Stock story: Novartis

A Swiss giant reimagining healthcare.

Over recent generations, ageing populations, biologic breakthroughs, scientific innovations allowing companies to safely mass-produce drugs, greater access to healthcare across the emerging world and the formation of national healthcare systems have boosted global healthcare spending to about 10% of the world economy.[1] These forces, to varying degrees, will bolster this percentage higher still in decades to come.

The pharmaceutical sub-segment of an expanding healthcare industry is well placed to provide selective opportunities that are economically defensive if a business can deftly and consistently manage the scientific risks of new projects and major periodic patent expiries. One of the best placed to manage this dilemma is the Swiss-based pharmaceutical company Novartis, which has a leading innovation track-record.

The company that seeks to 'reimagine medicine to improve and extend people's lives' spends about US$9 billion a year on research and development. The aim is to tackle some of society's most challenging healthcare issues and deliver them to as many people as possible. Novartis, which earned US$49 billion in fiscal 2019, already provides 70 billion doses to one billion patients a year.

Novartis, which traces its roots to 1758, now comprises two global operating divisions since it spun off its Alcon eyecare-devices business in 2019. Novartis's key arm is Innovative Medicines, which delivers about 85% of Novartis's earnings (but only about 80% of revenue) and seeks to develop patent-protected prescription medicines that change the standard of care for often acute ailments and diseases. The other division is Sandoz, which mass markets generic pharmaceuticals and biosimilars.

The Innovative Medicines division researches, develops, makes, distributes and sells patented prescription medicines. The division is in turn split into two business units: Novartis Oncology and Novartis Pharmaceuticals. The latter consists of the following global business franchises: ophthalmology; neuroscience; immunology, hepatology and dermatology; respiratory; cardiovascular, renal and metabolism; and established medicines. Novartis's leading global capability in emerging gene and cell therapies also complements these therapeutic areas.

Some of the world's amazing and lucrative drugs have emerged from these businesses. Novartis has more than 15 innovations that each haul in more than US$1 billion in revenue every year. These innovations include the multiple sclerosis drug Gilenya and the recently launched Mayzent and Kesimpta improvements in the standard of care for sufferers of multiple sclerosis; psoriasis and arthritis drug Cosentyx; heart-failure-prevention medication Entresto; and the neuroscience Zolgensma that almost cures previously terminal spinal muscular atrophy in babies.

Zolgensma, a future blockbuster earner, is worthy of special mention. Accumulative sales already top US$1 billion for a medication that is the world's most expensive at about US$2 million a dose. Novartis is pioneering gene therapy as a new class of treatment. Novartis's prescient AveXis acquisition and buildout of the global infrastructure necessary to commercialise this technology and expand the market via manufacturing cost innovation has significant potential given its first-mover advantage.

The Sandoz division develops, makes, distributes and sells prescription medicines and active ingredients that are not protected by patents (because they have expired). Sandoz is organised globally into three franchises: retail generics; anti-infectives (antibiotics); and biopharmaceuticals. It's from its biopharmaceuticals arm that Sandoz develops, makes and markets protein and other biotechnology-based products, including complex biosimilars, and provides biotechnology manufacturing services to other companies.

CEO Vas Narasimhan, a doctor by qualification who was appointed in 2018, has reshaped Novartis via acquisitions and divestments (and careful cost-cutting; US$2 billion in costs pruned so far and another US$2 billion to come). In 2020, for instance, Novartis paid US$9.7 billion for Medicines Co, the maker of Inclisiran, a low-risk and promising novel solution for bad cholesterol and heart disease. Similar strategic acquisitions, along with the sale of assets such as Alcon and Novartis's stake in a venture with GlaxoSmithKline (consumer health), has refocused the once-sprawling conglomerate.

Magellan boils Novartis's sustainable competitive advantages down to two key drivers. The first is the breadth and depth of Novartis's R&D capability in areas of significant unmet need. The stock market is undervaluing the 200 or so projects that are in 'clinical development', especially those that are line extensions and mostly low risk. Novartis's other advantage is that these research efforts are largely independent of each other in terms of medical efficacy and commercial success. One going wrong doesn't mean the others will fail, which helps us manage our exposure to the inevitable failure of expensive research projects – and this also decreases the risk of irrational internal capital allocation. All up, Novartis is one of the leading pharmaceutical innovators with encouraging early evidence of much-improved capital allocation. That bodes well for future shareholder returns.

Novartis, which operates in an industry that is ever more complex in terms of the science it advances, the trials it conducts and the regulation it must navigate, faces risks. The covid-19 pandemic has hurt Novartis's sales growth because fewer people visited their doctors so fewer prescriptions were written. However, this setback to revenue growth will pass when a vaccine is widely distributed. Novartis's exposure to political reimbursement risks, especially in the US, is shared by all pharmaceutical companies but Novartis benefits from a relatively favourable geographic mix of global revenue. Expiring patents are also a key threat to revenue growth – that's a standard challenge for successful pharmaceutical companies. Only about 5% to 10% of medicines developed for trials work on humans and that success could take 10 to 15 years to achieve from discovery to the launch of a commercial product. This is a risk all pharmaceutical companies face.

Novartis is less of a risk on this basis than many of its peers because its pipeline of projects is relatively transparent, there's so much intellectual capital in the firm, and it has so many 'bets' on different drugs where the success or failure of each is bespoke. Novartis will grow through pending patent expiries, with attractive forecast returns driven by steady earnings growth and material unpriced option value from leadership in emerging gene, cell and nuclear medicine technologies.

Sources: company website, Bloomberg, Dunn & Bradstreet.

[1] World Bank. 'Current health expenditure (% of GDP)'. data.worldbank.org/indicator/SH.XPD.CHEX.GD.ZS

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