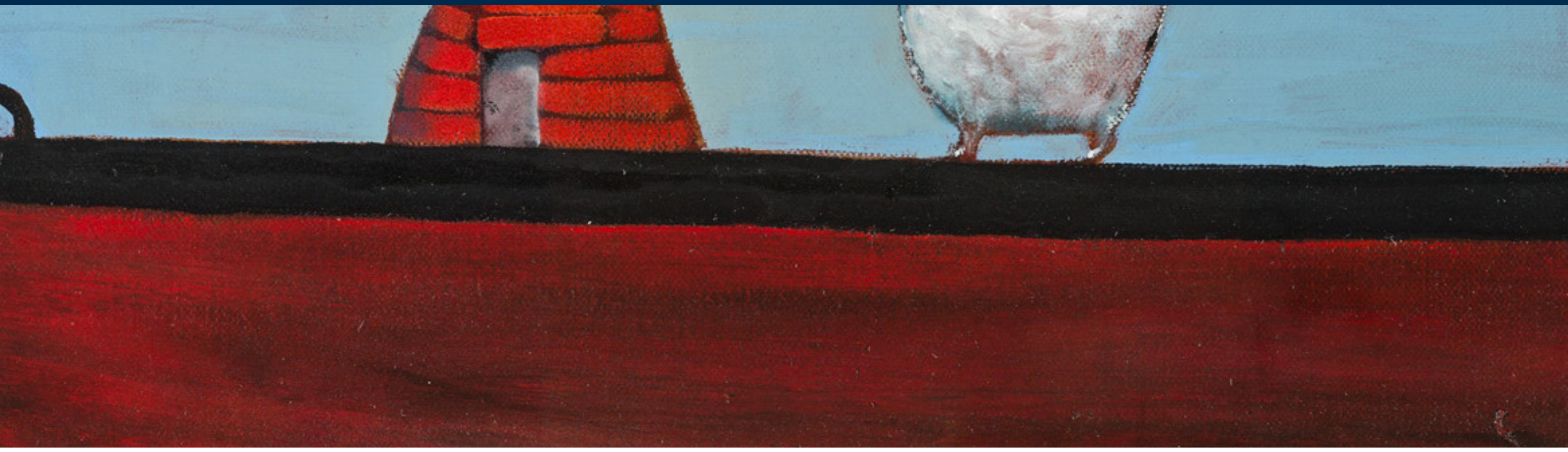
WALTER SCOTT

BNY MELLON | INVESTMENT MANAGEMENT



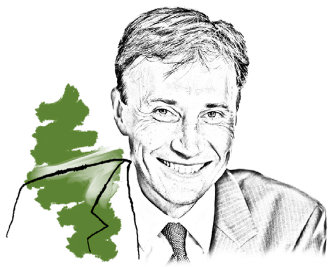
FOR USE BY INSTITUTIONAL INVESTORS ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

A HEALTHY BALANCE

Article

FIRST PUBLISHED 23 JULY 2019

The healthcare industry will continue to be driven by growing wealth around the world, ageing populations and rapid advances in treatment. Rising demand creates new pressures, however, forcing companies to balance profitability, productivity, the patient and public service. Walter Scott's Co-Head of Research, Alex Torrens, and Investment Managers Tom Miedema and Maxim Skorniakov consider the opportunities and challenges ahead.



ALEX TORRENS
Co-Head of Research

TOM MIEDEMA
Investment Manager

MAXIM SKORNIAKOV
Investment Manager

ALEX TORRENS: The healthcare industry has been an area of particular interest since the firm's earliest days. Today, we invest across the sector – in pharmaceutical and biotechnology companies, medical technology firms and the odd private hospital. Why? Because the underlying social, political and economic trends mean that there are ample opportunities to find growing, profitable, sustainable businesses that meet our investment criteria.

TOM MIEDEMA: If we look at demographics, developed markets are ageing, but certain emerging markets are ageing rapidly as well. China, Thailand and Korea, just to name a few examples. At the same time, there is a real shift in the provision of care, as governments try to provide healthcare services to most of the population rather than a subset of wealthy or well-connected individuals. Obamacare exemplifies this trend, but China and India are really trying to provide improved access to reasonable care, too. This brings clear challenges.

"If someone can be diagnosed accurately, time and money aren't wasted on treatments that won't work. If you can decode someone's genome, you know what treatments they won't respond to. Conditions can then be managed or even treated more accurately, and often earlier."

TORRENS: In China, for example, there is a lack of historic infrastructure and a shortage of trained professionals, so companies are working on incremental diagnostic tools and treatments to overcome these issues. For example, one medical devices business has a robotic platform, which is a diagnostic tool used to carry out minimally invasive lung biopsies. It is being targeted at China, because lung cancer is a huge and growing problem there and, without technology, it will just not be solved.

MAX SKORNIAKOV: Diagnostic companies also have a critical role to play in healthcare because identifying issues early can make such a difference. Advances in genetic testing play a key part in this. For instance, one company is developing diagnostic tools based on analysis of genes, cells and proteins, which provide an incredibly detailed picture of what is happening in the body and what might happen in the future.

TORRENS: The whole area of diagnostics is fascinating. Some pharmaceutical companies focused on, for example, cancer drugs, can now also incorporate impressive diagnostics divisions. And that really adds value, because at a time when there is a growing focus on costs, there is a growing realisation that better diagnostics can generate huge cost savings and remove waste from the healthcare system. Clearly, if someone can be diagnosed accurately, time and money aren't wasted on treatments that won't work. If you can decode someone's genome, you know what treatments they won't respond to. Conditions can then be managed or even treated more accurately, and often earlier.

"There is an interesting dynamic that applies across the healthcare sector between clinical outcomes, the standard of care and affordability. Can companies deliver on all three and still generate robust profits?"

SKORNIAKOV: There are clear implications for patients' welfare, too. Studies have shown that over 50% of cancer drugs don't work. The physical and emotional repercussions are huge, both for the patients and their families. Genetic profiling can really help to personalise medicine so that patients get the treatment they really need.

TORRENS: And when the cost of some drugs runs into six figures, the benefits of getting it right become ever more clear.

SKORNIAKOV: But reducing costs and waste does not only revolve around personalised medicine. Looking back 30 years, radiation therapy technology was much less sophisticated, so large areas of the body were targeted when treating patients. Today, treatments and solutions can be much more targeted, so outcomes are better and, ultimately, costs are reduced.

MIEDEMA: There is an interesting dynamic that applies across the healthcare sector between clinical outcomes, the standard of care and affordability. Can companies deliver on all three and still generate robust profits? This is something that we analyse extremely carefully. We believe they are all interlinked, but the provision of care to a very high standard comes first. From an investment standpoint, you then need to see whether management is properly incentivised to focus on consistent clinical excellence. And, of course, you have to look at patient outcomes and ensure they are sound.

TORRENS: There is also a judgement to be made around profitability and innovation. How much profit does a company need to generate in order to justify the investments it makes upfront? And there is the question of how customers elect to use that technology. For example, if a hospital invests in a $2.5 million robotics system and it manages its business, throughput and utilisation well, there are huge

savings to be made in terms of shorter hospital stays, fewer complications, less blood loss and such like. All of that has a notable impact on the bottom line – quite distinct from the personal aspect, such as smaller scars, shorter convalescence and better ultimate recoveries, which can make a real difference to people's lives.

MIEDEMA: Companies can deliver affordability and excellent levels of care by doing things better and by doing things at scale. They can procure at scale and save costs. They can buy the best systems and get high utilisation. They can drive efficiency and create well-run organisations that do the basics right, particularly as there is so much waste in healthcare, almost irrespective of where you look. Standards of hygiene are often poor, people end up staying in hospital too long because of infections and basic issues are overlooked, so there are massive savings to be made just by doing things better. And when it comes to drugs and devices, companies that deliver the best medicine or the best tools provide tangible benefits for patients. Ultimately, that means better, more cost-effective healthcare.

TORRENS: There has been a lot of controversy in the industry about overcharging, but if a company is price-gouging, it will be caught out by customers, the media, competitors, regulators or any number of interested others. That said, there is widespread agreement today that healthcare expenditure is a growing problem and there are undoubtedly some bad actors in the sector. As we look for businesses that can produce sustainable returns over the long term, we pay close attention to pricing and, when we invest in a company, we ask if it can genuinely justify the prices charged.

MIEDEMA: The issue also has to be looked at more broadly. Individual drugs may seem very costly, but finding effective new drugs is incredibly challenging and expensive. So overall return on investment is much lower than the returns made on individual successes. And if governments want to incentivise that overall huge research effort, they have to be careful about how they approach the industry. The other nuance to recognise is that the US is funding a lot of this research and US pricing is on a different level from anywhere else in the world.

TORRENS: The US spends more on healthcare as a percentage of GDP than any other country, so it is fostering innovation and the rest of the world benefits.

"If a hospital invests in a $2.5 million robotics system and it manages its business, throughput and utilisation well, huge savings can be made."

MIEDEMA: And those benefits are particularly notable when drugs come off patent. Bio-similars of previous generations of drugs mean that cash-strapped health services and emerging markets will have access to treatment that would not have been available to them before now.

SKORNIAKOV: Culture is a very important factor, too, when it comes to investing in healthcare. Integrity of pricing, the approach to a product recall, the attitude towards the end patient amongst other issues all very much stem from a company's corporate culture. We make sure that we don't just meet the CEO or CFO of the companies we invest in; we also go on site visits and visit managers in key markets around the world.

TORRENS: Those visits are an essential part of our toolkit. Fundamental analysis and studying an individual company's track record and performance are clearly vital but meeting the management and seeing the way the business operates provides an extra level of insight. That is true of every company, but it is especially relevant in healthcare, where good outcomes at the human level are absolutely critical. Many of the leading companies in this sector have a passion and a purpose that is unrivalled. They are the ones best-placed to navigate the complexities of this industry and are the ones we aim to invest in on behalf of our clients.

IMPORTANT INFORMATION

This article is provided for general information only and should not be construed as investment advice or a recommendation. This information does not represent and must not be construed as an offer or a solicitation of an offer to buy or sell securities, commodities and/or any other financial instruments or products. This document may not be used for the purpose of an offer or solicitation in any jurisdiction or in any circumstances in which such an offer or solicitation is unlawful or not authorised.

This article is from Walter Scott's Research Journal 8 (**May 2019**)