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Value Investor INSIGHT

The Leading Authority on Value Investing

The following excerpt, reprinted with permission, is from an interview with Matthew Kamm as part of a feature titled "Investing in Healthcare" in the July 31, 2017 issue of *Value Investor Insight*.

INVESTOR INSIGHT

Matthew Kamm
Artisan Partners

"Our ideal company has a drug or drugs that have completed the approval process but are early in their adoption curves."

In general, why do you consider the healthcare sector a source of good ideas?

Matthew Kamm: We look for three primary things in a stock. The business has to have franchise characteristics built on sustainable competitive advantages. There have to be identifiable catalysts driving profit growth into the future. And the valuation has to be reasonable, to the extent that if we're right about the profit growth, the stock will be a good investment.

Healthcare has generally been a good place for us to hunt over time, particularly satisfying the first two criteria I mentioned. You often find franchises based on things like intellectual property, brand strength, scale economics and regulatory barriers to entry. You can also find significant instances of profit-growth potential, most reliably from innovation, which is still prevalent in healthcare.

You didn't mention demographic tailwinds. Isn't that a big plus?

MK: While tailwinds from an aging population are well known, we've actually been lukewarm on the overall growth we expect in developed-market healthcare spending. It consumes a large and rising amount of most countries' GDP, and governments, employers and consumers are aggressively trying to control that spending. Even as baby boomers have aged, healthcare spending is growing at a slower rate than it was 10 to 15 years ago. That pressure to arrest spending growth will continue.

That said, this is a $7 trillion global industry, so even if it isn't growing particularly fast there's tremendous opportunity for well-positioned businesses that deliver higher-quality treatment or are driving costs lower. We're essentially looking for market-share gainers who can prosper regardless of the rate of growth in the overall market.

Are some sectors of the industry more attractive to you than others?

MK: We often find opportunity in pharmaceuticals, where there are still significant unmet medical needs that can be addressed. Our ideal company has a drug or drugs that have completed the regulatory approval process but are early in their adoption curves. We're students of how drugs get taken up over time, which involves evaluating market size, the competitive environment, feedback from doctors, pricing potential and other inputs that allow us to model the products' potential revenue and profits over time.

Behind those profit-cycle catalysts we also like to see a compelling pipeline of new opportunities. We're taking risk on those, but the pipeline is more or less optionality on the upside. If there is a diversified portfolio of products in development, the company has proven R&D leadership, and the funding and balance sheet are in place to support investment, with a longer time horizon you can conclude there's a fairly high probability that one or two of those drugs is going to be a meaningful future driver of profit growth.

The type of company I'm describing isn't easy to find, but when you find one, it can compound value rapidly and for a long time. For example, we first bought into Regeneron [REGN] in 2010, when clinical trials of its treatment for age-related macular degeneration, Eylea, had succeeded and the drug was about to launch with what we thought was very large commercial potential. The company had a compelling R&D program, with expertise in key areas like monoclonal antibodies and biologics, and the leadership had several proven scientists, including Chairman Roy Vagelos, who was the CEO of Merck during its remarkable growth in the late 1980s. Also important was the fact that Sanofi, the big French drug company, owned almost 20% of the equity and was essentially funding much of the R&D cost.

Fast forward to today: Eylea has succeeded beyond our wildest dreams and the company has launched three meaningful new drugs since we first got involved, including Dupixent, for allergic conditions, which we believe has extremely high potential. There's still a strong pipeline of longer-term opportunities and we believe Regeneron is ahead of the curve in harnessing genetic-sequencing data to further improve the hit rate of its R&D efforts. This isn't an undiscovered small-cap gem any more, but in many ways we think it still has the same attractive characteristics today that it had five years ago.

The stock's dramatic rise hasn't always been a smooth ride. Any lessons there?

MK: There have been some issues over the past couple of years. One was the concern about drug pricing that cast a pall over the whole sector in 2016. Another was the fact that the firm's cholesterol-lowering drug, Praluent, didn't launch as well as expected due to slow uptake on reimbursement and approval from insurers. Finally, the company lost a patent-infringement case concerning Praluent to Amgen.

What that tells you is that this can be a risky business. You obviously need to be able to separate what matters from what doesn't, but you also better have a long-term perspective and staying power. The short term isn't always pretty.

What's your take on service providers like hospitals and physician practices?

MK: These don't tend to interest us that much because it's harder to find emerging profit-growth situations. We also find the stroke-of-the-pen risk – say, you're reimbursed at X for your service today but that becomes 80% of X tomorrow – to be material and difficult to underwrite.

This area has the most at stake in the current discussion in Washington, particularly around changes in the numbers of insured and in Medicaid. While uncertainty could be creating some opportunity, it's just not our favorite part of the market.

You mentioned the political rhetoric in recent times over drug pricing. As an investor do you see that creating more opportunity or risk?

MK: The pharmaceutical industry hasn't done itself any favors by its actions on pricing in recent years, and that has threatened its political position. We don't really believe the Trump administration has the appetite to do anything meaningful on drug pricing, but either way, private payers every day are looking for ways to rein in pharmaceutical spending. That's not going away.

We're most interested in companies that grow by bringing to market differentiated medicines that can have relative and justified pricing power. We're not interested in companies that built their business models on raising prices, but there are firms like AbbVie [ABBV], Biogen [BIIB] and Amgen [AMGN] that have relied to some extent on price increases on older drugs and whose valuations can be relatively attractive when pricing concerns are high. There you have to judge the future opportunity set tied to innovation versus how much relies on outsized price increases. We're doing some of that work now.

Turning to medical devices, describe the thesis for one of your key holdings in that area, Boston Scientific [BSX].

MK: As with pharmaceuticals, there's also innovation in medical devices and the innovation tends to be a bit less risky. It's more of an engineering process, not a biological one, so in development you're able to iterate and optimize to a greater extent. Costs of innovation are lower and the results are somewhat more predictable.

INVESTMENT SNAPSHOT

Boston Scientific
(NYSE: BSX)

Business: Develops, manufactures and markets medical devices used in the diagnosis and treatment of heart, digestive, pulmonary, vascular, urological and other conditions.

Share Information (@7/28/17):

Price	**27.01**
52-Week Range	19.67 - 28.51
Dividend Yield	0.0%
Market Cap	$36.99 billion

Financials (TTM):

Revenue	$8.58 billion
Operating Profit Margin	16.4%
Net Profit Margin	5.1%

Valuation Metrics
(@7/28/17):

	BSX	S&P 500
P/E (TTM)	86.6	23.9
Forward P/E (Est.)	19.3	18.9

Largest Institutional Owners
(@3/31/17):

Company	% Owned
Fidelity Mgmt & Research	13.0%
Capital Research & Mgmt	7.3%
Vanguard Group	6.7%
Wellington Mgmt	5.0%
BlackRock	4.3%

Short Interest (as of 7/14/17):

Shares Short/Float	0.9%

BSX PRICE HISTORY

THE BOTTOM LINE

The company has transformed its margin structure, balance sheet and R&D efforts and now has a nicely diversified mix of mature products, growth franchises and high-potential new products, says Matthew Kamm. In his base case, its stock maintains a deserved current multiple and grows along with earnings at the mid-teens annual clip he expects.

Sources: Company reports, other publicly available information

On the other hand, medical-device markets can be somewhat more competitive and there are fewer big, unmet needs that can be addressed by devices. But we can find interesting franchises in the sector and today there are a number of areas of innovation with excellent growth potential, whether in transcatheter devices that don't require cracking people's chests open to replace a heart valve, to glucose-monitoring devices for diabetic patients, to brain stimulation to manage pain and other neurological diseases.

Boston Scientific has transformed itself. Ten years ago it was highly dependent on drug-coated cardiac stents, where it had been a pioneer, but that market got big and then competitive quickly. The prior management team responded by making some poorly chosen acquisitions in order to diversify, which stressed the balance sheet and did nothing for growth.

New management took over in 2012 and has really transformed the culture, margin structure, balance sheet and R&D efforts. Today the company has a diversified mix of businesses. There are mature but healthy franchises with lower growth, such as in cardiac stents, defibrillators and pacemakers. They have a stalwart growth franchise in medical surgical products, including minimally invasive tools to get rid of kidney stones and neuromodulation devices that stimulate the spinal cord to help address chronic pain. They generate extra growth in these areas by introducing a steady stream of new products and by building out their non-U.S. sales efforts.

We're also focused on two product areas with even more growth potential. One is the Watchman, an implantable device used to reduce stroke risk in patients with atrial fibrillation. Patients today are untreated or treated with anti-coagulation drugs that can have risky side effects. Having a device to address this disease in a different way is a real innovation. It's early in the growth cycle, but we think the Watchman could be a $1 billion product for Boston Scientific, in a market that at least for the next four years it is likely to have to itself.

The second high-potential product is called Lotus, a transcatheter aortic-valve-replacement device. Edwards Lifesciences pioneered this market and we think it's on its way to being a $5 billion annual market over time, more than double the current size. BSX is having to work through some manufacturing issues in Europe, but it's aiming to be a solid #2 player when it brings Lotus to the U.S. market next year.

How do you see all that translating into revenue and profit growth?

MK: From negative organic growth when the new management team came in, last year the company grew 10% organically. They talk about 6-8% being the right level going forward, but we think it can be at least a point or two higher than that based on these new products.

At the same time, it's hard to find other large device companies with a similar margin-expansion opportunity. Operating margins rose from close to 18% in 2012 to 24% last year, and we think management's goal of 30% is more than reasonable. The company has been very smart about redesigning products for higher gross margins, introducing new, higher-margin products, and leveraging its global sales and marketing infrastructure as it grows.

We think there's high visibility here into mid-teens sustainable EPS growth. That's easily in the top-tier of medical-device companies.

How are you looking at valuation at today's $27 share price?

MK: The shares have done well and now trade at the top end of the 15-20x next-12-months' earnings range at which they've valued in recent years.

We value stocks on a scenario basis. In our base case, we think they deliver that mid-teens earnings growth, the multiple stays around where it is as a reflection of the company's transformation, and the stock compounds along with EPS growth. In our bull case, Watchman and Lotus drive earnings growth materially higher and there's potential as well for multiple expansion. In our bear case, the new products don't do as well as we hope, but even then we believe earnings can compound at 10% or more, so even with some multiple contraction we shouldn't be overly hurt.

Another leg of the stool to mention is free-cash-flow deployment. In recent years roughly 80% of free cash flow has been called for, due to some legacy product-liability and tax issues. As those run off, starting in 2018 some 90% of the free cash flow generated is truly going to be free. As that is directed toward tactical acquisitions and stock repurchases, free cash flow becomes part of the compounding process moving forward in a way it has not been.

Clarification: Initial purchase of Regeneron Pharmaceuticals Inc. in Artisan Mid Cap Fund occurred in November 2010. Initial purchase of Regeneron Pharmaceuticals Inc. in Artisan Global Opportunities Fund occurred in February 2011.

Past performance is not a reliable indicator of future results.

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For the purpose of determining the Fund’s holdings, securities of the same issuer are aggregated to determine the weight in the Fund. The holdings mentioned comprise the following percentages of the Funds’ total net assets (including all classes of shares) as of 30 Jun 2017: Artisan Global Opportunities Fund: Regeneron Pharmaceuticals Inc 3.5%, Boston Scientific Corp 3.8%; Artisan Mid Cap Fund: Regeneron Pharmaceuticals Inc 3.6%, Boston Scientific Corp 3.5%, Edwards Lifesciences Corp 1.0% . Portfolio holdings are subject to change without notice and are not intended as recommendations of individual securities.

Free Cash Flow is a measure of financial performance calculated as operating cash flow minus capital expenditures. **Earnings per Share (EPS)** are the portion of a company's profit allocated to each outstanding share of common stock. **Dividend Yield** is a financial ratio that shows how much a company pays out in dividends each year relative to its share price. **Market Cap** is the aggregate value of all of a company's outstanding equity securities. **Price-to-Earnings (P/E)** is a valuation ratio of a company's current share price compared to its per-share earnings. **Short Interest or Shares Short/Float** is the number of shares short divided by the float. Shares Short is the number of shares currently borrowed by investors for sale, but not yet returned to the owner. **S&P 500® Index** measures the performance of 500 US companies focused on the large-cap sector of the market. The index(es) are unmanaged; include net reinvested dividends; do not reflect fees or expenses; and are not available for direct investment.

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