

The growing attractions of investing in healthcare

By Nick Armet, 31 March 2010

The healthcare sector is getting interesting again. A series of recent mergers and acquisitions are transforming the outlook for the sector meaning that investors have cause to be bullish for the first time in several years.

The hullabaloo over President Obama's healthcare reform bill has brought the global healthcare sector back into public focus. Healthcare stocks have generally been off investors' radar screens for some time. There are, however, a number of reasons why they could be about to make a comeback. And not just because, the successful passage of Obama's bill removes a cloud of uncertainty from the sector.

Healthcare shares have endured a troubled time from their sweet spot in the 1990s when companies saw fast growth based on blockbuster products and healthy drug pipelines. Despite high levels of R&D, new product development failed to keep pace with investors' expectations. This, combined with the threat of expiring patents on leading drugs and growing competition from lower-cost generic manufacturers, brought about a sustained de-rating of the sector over the last decade.

Recently, however, there have been some encouraging signs of a change in strategy among the large pharmaceutical companies. We have seen a wave of intelligent deals that have the ability to transform the outlook for a number of companies and the overall shape of the industry.

Last year, Pfizer bought Wyeth, Roche completed its acquisition of Genentech and Merck merged with Schering-Plough. These purchases have significantly boosted the product pipelines of the enlarged firms and provided cost-cutting opportunities and free cash flows that are not yet reflected in share prices.

Patent expiries have been a major driver behind this wave of creative corporate activity. For example, Pfizer's multi-billion dollar revenue generator, Lipitor (an anti-cholesterol drug) goes off patent in 2011. The good news for investors is that depressed share valuations currently discount the loss of revenues from these patent expiries.

HEALTHCARE STOCKS ARE CLOSE TO HISTORIC LOWS



Source: DataStream, 02.01.1973-15.02.2010.

The large pharmaceutical companies are also finally dealing with the threat of generic competition. In 2003, Novartis made the initial move to take the low-cost manufacturers on at their own game by moving into the generics market when it set up its Sandoz arm. Sandoz is now the world's second-largest seller of generic drugs, after Teva Pharmaceuticals.

In recent years, the rest of the industry has followed Novartis' lead. Japanese company Daiichi Sankyo bought India's leading generics company Ranbaxy, while Sanofi-Aventis acquired the Czech company Zentiva. GlaxoSmithKline signed a deal with South Africa's Aspen PharmaCare to sell generic products in fast-growing emerging markets. And, we can expect to see more deals going forward.

It's not just about mergers and acquisitions though. There are a number of other interesting drivers that make the outlook encouraging for healthcare stocks:

- **Increasing demand for healthcare** - People are living longer. The World Health Organisation estimates that the world's population aged over 60 is likely to treble from 600 million in 2000 to 2 billion in 2050, mostly in developed countries. Rapidly ageing populations, coupled with economic and population growth in emerging countries, is likely to increase the healthcare industry's customer base significantly as the proportion of income spent on healthcare rises. As people live longer, this results in increased demand for particular products such as orthopaedic products (e.g. hip replacement), eye care, and hearing aids.
- **Unmet medical needs** - Chronic disease areas present the largest growth potential for healthcare companies in developed markets. The WHO predicts that the incidence of death from diseases such as chronic obstructive pulmonary disease (COPD), cancers and diabetes/metabolic conditions will increase from less than 20% in 2005 to almost 30% in 2030. In terms of their R&D spending, pharmaceutical companies are increasingly focusing on chronic diseases. Half of the US population is set to be classified as obese (a body mass index in excess of 30) by the end of this decade and the prevalence of diabetes has more than doubled over the last 25 years.
- **Growth of generics** - There is huge growth potential for the generics industry, with opportunities in both emerging and developed markets. Building on recent developments, the lines between the traditional R&D-driven, large pharmaceutical companies and generic manufacturers will increasingly blur.

In summary, the healthcare industry seems to be undergoing something of transformation. Beneath the surface of an overlooked sector, underappreciated cash flows, strong emerging market growth potential and interesting corporate activity give investors a number of reasons to be bullish for the first time in several years.

Moreover, there seems to be limited scope for downside. Amid the current uncertainty in stock markets, investors may want to de-risk their portfolios. If we were to see a period of market consolidation, the health care sector should outperform due to its safe haven status and relatively defensive earnings. Beyond that, the sector seems to be ripe for a re-rating as investors realise risks are priced in and valuations are attractive in the light of many encouraging developments.

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