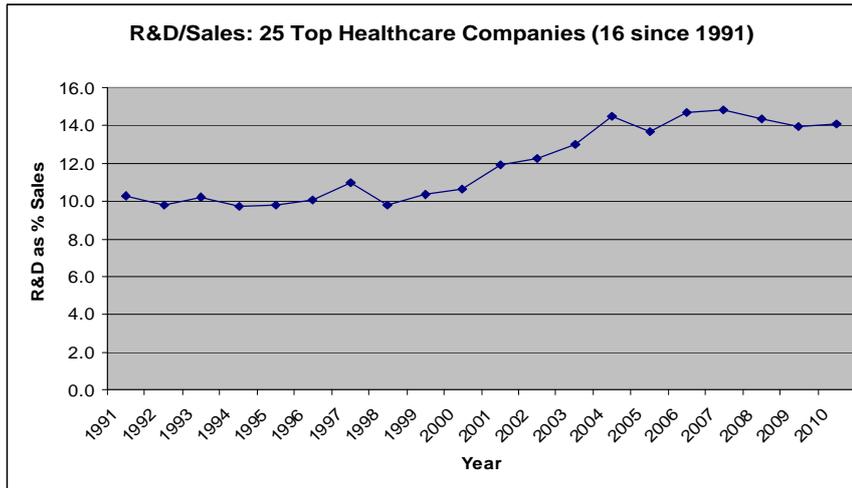
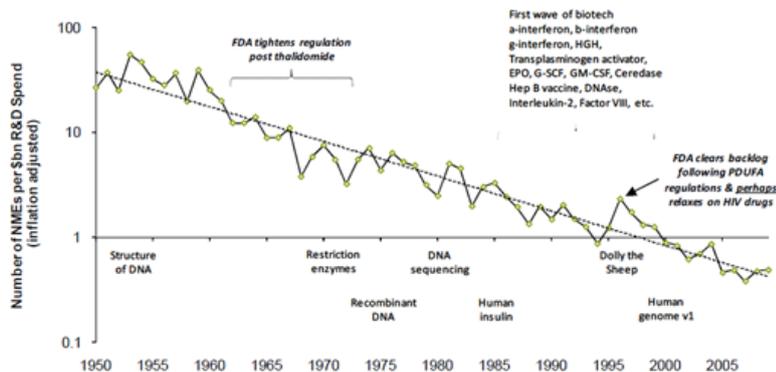


Exhibit 2: >100x increase in inflation-adjusted cost of finding a new drug entity over the past 60 years – Bernstein Research Sep 30th 2010

Exponential 100x decline in R&D productivity despite major advances in biological science and technology



Source: Munos in Nature Reviews Drug Discovery 2009, the FDA, Paraxel R&D Statistical Source Book 2009/10 and Bernstein estimates.

Note, that R&D costs are estimated from PhRMA Annual Survey 2009 so under-estimated R&D spending at an industry level, while NMEs are the total number of small molecule and biologic approvals by the FDA. Costs per NME are higher today if one also adds the R&D costs of smaller drug companies and the biotech sector. We have estimated real-term R&D cost inflation figures from Munos. The overall picture seems fairly robust to the precise details of cost and inflation calculation.

Drug companies have been able to mask this trend with cost-cutting and significant price increases, which have helped to offset the impact of lost sales as patents have expired. However it will not be possible to sustain this indefinitely. Anecdotally, there have been increasing instances of manufacturing deficiencies amongst drug companies (which may indicate under-investment) and governments and private insurers are exerting opposition to price increases.

Drug sector bulls claim that the pipelines come for “free” at current prices. I do not subscribe to this view at all. Based on my simplistic DCF valuation exercises, using a 10% nominal required rate of return, drug stocks are worth about 60% of current prices if the companies continue to invest in R&D but achieve zero return on their investment (i.e. no new drugs). Such a scenario is highly unlikely but would be characterised by a profile of steady cash flows for circa ten years followed by a rapid fade. Alternatively, if all R&D were scrapped immediately drug stocks appear fair value using a 10% nominal required rate of return. Such a scenario is also highly unlikely but would be characterised by even higher cash flows for circa ten years followed by a rapid fade. We can thus infer that if R&D investment is to earn a cost of capital return (10% nominal), then the stocks are priced fairly. While such exercises are very simplistic my general impression is that drug stocks are priced to deliver cost-of capital returns on R&D investment and if achieved the stocks should deliver us our required nominal 10% rate of return in the long-run. This of course assumes that management will be disciplined in investing other undistributed cash-flows.

Q: Do you think the sector is reasonably valued?

A: My conclusion is that drug stocks are reasonably good value but overall I do not believe there is the wide margin of safety that some believe. I do not believe that aggregate returns above the cost of capital are likely. Furthermore, there is likely to be a wide dispersion in outcomes between companies. This is because of the highly uncertain nature

of the return on investment in R&D as well as the varying impact of competition on existing products. This is particularly the case for drug companies – relative to medical products companies for example. In general, traditional drugs generally have a finite lifespan: when the patent expires, developed distribution structures (i.e. the pharmacy network) simply replace the drug with a chemically-identical copy provided by a generic company for a fraction of the price. The market for generic biotech drugs is beginning to open-up in Europe and the US for the first time. For various reasons the impact is not likely to be equivalent to that witnessed in the traditional drug industry, but this is a legitimate concern for biotech investors that was not really visible just five years ago. It is vastly more difficult to prove that a “generic” medical device or service is identical to the original and the fragmented distribution networks are not conducive to easy transmission of cheaper copies of such products/services. For this reason, *if all else is equal*, medical product/service companies seem to provide superior risk-reward propositions for investors.

To expand on this investment in R&D further; while the potential return on incremental R&D for a drug company is higher than for a typical medical products company (such as Steris or Medtronic for e.g.), asset lives are shorter and the cost of investment is higher with the probability of success usually lower. The presence of a well-developed generic industry poses a substantial investment risk for investors in drug companies that is not present to the same degree in the medical device/products universe for example.

Bottom line: it has become clearer to me just how misleading static valuation metrics can be in this sector. Is that 9% free cash flow yield really attractive if the reinvestment outlay fails to achieve its objective of replacing finite assets? Differing asset lives and varying returns on R&D and marketing investment can significantly diminish the usefulness of such metrics. Drug companies, which are trading on amongst the lowest multiples of cash flows/earnings in the sector and represent the largest sub-sector, present investors with possibly the greatest reinvestment risk of all sub-groups. This risk is exacerbated by increasingly aggressive attempts to buy a way out of trouble by acquiring “growth” businesses (Asia, Consumer health, Biotech). As such the current low multiples that drug companies trade on *may* represent “value-mirages”. My judgement at this point is that we are being adequately compensated for this risk at current prices in our key holdings.

My failure to recognise the full-implications of the above valuation conundrum has resulted in significant opportunity cost for the fund over the past 8 years. Ironically, given current valuations, it is probably too late to do much about this now. With regard to tackling the particular challenge posed by estimating reinvestment cost, I propose no easy solution. However it seems logical to favour companies that are less exposed to this reinvestment risk (medical device/product/service companies) in addition to diversified companies that are more likely to achieve average returns.

Q: What are the most common ‘destroyers of value’ in the Healthcare Sector?

1. Lack of Capital Discipline by Management

Taking a very simple example of Company X, which operates a decent business and trades on a (real) free cash yield of 8%; a yield we determine to be adequate. For the stock to be worthy however we must believe that ALL of the retained cash flows (i.e. anything we don’t get) will be reinvested to produce a return of at least 8% p.a. real. The higher the portion of retained cash flow, the longer the duration of the investment, and the greater the risk for shareholders if management invests poorly. The worth of a business is usually determined by its performance over 30 or more years. Light years separate companies that can invest well over a 30 year period and those that invest poorly over 30 years. Therefore Return on Capital is of immense importance. Measurement of return on capital is a somewhat nebulous subject. There are all sorts of weaknesses with accounting data that can weaken the utility of GAAP-based returns. However the fact remains that unless stock valuations are so low as to imply value-destruction, we as shareholders must believe that management will achieve returns on incremental investment at least equal to our required rate of return.

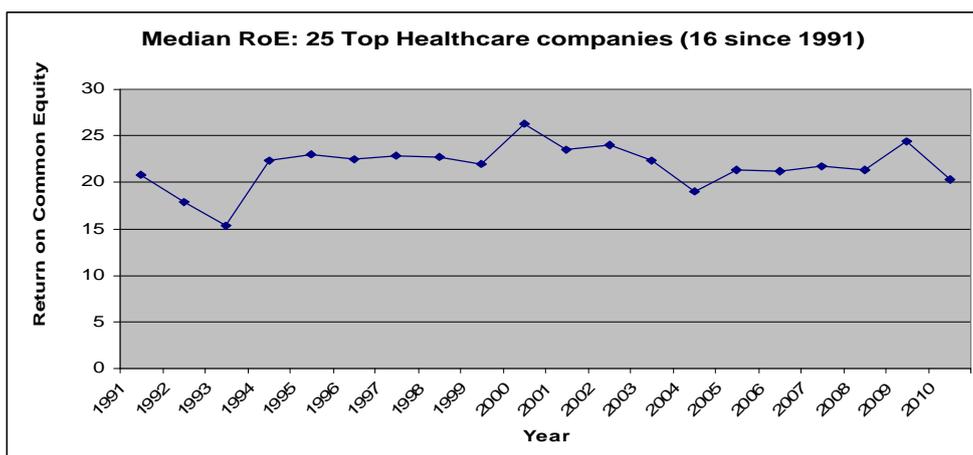
On this point alone I have ruled out a number of potentially attractive investments in recent times. Seemingly every company aims to get bigger: this is worrisome because it can’t make sense for everyone to grow. Virtually every manager I have ever asked has claimed that management has a mandate to earn an adequate Return on Capital, but I remain deeply sceptical in most cases as only very rarely do I see such criteria embedded in incentive goals. I regularly see deals consummated at prices that I don’t believe will generate a reasonable return in the absence of good fortune. More and more I see company management as being one of the most dangerous adversaries of rational investors. For this reason, I am increasingly of the view that whenever I find a company with a management team that I believe has the intention to invest capital only when it makes sense, I should back it quite heavily, even if it means paying up some premium (note: these companies appear to be extremely rare). As an aside, Biotech has been the worst-offending group in terms of capital discipline and regard shareholder value, with glamorous growth companies in general scoring poorly in this regard.

2. Profit Margins – Will they revert to the means?

Whilst RoE/RoC metrics for the healthcare group appear very high this fails to recognise the capitalised value of investment in R&D, brands, etc. Actual economic returns are almost certainly much lower. If we consider that the long-run real return from equities in the US has supposedly been around 6.5-7% (~10% nominal), I believe this is probably a good approximation of the real return on equity for the market as a whole. My best guess is that most companies in this sector (and probably in all sectors) will not be able to achieve incremental real returns on capital invested above this level and some will do worse as they aggressively pursue expansion. For example, a report from Mckinsey suggests that current R&D spend on traditional pharmaceuticals generates a nominal IRR of only 7.5%, i.e. below the cost of capital. I have not seen the data behind this calculation but if it is accurate I'm not shocked. With this in mind, companies with strong business foundations, rational management and opportunities to invest profitably for growth should serve investors best, provided the shares can be purchased at attractive prices. My hunch is that for many other companies (most of the large cap drug companies for e.g.), the best investment they can make, after core investment in R&D and marketing, may be to buy their own stock when prices are reasonable/low and/or to pay high dividends, as opposed to making investments in "growth businesses". This is happening to some extent but the obvious disposition of most management teams to make acquisitions causes me worry. I also am wary of mindless ongoing share buyback programs that are active even at high prices.

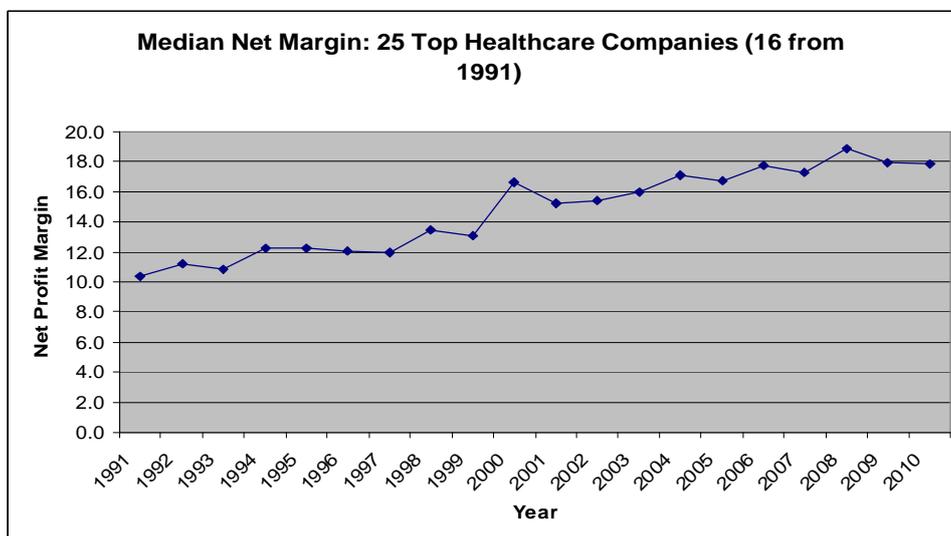
Profit margins deserve some mention. Whilst my data (Exhibit 4) is biased by survivorship effects, we have noticed a phenomenon across the entire market characterised by rising profit margins in recent years. This is worrisome as it is not clear why this should be sustained in the face of the usual tendency to revert to the mean.

Exhibit 3: Median Reported Return on Equity for 25 Top Healthcare Companies (data for 16 from 1991)
Mckinsey Quarterly Feb 2010.; "Pharmaceutical & Medical Products Practice; the road to positive R&D returns"



Mckinsey Quarterly Feb 2010.; "Pharmaceutical & Medical Products Practice; the road to positive R&D returns"

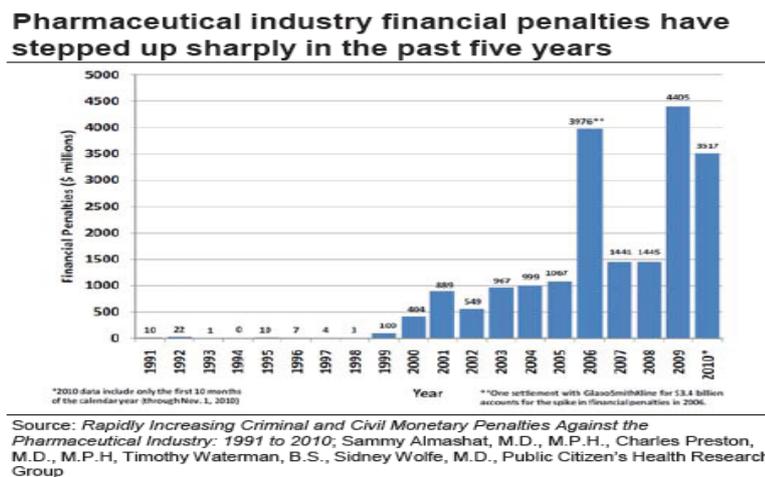
Exhibit 4: Median Net Margin for 25 Top Healthcare Companies



3. Litigation

Provisioning for legal costs represents a potentially significant and often unaccounted for drain on earnings power. These relate to a range of matters, such as the sale of unsafe medicines, Intellectual Property disputes and over-charging government agencies. It is often difficult to gauge the cost of these for a number of reasons. Disclosures tend to be limited with defendants keen not to admit to liability or to provision until responsibility and cost becomes quite apparent (for fear of coaxing plaintiffs). Also costs can be very lumpy resulting in a tendency to completely ignore these as “non-recurring”. Anecdotally it seems to me as though these costs are generally increasing in prevalence and the following chart from Morgan Stanley supports this. Some sub-industries are more prone to suffer these costs than others, with Pharmaceutical companies seeming most prone. My crude approach to dealing with this now involves reducing my estimate of earnings power by 10% to account for this, in the case of drug companies. I believe this is probably conservative on average.

Exhibit 5: Financial Penalties within the Pharmaceutical Industry



4. Other

Other forms of drain on earnings power or investment return are the cost of value-destructive acquisitions (most acquisitions probably fall into this category), equity-based compensation, convertible debt, dividend withholding tax. On dividend withholding tax; this is something we are inclined to ignore but we should not. Over the years we have been investing more in high-yielding stocks. The dividends usually incur a tax penalty which can be very expensive cumulatively. We need to make sure we are accounting for this in our valuation-work.

Q: What other factors are important in the Healthcare Sector?

A: Demographic and Social Factors

We all know by now that the global population is growing and ageing, with ageing most notable in the west. The following chart highlights that over the net 20 years the population aged 65 and above in the US is expected to increase by almost 80% (3% p.a.), versus less than 20% for the rest of the population (1% p.a.).

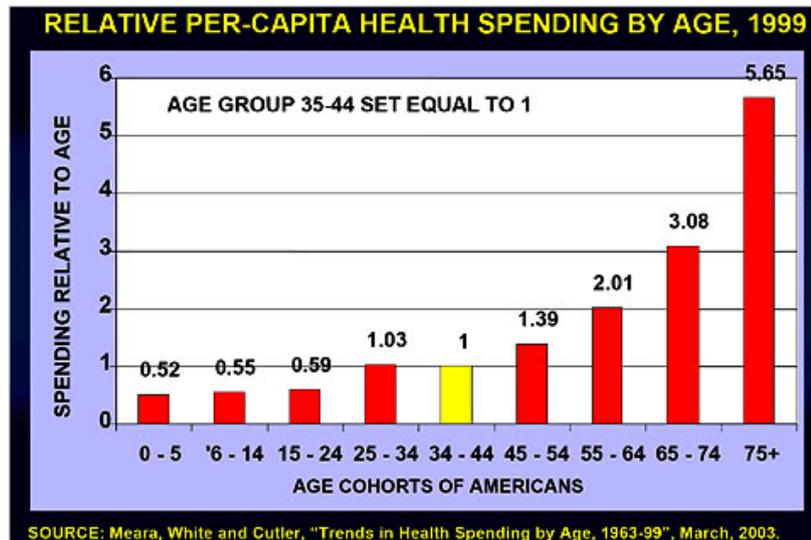
Exhibit 6: Greying population

Shifting Demographic Landscape

Age Groups	Total % Change in Population		
	5 Years	10 Years	20 Years
0-14	5%	9%	17%
15-29	2%	4%	12%
30-44	3%	8%	16%
45-54	-3%	-7%	-2%
55-64	12%	19%	11%
65-74	26%	51%	81%
75-84	4%	22%	89%
85-94	8%	11%	48%
95+	22%	51%	89%

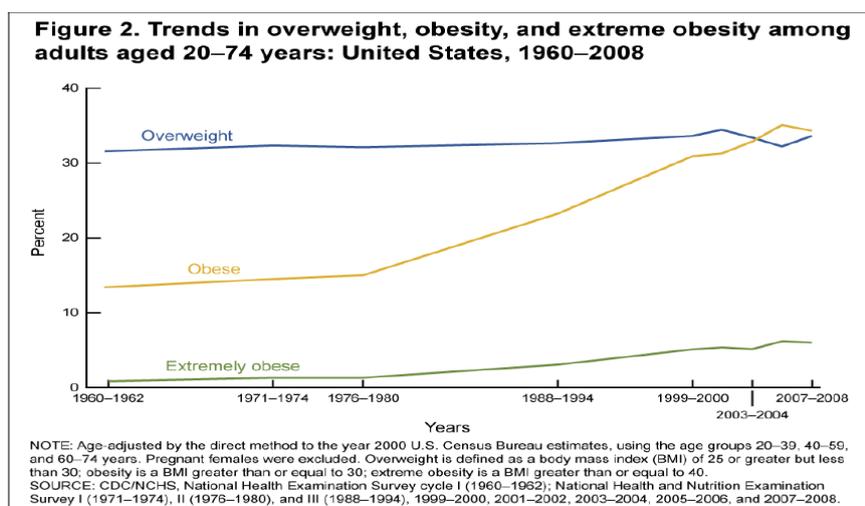
The cost of annual healthcare for a 65 year old is as much as three times that for a 40 year old, with a 75 year old costing up to twice as much again. This has many implications. One suggests a supportive backdrop for companies selling products/services to this increasingly demanding customer base. On the minus side the consequent financial pressures may result in continued attempts at significant reform of the Health system. As yet such attempts have had relatively minor impacts. The most recent effort in the US (“Obamacare”) has served primarily to broaden access to healthcare and as such is appears likely to be a long-term net positive for providers of valuable products/services.

Exhibit 7: Step-change in cost of Healthcare for 65+ years



Obesity is closely linked to a range of chronic and expensive-to-treat medical conditions such as diabetes and heart disease. Although this is a global concern, the statistics for the US in particular are quite staggering (see exhibit 8). For the first time in our evolution, humans currently have access to abundant and cheap calories. We are running a great experiment and the early results are concerning. This phenomenon enhances the supportive backdrop for healthcare companies.

Exhibit 8: Rising levels of obesity in the US



Q: Which area of the Healthcare Sector do you see as offering the best investment opportunity?

A: Based on my preferred measures of valuation (historic cash-flow and earnings-based metrics), Large Caps offer the best opportunities, with Pharmaceuticals appearing to be the most attractive sub-group. Depending on how successfully assets are replenished and how surplus capital is reinvested, these statics metrics may prove highly misleading, but are a useful starting-point. Small-/Mid- caps, especially those in glamorous segments such as biotech and diagnostics, seem to perennially attract a glamour- (or bid-) premium. The unfortunate reality that many of the large cap companies seem inclined to acquire these small- and mid-caps should perhaps result in some valuation-spread being maintained, but these spreads appear, in many cases, too wide currently. This explains our heavy exposure to large-caps. This heavy exposure to the largest stocks in the sector makes it more difficult to out-perform the benchmark.

Companies with “moats” are immediately attractive. As implied above pharmaceutical companies can possess such characteristics but their assets are often shorter in duration and reinvestment risk is often highest. Therefore medical product/device companies and service providers may prove to be a better source of ideas, valuation permitting. We are always on the look-out for under-valued “self-help” stories and “out-of-favour” investments in general.

Within the confines of the requirement to remain fully-invested, I will always attempt to preserve capital first and foremost. In this context the current portfolio consists primarily of large cap stocks with durable businesses which are confronted with challenges that I believe the market is mis-pricing somewhat. I would describe all of our investment as financially-robust. Our portfolio has been broadly similar for many years. Our results have been reasonable but I am hopeful that our results in the future will be better. In my opinion, investors are currently over-valuing “hope” and as long as this is sustained it might prove difficult for our portfolio to significantly out-perform.



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