Value Investor INSIGHT

December 30, 2022

The Leading Authority on Value Investing

Picture of Health

Healthcare has been a port in the storm for investors in this year's tumultuous market, for understandable reasons. As the storm continues to roil, Artisan Partners' Matthew Kamm describes where the sector might continue to offer refuge.

INVESTOR INSIGHT

Matthew Kamm
Artisan Partners

Editor's Note: *As the lead portfolio manager of Artisan Partners' $4.5 billion Mid Cap Fund, Matthew Kamm targets companies with competitively advantaged franchises and clear catalysts for future profit growth, ideally as those catalysts are just starting to bear fruit. While many sectors are home to such ideas, healthcare – where intellectual property and new-product innovation is at a clear premium – has often been particularly fertile ground. "The profit cycles in healthcare are less likely to be disrupted by the macroeconomy and tend to play out over many years," he says. "The payoff in finding the right ideas can be quite high."*

At a time when general concerns about the macroeconomy and disrupted profit cycles are high, we recently asked Kamm for his take on the current investing opportunity set in healthcare and to describe some ideas in the sector he's finding particularly interesting.

Describe generally what you're looking for as an investor and why healthcare has traditionally been an important source of good ideas.

Matthew Kamm: We're looking for a few key elements in a stock. One, we want to invest in companies with franchise characteristics, meaning those with sustainable competitive advantages like a strong brand, valuable intellectual property or scale advantages. We want to own them when we see clear catalysts for future profit growth that we're identifying relatively early on as profits are accelerating. And we want to pay a reasonable valuation, so that if we're right about where the profits are heading we'll earn a good return on the investment.

Healthcare is a fertile area because you can find those franchise companies with strong market positions and barriers to entry from brands, patents and regulatory license. There is also always something going on from an innovation perspective. In a large and diverse sector, there are regularly companies with interesting products or services in development or early in their lifecycles that can gain market share by adding a lot of value for patients, healthcare providers and healthcare payers. We also like that the profit cycles in healthcare are less likely to be disrupted by the macroeconomy and tend to play out over many years. The payoff in finding the right ideas can be quite high.

Our mindset on valuation is to focus on what a rational private buyer would be willing to pay to own the entire business. That's based on an assessment of the company's future cash flows and risk profile, taking into account the market's risk-free interest rate. As minority public shareholders we don't have control, so we need a discount and are looking to pay no more than 60-80% of our estimate of private market value.

The Artisan Mid Cap Fund you manage has close to 30% of its assets in healthcare. Is that more or less than usual?

MK: It's usually over 20%, but the current level is at the higher end of the range. That's not a top-down decision based on our view that the economy is going into a recession and we want to own defensive healthcare stocks. It's not a belief that healthcare spending is going to take off and we want to own the group. It's stock by stock, based on the opportunities we're seeing from a fundamental perspective and also from a valuation perspective.

With respect to fundamentals, we're finding the most innovation and the biggest opportunities in pharmaceuticals. We're 20 years after the sequencing of the human genome and in the last 10 we've really entered an era where that molecular knowledge base is translating into practical breakthrough biologic therapies that are safe and effective. For example, there's much more product development around antibody drugs that attempt to harness the human immune system to combat disease. There are exciting gene therapies that look to correct faulty genes and provide cures or quasi-cures for debilitating diseases. Elsewhere, in diagnostics, we're seeing breakthrough tests based on molecular biology that can identify disease earlier and with greater accuracy. Companies just have more tools in their toolkits to foster innovation and to drive growth.

On the other end of the spectrum, we don't see the same level of business innovation when it comes to healthcare services, including hospitals, physician practices, hospice and home care. We're seeing less opportunity for companies to deliver breakthrough results for customers, so there's not a lot in those areas that interests us.

On the valuation side, there's been a big change over the past year in the perception of the risk-free rate. The long cycle of low interest rates clearly helped companies that weren't currently maximizing earnings, but had the potential to grow them significantly in the future. Plenty of healthcare stocks fit that profile, so we've seen real multiple contraction for most growth stocks in the sector over the past year. This reset in expectations, which is perfectly appropriate, is also creating opportunity. As the market establishes sustainable multiples for these stocks, returns become all about the earnings growth. We think that plays to our strengths.

You can't talk about healthcare in the U.S. without asking for an assessment of the regulatory environment. How is that impacting what you are or aren't finding interesting in the sector?

MK: Drug pricing is always an important risk consideration. When I say we focus on pharmaceutical company innovation, we're also assuming that the companies we invest in will be able to price the drugs they produce at a level to benefit from all that innovation.

In the Inflation Reduction Act passed earlier this year, there are provisions for Medicare to begin negotiating prices on the drugs that cost it the most. Negotiations will start with the top 10 drugs, with new prices going into effect in 2026. Over time the list of drugs they can negotiate is going to expand. In certain cases this will likely lead to pretty significant price cuts on older blockbuster drugs.

On the other hand, the Act still provides pretty strong intellectual-property protection for biologic drugs, protecting them for established periods against Medicare price negotiation. So while this legislation is not good for overall sector profits over the next decade – and is particularly problematic for certain companies with more mature product portfolios – for innovative biotech and pharma companies we think it's more likely to put a premium on their franchises.

Tell us about one such company you're finding interesting today, Denmark-based Ascendis Pharma [ASND].

MK: When we look for emerging biotech franchises we put priority on companies that have a platform technology and/or de-risked assets in the form of products that have FDA approval. They have real franchise value underneath them, but also have multiple shots on goal that should keep them from being one-hit wonders.

Ascendis is an excellent example of that. It has a core technology platform called TransCon, which is a chemical link essentially attached to molecules in a proprietary way that allows a drug to better address unmet medical needs. For

INVESTMENT SNAPSHOT

Ascendis Pharma
(Nasdaq: ASND)

Business: Research, development and sale of biopharmaceuticals using proprietary technology that provides for predictable and sustained release of the drugs in the body.

Share Information (@12/29/22):

Price	**120.71**
52-Week Range	61.58 – 143.09
Dividend Yield	0.0%
Market Cap	$6.86 billion

Financials (TTM)

Revenue	$33.2 million
Operating Profit Margin	n/a
Net Profit Margin	n/a

Valuation Metrics
(@12/29/22):

	ASND	S&P 500
P/E (TTM)	n/a	21.5
Forward P/E (Est.)	n/a	17.6

Largest Institutional Owners
(@9/30/22 or latest filing):

Company	% Owned
Artisan Partners	12.8%
T. Rowe Price	10.6%
Fidelity Mgmt & Research	9.4%
Janus Henderson	6.9%
Wellington Mgmt	6.6%

Short Interest (as of 12/15/22):

Shares Short/Float	17.4%

ASND PRICE HISTORY

THE BOTTOM LINE

Matthew Kamm believes the company has an attractive mix of innovative platform technology, an approved product already on the market, and a fertile pipeline of high-potential drugs, one of which could earn FDA approval by April 2023. Based on his estimate of the company's private market value, he thinks the shares are worth "much closer to $200."

Sources: Company reports, other publicly available information example, the technology can keep the body from breaking down drugs quickly, providing longer-lasting effects. It can also be designed to deliver drugs to a specific area of the body, improving both efficacy and safety.

Their first product, already approved and on the market, is a pediatric growth-hormone drug called Skytrofa. Injectable growth-hormone drugs for kids who aren't growing as they should be already existed, but they had to be administered daily. The holy grail was a longer-acting version, so you didn't have to inject your child every night. Skytrofa delivers that because it only needs to be administered weekly. By attaching the TransCon technology to a proven synthetic growth hormone, they've created a novel product that we believe is in the early stages of taking significant market share over time.

The second drug in the company's pipeline, now just called TransCon PTH, is a treatment for hypoparathyroidism, a rare condition where the body does not produce enough parathyroid hormone. It often comes about after surgery for throat or neck cancer that impacts the glands that produce the parathyroid hormone. The condition results in too little calcium and too much phosphorous in the blood, causing serious short-term issues like cramps, seizures and brain fog and can also lead longer-term to kidney disease and other serious complications.

All people can do now for hypoparathyroidism is to take vitamin supplements. That doesn't truly treat the condition – what you want is to actually replace the parathyroid hormone the patient doesn't have enough of, just as in treating diabetes you inject insulin. That's been known, but no one had the right molecule that could actually do it. That's the problem TransCon PTH is looking to solve, and the clinical data has been very compelling. In Phase III trials reported earlier this year, 79% of patients achieved normal levels of parathyroid hormone without vitamin supplements, and the endpoints look very good with respect to quality of life and physical and cognitive function. Also encouraging is that in an extended trial still underway, 57 of the 59 patients who entered the trial continue to take the drug. You don't see levels like that unless patients are really seeing benefits.

In addition, the clinical community of endocrinologists who treat this condition have recently added the therapy to the treatment guidelines for hyperparathyroidism. That's quite unusual to see before a drug is fully approved and a good sign that those who have used it in treating patients are eager to have it approved. The company has asked for formal approval from the FDA, which recently gave the drug priority-review status. They're expecting to decide on it by April 2023, and we believe all the signs point to approval.

ON DRUG MANUFACTURING:

There are a handful of leading franchises that provide the picks and shovels for biologic-drug production.

Skytrofa is a nice opportunity, with the potential to be a $1 billion seller over a number of years. But we believe the TransCon PTH product could be a far bigger opportunity. The company estimates there are about 200,000 patients in the U.S., Europe and Japan with hypoparathyroidism. Even if you haircut that meaningfully this could be a multi-billion-dollar blockbuster. They already have the sales force in place, so the leverage from a second endocrinological drug – and more beyond that – could translate into very high margins over time.

With the shares recently trading at around $121, how do you look at valuation for something like this?

MK: Our estimate of the company's private market value is based on the potential we see in Skytrofa as well as a risk-adjusted assessment of TransCon PTH, the latter assuming a high probability that it's approved and succeeds in the market. In both cases we believe we're being conservative in our estimates of the size of the market, the pace of adoption and pricing to arrive at the cash flows generated over time. Without putting too fine a point on it, we think the shares are worth much closer to $200 using that valuation framework, with plenty of optionality on the upside both from these two drugs and from other promising ones in the pipeline using the TransCon technology.

Turning to a different type of opportunity in the sector, describe the investment potential you see today in West Pharmaceutical Services [WST].

MK: One implication of the industry shift toward biologic drugs is that the manufacturing process is more complicated. You essentially need to grow the biologic material and then through a series of complicated steps filter out the impurities to concentrate the actual drug. All of this needs to be done under sterile, highly controlled conditions.

That's led to a handful of leading franchises, one of which is West, that provide what could be considered the picks and shovels for that biologic-drug production process. It makes a range of products used in pharmaceutical packaging, focused primarily on rubber components like stoppers and plungers for injectable drugs. It's an excellent model. The components are very inexpensive relative to the valuable medicines they protect. They typically get designed into the manufacturing process when drugs are still in clinical trials, and companies are hesitant to change suppliers once a drug gets approved, creating a growth annuity of sorts for West. It is by far the market leader in most of its product line and benefits from scale and reputational advantages from making billions of these products effectively and reliably over a long period of time. It's the go-to standard, sourced into the vast majority of the most valuable medicines that come out each year.

The company has continued over time to introduce higher-value versions of its products using advanced materials that improve performance. They've added services around sterilization, inspection and transport of drug material and finished drugs. All of that continues to have a meaningful impact on West's revenues and margins. Higher-value products grow consistently as a percentage of total revenues by about one percentage point a year – that alone drives 7-9% revenue growth, at gross margins that are almost triple those on older commodity products.

Another initiative is to broaden the definition of packaging to include vials and other similar products as part of a larger packaging solution for customers. They have a partnership with Corning for glass products, for example, that we think could have considerable potential.

The shares at a recent $245.40 are trading at about half their 52-week high. Does that signal some sort of Covid-related hangover?

MK: This steady, predictable growth business did see a lot of excitement during the pandemic, as West was a major supplier in the push to vaccinate the world against Covid. From 2019 to 2021 revenues grew 50% and profits more than doubled. As the vaccine impact fades, that's been a real headwind for growth this year and probably will be into next year as well. That's clearly disappointed investors.

The company believes – and we agree – that it has the organic demand from regular biologic drugs to in relatively short order utilize the capacity it added during Covid. The next couple of quarters will likely be bumpy during this transition, but we expect at some point over the next year they'll get back to the steady and very solid level of revenue and profit growth from the basic business. That's the opportunity in the stock.

The current multiple at over 30x next year's estimated earnings isn't low, but it is at the low end of where the stock has traded in recent years and we think is a sustainable level going forward given the company's underlying growth potential and the business's lack of economic sensitivity. If they get back on the annual mid-teens to 20% earnings growth track we expect, that should translate into upside for shareholders.

We're curious if you're finding Covid vaccine hangovers to be a more general source of ideas today.

MK: There are other ideas that would fall into that category. One would be Catalent [CTLT], which is one of the largest contract-manufacturing suppliers to the pharmaceutical and nutritional-supplement industry. Its 2023 guidance came in below expectations due to a sharper-than-expected decline in Covid vaccine sales, but it too has what we believe is a strong long-term profit cycle in place. The increasing use and complexity of biologics and the growing proportion of small companies taking products to market are driving outsourcing to companies like Catalent who can reduce manufacturing costs. It's also investing to increase capability in areas such as cell and gene therapies and gummy vitamins that have strong incremental growth potential. Despite

INVESTMENT SNAPSHOT

West Pharmaceutical Services
(NYSE: WST)

Business: Development and manufacture of components such as stoppers, seals and vials as well as drug-delivery systems used to package and administer injectable drugs.

Share Information (@12/29/22):

Price	**245.37**
52-Week Range	206.19 – 475.00
Dividend Yield	0.3%
Market Cap	$18.65 billion

Financials (TTM)

Revenue	$2.91 billion
Operating Profit Margin	25.5%
Net Profit Margin	21.7%

Valuation Metrics
(@12/29/22):

	WST	S&P 500
P/E (TTM)	27.9	21.5
Forward P/E (Est.)	32.6	17.6

Largest Institutional Owners
(@9/30/22 or latest filing):

Company	% Owned
Vanguard Group	12.1%
BlackRock	10.9%
T. Rowe Price	7.5%
State Street	4.5%
Franklin Resources	3.5%

Short Interest (as of 12/15/22):

Shares Short/Float	17.4%

WST PRICE HISTORY

THE BOTTOM LINE

The transition might be bumpy as organic demand from its traditional business fills manufacturing capacity added during the pandemic, but Matthew Kamm expects the company to return to the 15-20% annual growth it had pre-Covid. Given what he considers today's sustainable valuation level, that would translate into attractive shareholder upside.

Sources: Company reports, other publicly available information some short-term risk, for a company that we also believe can grow at 15-20% per year, the stock [at a recent $45.25, down from $130 a year ago] could ultimately look very inexpensive at today's valuation of 10x EV/EBITDA.

So yes, during the peak of Covid we didn't think the vaccine production volumes were sustainable, and now in the aftermath we expect this depressed level of growth to be temporary as well. As investors, we're trying to keep our eye on the medium and long-term horizon as we look for opportunities.

Carefully consider the Fund's investment objective, risks and charges and expenses. This and other important information is contained in the Fund's prospectus and summary prospectus, which can be obtained by calling 800.344.1770. Read carefully before investing.

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The discussion of portfolio holdings does not constitute a recommendation of any individual security. These holdings comprise the following percentages of the Artisan Mid Cap Fund's total net assets as of 31 Dec 2022: Ascendis Pharma A/S 4.0%, Catalent Inc 2.5%, West Pharmaceutical Services Inc 2.4%. For the purpose of determining the portfolio's holdings, securities of the same issuer are aggregated to determine the weight in the portfolio. Securities mentioned but not listed here were not held as of the date of this report. Portfolio holdings are subject to change without notice and are not intended as recommendations of individual securities.

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1/25/2023— A23521L-vR