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PODCAST TRANSCRIPT

TALKING RESEARCH - Q3 2023 UPDATE

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Katie Boyce:
Hello and welcome to Talking Research. I'm Katie Boyce, an investment writer at Walter Scott. This podcast is an opportunity to hear first-hand from members of our Research team as to



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what they've been up to and the topics at the forefront of their debates. Joining me in the studio today are investment managers Paul Loudon and Lindsay Scott. Paul has been



PAUL LOUDON
Investment Manager

at Walter Scott for almost ten years, having first been an intern back in 2008. For much of this quarter, he has been chair of the Research team. Lindsay has been at the firm for almost 20 years, and today she's here to talk

about obesity or, more specifically, the ground-breaking, hugely topical and sometimes controversial obesity drugs that have been developed by Novo Nordisk and Eli Lilly. Paul, Lindsay, welcome and thank you both for being here today.

Lindsay Scott:

Hi, Katie.

Paul Loudon:

Great to be here.

Katie:

Let's start with you, Paul. I mentioned that you've been chair of the Research team. Briefly, what does that role involve?

Paul:

Members of the Research team undertake six-week rotations throughout the year where they act as the chair, as you say. The role is a vital conduit between the Research team and the Investment Executive. There are three main tasks that I would mention.

Firstly, they tend to run the research meetings. They try to make sure the appropriate questions are answered and, at the end, summarise the various discussions.

Secondly, they sit in on all of the Investment Executive meetings. And this again is a very important role to make sure that they are relaying the Research team's thoughts, the conclusions from these meetings.

And then there's a third area, I would call *ad hoc* projects that the chair might oversee or organise. Whenever there are big trends or developments that might impact several companies and different industries, different regions. For instance, during the onset of the Covid pandemic, clearly we were thinking very, very carefully about what that might mean for company balance sheets. And then more recently, we've had China exposure exercises and with the advent of generative AI, given it's such a dynamic space, we felt it was

appropriate to make sure we knew exactly where our exposures lie.

Katie:

And as you've mentioned China, over the last three months, it's never been far from the news and I know it's been discussed at length within the team. Perhaps you could give me your thoughts on what's been going on of late?

Paul:

There's been so much going on in China. I think it's fair to say it really started a couple of years ago with the clampdown on the property sector speculation that we saw and President Xi's drive to common prosperity. And a lot of these problems have really come to the fore more prominently in the last few months. The housing issues in China are certainly very, very important to understand. I think the majority of the net worth of an average person in China is captured in their housing so when there is pressure on house prices that has a real knock-on effect on various different other aspects of the economy. Estimates suggest a third of the Chinese economy is involved, either directly or indirectly, in housing. This has been a huge unravelling that we're witnessing.

The big question that people are debating is "is China undergoing a 'Japanification'?" – so what Japan endured in the 90s after their spectacular bubble and then collapse. A lot of that was based on the unravelling of property in Japan. Are we seeing something similar play out in China? There are certainly parallels that we are acutely aware of. Another analogy, another similarity would be in the demographic headwinds facing China – partly down to the one-child policy, but also it's increasingly expensive to live in China. I read a stat the other day that the home-price-to-income ratio in Shanghai is five times that of New York.

Then you have the fact that it is a hyper competitive, exam-driven

education system, so people are often opting out of the rat race, and this is all putting real downward pressure on fertility rates and therefore creating this demographic headwind which the country has not seen. Youth unemployment is another one which we are hearing more and more about. You can see there are a handful of issues that are really causing a lot of problems economically, so we're spending a lot of time talking about it.

We're also traveling to make sure that we see what's happening on the ground. And I think it's fair to say that, while there are a lot of concerns, there is a risk of recency bias and seeing a kind of a tepid recovery from Covid and extrapolating the current headwinds indefinitely. That would be dangerous. There are obviously problems and structural issues in China but when we had a couple of colleagues on the ground in June, and we've got more colleagues heading out this week, we're hearing a slightly different picture. It's not all rosy, it's not boom times, but there are certainly pockets of excitement which you certainly don't read about that in the Western media so that is one thing to bear in mind. They still have excellent ascendancy in electric vehicles and battery supply chains, other kind of technology spaces. It's not all doom and gloom is the message.

Katie:

And you mentioned travel. Let's bring it back to what the team has been up to. It may be summertime (although often doesn't feel like it here at Edinburgh) but it has been as busy as ever so perhaps you could talk about what everybody's been up to?

Paul:

Sure, we've had colleagues do shorter trips to Germany and Spain to see companies there. We've got a south-east Asia trip coming up, potentially Japan at the end of the year, US trips as well. And Lindsay, you're off to Italy soon?

Lindsay:

So I'm heading out to Milan with Jamie in two weeks' time. So we're got five days in Florence, Bologna and Monza. We're meeting some owned companies as well as some new companies, to get a feel for the operating environment and what's going on on the ground out there. Hopefully we'll do some interesting plant tours.

Katie:

As a team, you recently spent a day away from the office, away from Charlotte Square, challenging each other on the bigger picture, future assumptions and how they play out for portfolios. Can you tell me a bit about that?

Paul:

Sure. I think it's really helpful every now and again to get out of the office, to take a step back from the daily functions of analysis and fundamental research. We had a curated day of different thought-provoking sessions which were really, really helpful. One aspect of it was that we re-examined some of our closely held assumptions about what makes a quality business "quality". We had a devil's advocate make the case that maybe, for instance, acquisitive growth isn't all bad, maybe returns on capital can be justifiably low and we don't need to be too stringent about some of the hurdles there. Is there a case of finding companies that are maybe not profitable yet, but where we can see a very clear avenue to them becoming profitable in time?

We also revisited some of our past mistakes and I think this is a very useful exercise. If you are not willing to face those mistakes, work out where your process, your decision making could have been improved, then you'll never get better.

One of the other really interesting sessions was we had one of our colleagues do a big presentation on the energy transition. Now, we've obviously done a big project on climate change and the carbon project historically, and

this was in many respects a revisitation of some aspects of that, trying to understand just the sheer ramifications of transitioning an entire society from one energy form to another, hearing some of the challenges that we will face moving to a decarbonised society and some of the demands for metals that we'll have to produce. We were really looking at potential opportunities in the mining space, in the "picks and shovels" to that space literally, and seeing, maybe, if there were opportunities that we hadn't quite assessed just yet. There was a heated debate about the best way to play this very powerful long-term trend. And I'd be hopeful that there are some interesting ideas popping up on the back of it.

Katie:

Lindsay, I'd like to turn to you now to talk about these obesity drugs. Whilst everyone in the team is a generalist, with no industry or geography focus, you have a natural interest in health care. You studied biology at university, you worked in the industry before you came to Walter Scott and you know these two companies, Novo Nordisk and Eli Lilly, very, very well, having met them both countless times over the years. Why has obesity been in the headlines recently?

Lindsay:

These two companies, as you mentioned, Novo and Lilly, they have developed these drugs called GLP-1s, and they have the potential to revolutionise what is a growing crisis in obesity. Very recently, for Novo Nordisk in particular, there was one clinical trial for these drugs that not only is it showing weight reduction, but also, it's showing a 20% reduction in cardiovascular events.

This trial was called Select, and that sent the share price up significantly on the day when these results came out. Understandably, there's a huge amount of enthusiasm because it has an enormous potential. It's an enormous market. The most recent

stats that I was looking at suggest almost a billion people globally are obese and it's a really complex disease. It can be influenced by lots of different factors; genetics, physiology, your environment, your job, your education, and what's going on in the brain as well.

It's only been ten years since it's been recognised as a disease and there are very few specialists, so we're at the very, very beginning of the evolution of treatment for this. The drugs that Lilly and Novo have, as I said, they're called GLP-1s and they have been indicated in type-two diabetes for quite some time. They essentially stimulate insulin production, which then reduces your glucose levels, but they also work in other ways.

They work in your brain to reduce your appetite and they work in your GI tract, they slow down the release of food from the stomach and that helps you feel fuller for longer. We've now got this evidence that there is also some cardio protection too, so it's really quite exciting. Novo's molecule is called semaglutide and it's approved in a couple of different formulations. There is a weekly injectable for type-two diabetes that goes up to two milligrams called Ozempic, and it's been available since 2017. More recently, up to 2.4mg is the brand name Wegovy. It's the same molecule, it's still semaglutide. Then they also have an oral formula of semaglutide, again for type-two diabetes, and this is called Rybelsus.

Lilly's molecule is called tirzepatide and that currently is only approved in type-two diabetes under the brand name Mounjaro, but we are expecting approval for tirzepatide in obesity in the coming months.

Now looking at what these drugs do, for Wegovy, you're seeing 17% weight loss after 16 months on this drug. The highest dose of tirzepatide betters that at 22% weight loss, and that's after 17 months. These are really quite significant results, which is game

changing for some of these patients who have suffered mostly for their whole lives with this disease.

On top of that, there are next-generation products coming through. Novo has a product in clinical trials called CagriSema, and that's up to 25% weight loss. A lot of progress is being made in this disease space.

Katie:

It's the Select trial that you referred to earlier which has driven this latest media frenzy. Why has it created such a huge impact?

Lindsay:

So, because obesity is quite a new condition, the insurance coverage in the US is generally quite good but Medicare, which looks after seniors over 65, of which there, I think, are between 50 and 60 million of, does not cover obesity drugs. It's a big section of the population and it's currently barred by law to cover weight-loss drugs. But the Select trial, that changes the proposition because it's not just about obesity anymore. This 20% reduction in cardiovascular events for obese people, really, you can't ignore that. The CDC estimates that cardiovascular diseases cost the US around \$250 billion a year, and actually that stat is from a couple of years ago. So there's really good pharmacoeconomics as to why Medicare should cover this. These GLP-1 drugs are in trials for other conditions, mostly comorbidities, so things like sleep apnoea, heart failure, chronic kidney disease. And this all adds to both the clinical profile, but also the financial benefit for the insurers and particularly Medicare to cover these drugs.

Katie:

Presumably there have been companies trying to tackle these issues up until now, so there's likely to be huge knock-on effects with this drug for other companies in health care?

Lindsay:

Yes, it's been quite interesting since the Select trial came out, in particular.

Wegovy has actually been on the market since June 2021 and they've not been able to keep up with the demand. It has been enormous. More recently, as they've increased supply, we've started to see results and impacts on other companies. The one that was most notable for me, so Glambia, who owns SlimFast, which is a weight-loss or weight-management products, their sales were down 33% in the last quarter and they cited that was entirely due to weight-management drugs so that had direct straightaway knock-on effect. But there's much more far-reaching potential over the next five, ten years.

MedTech markets in particular have been volatile recently. If you think about knee replacements and intraocular lenses for cataracts, continuous glucose monitors, dialysis, heart failure devices, lots of these are related to or for patients who are obese. For example, patients with osteoarthritis often caused by obesity, there are some really clear studies that, after bariatric surgery, they no longer require a knee replacement. If they can achieve this weight loss with these drugs, then there are huge risks to companies like Stryker who do hips and knees. We've also seen similar sort of meta analysis looking at patients with cataracts, often a side effect of diabetes and obesity. Again, companies like Alcon and J&J, who produce intraocular lenses, are at risk.

And I think where we've seen the most movement in is the sleep apnoea companies who make the masks that you wear overnight. These companies have been particularly volatile recently. Lilly has a trial with tirzepatide looking specifically at sleep apnoea, and that's due to read out next year. There could be a lot of impact on some of these medtech companies if we can keep obesity in check or reduce the obese population.

Katie:

And it could go even further, presumably beyond health care?

Lindsay:

Yes, there are two aspects of looking at it. On the positive side, we've seen some really some strong responses in the supply-chain companies, the contract manufacturing organisations, the suppliers, so companies like West or Stevanato, who make the glass vials that the drugs are enclosed in. We're actually going to see them when we're in Italy next week. Some of these companies in the supply chain have seen really strong bounces in their share price just because of the huge, huge demand.

On the other side, there's a quite a debate starting around what does this mean for food and beverage companies, for example? There was one study that showed that calorie consumption on these drugs essentially goes down by 20 to 30%. It's basically from your salty snacks, your sugary sweets, your fizzy beverages. What does it mean for fast food companies, your McDonald's of the world? We've also seen reported drops in alcohol consumption and even in smoking. These are all companies that in five, ten years when a big portion of the population are on GLP-1s, it could be a risk.

Paul:

Lindsay, I might jump in there as I've done a lot of time thinking about all of these knock-on effects. I was in Barcelona at a Nestlé event recently where a lot of these topics were being discussed. From Nestlé's perspective, despite being known for confectionery, they actually make up a relatively small proportion of the overall sales split. They have a much bigger business in pet care, much bigger business in coffee, in infant nutrition etc.

And, actually, I think there are also interesting opportunities for a company like Nestlé because they have quite a large health science business and Nestlé will certainly be looking to offer solutions for nutrient deficiencies and other knock-on effects of this.

Lindsay:

Absolutely. That's the kind of flip side of the unhealthy snacking is the healthy snacking and other kind of health-related companies, your Adidas, your Nike, your gym companies. Another company we're seeing in Italy next week is Technogym, that does all the high-end gym equipment that you would find in really nice hotels. You know, that could be a boost for them as people are investing in their health more. It's quite a big trend with potentially quite far-reaching implications for lots of different sectors.

Katie:

And the question that often comes up is around the ethics of treating obesity with a drug. What would you say to those who are maybe a little less comfortable with this approach?

Lindsay:

We are now much more aware of the reasons that patients become obese. It's a hormonal imbalance. There's much more research into what's going on in your brain. There's a hormone called ghrelin that makes you feel full and obese people often don't produce enough of that. It's now categorised as a disease.

It's no longer just a case of willpower, that you're eating too much and not exercising enough or you have a bad diet. There's genetics involved, there's physiology that we have really good evidence of, a lot to do with the environment. As I said before, it's your job, your education, the way that society has moved over the last 30 years. We're more sedentary, we have much more access to fast ultra-processed food, which is not helping, but all of these things are creating physiological changes in the body. There are definitely some ethical questions around it but, for the patients who take these drugs, it's life changing.

Katie:

And it's worth noting that with Novo and to a lesser extent, Eli Lilly, the name has now become synonymous with obesity, but it does produce drugs to tackle other diseases.

Lindsay:

Novo is about 80% obesity and diabetes. That's really where the business has always been focused, but they do have 20% of the business where they do some really good haemophilia drugs, they do some growth hormone and they've got some gene therapy candidates. So there's definitely a part of the business there

that tends to get overlooked because of the focus on diabetes and obesity.

Lilly is actually only half diabetes. The other half of the business is oncology, immunology and neurology. The other bit of Lilly that you often hear about, or if you haven't you will, is their Alzheimer's drug, known as "Donna", (Donanemab) and it's a potential treatment in Alzheimer's, which has been really a difficult area to tackle, so they have a drug that's been approved. Both of these companies have really interesting parts to them, but it's all about the obesity at the moment.

Katie:

Absolutely. And I sense the conversation around these two drugs could go on for hours. But sadly, we've run out of time today. Thank you, Paul and Lindsay, for your incredibly interesting insights and for your time, of course.

As we speak, we have colleagues heading out to China, Indonesia, Malaysia and Singapore, and we will be talking to them on our next podcast.

In the meantime, to our listeners, thank you so much for joining us today. Until next time, goodbye.

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