

Healthcare offers compelling contrarian value in a stretched market

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Warren Buffett once warned: "You pay a very high price in the stock market for a cheery consensus." This market adage underscores the dilemma facing investors who are seeking to find compelling opportunities in a market that has seen valuations routinely surpass historical peaks.

When valuations are stretched, the real ability of a stock picker comes to the fore. This environment demands executing a conviction-based strategy and unearthing opportunities by identifying where hostility towards certain stocks, sectors and countries creates attractive points of entry.

By definition, the stocks in our portfolio are often diametrically opposed to our peers' allocations. As conviction investors, even when markets are elevated, we are able to exploit inefficiencies and drive long-term returns.



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Victims of indiscriminate selling

The ailing healthcare space was one of Europe's worst performing sectors in 2017, with the MSCI Europe Health Care Index underperforming broader European equities by 7.4%. This currently unloved sector is illustrative of where contrarian investor can pick up quality names that have been victims of indiscriminate selling.

Many investors continue to shun the European pharmaceutical and healthcare space on worries that sector fundamentals are challenging and we are entering an "era of uncertainty". Three key reasons are causing this increasing nervousness around the industry: Brexit, Trump and the targeting of healthcare by tech giants.

Industry headwinds

Given Theresa May is determined to leave the single market, the UK's membership in the European Medicines Agency has been thrown into doubt. The agency has recently announced it will relocate its headquarters from London to Amsterdam, but the bigger question remains around the potentially catastrophic impact that adding borders and tariffs to this industry will have on the UK's pharma players who currently export £11bn worth of products to patients across the EU. Any disruption to this free flow of trade could be catastrophic.

Across the pond, Donald Trump is adding fuel to the fire and putting further pressure on sentiment by announcing drug companies are "getting away with murder" and promising to drive down prices. Given European healthcare companies are interconnected with the US, Trump's comments transcend the Atlantic and weigh on these stocks.

Finally, the news that big tech is entering the scene caused billions to be wiped off healthcare valuations earlier this year. Months of speculation that Amazon will turn its disruptive instincts to healthcare has weighed on share prices in every sub-sector of the industry, from drug makers to insurers and pharmacy benefits managers.

However, despite these headwinds, there is still potential for growth in the healthcare space for one simple reason: demographics. The share of those aged 80 years or above in the EU is projected to more than double between 2016 and 2080, from 5.4 % to 12.7 %.

(Eurostat http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=demo_pjangroup&lang=en)

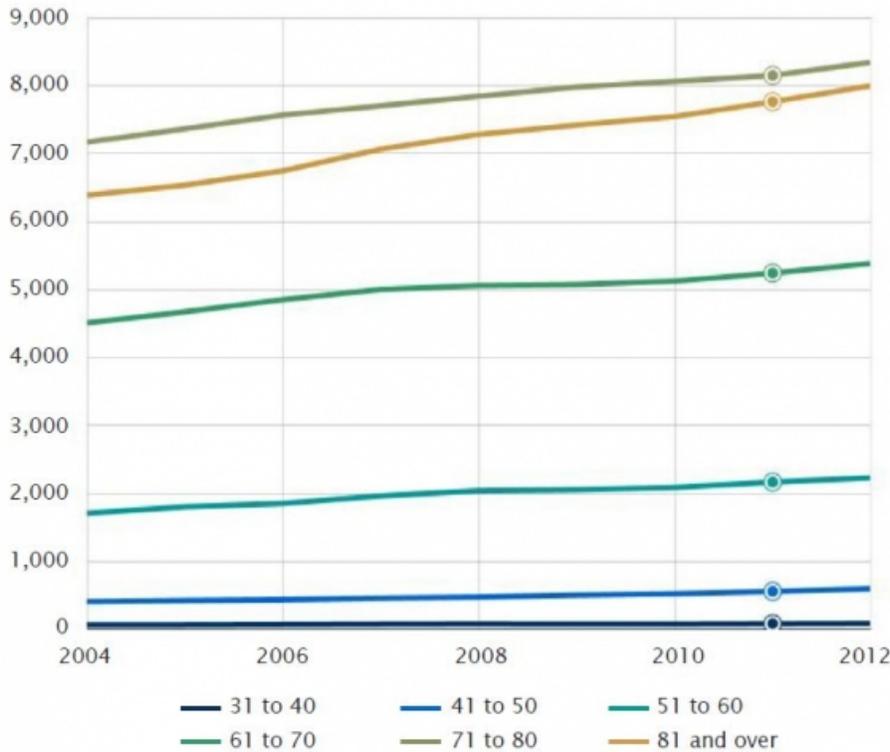
Moreover, the negative sentiment hanging over the industry is providing compelling opportunities to pick up quality companies at attractive valuations for contrarian investors like us. From proton therapy to ostomy, I discuss four sectors that are rising to the challenge of sustaining a better quality of life for the world's greying population.

Innovation in oncology

Proton therapy is a type of cancer radiotherapy deemed superior to conventional radiotherapy due to its better treatment efficacy and the minimisation of exposure to healthy tissue to the fact there is no exit beam. With cancer being the leading cause of death in the developed world and the prevalence as cancer rates rise dramatically in +55yrs old, the oncology market is set to continue to grow as companies continue to find ways to treat the disease.

Ion Beam Applications (IBA) is the market leader in proton therapy – with c50% of the global share – in this structurally attractive, oligopolistic market, which is expected to grow at a 15% CAGR to 2035. Belgian-listed IBA saw its share price more than half in the last twelve months; despite these short-term, cyclical headwinds, the company benefits from high barriers to entry, a strong backlog and a rock solid balance sheet which can support future growth.

Number of people ever diagnosed with COPD per 100,000, by age group, 2004



Source

British Lung Foundation, SYZ Asset Management. Data as at : June 2018

Opportunities in ostomy

Ostomy care involves performing surgery to create an opening in the body for the discharge of waste. As the prevalence of bowel disease increases with age, an ageing population is driving growth in this market. Due to the sensitive nature of such products, the customer base tends to be very sticky as you tend to find low switching rates.

Therefore, the market consists of a structurally attractive oligopoly, in which one of the world's largest players is ConvaTec. While ConvaTec's share price has been weak since June 2017, this is a business with strong competitive advantages, supported by attractive financials – high returns and profit margins and significant free cash flow.

Independent hospitals

With NHS budgets and resources under severe pressure and as the UK's demographic profile is changing, the UK's independent hospital sector has an important role to play offering private treatments and taking on NHS patients. In the UK, it is projected that the >65yr age group is expected to increase from c18% to 28% by 2050.

Moreover, the 'self-pay' segment of the market is growing rapidly with those typically in the over 50s age bracket opting to pay for treatment to avoid lengthy waits. Spire Healthcare plc is the number one player in this industry and should be well positioned to capitalise on this trend. It is one of the UK's largest private hospital providers, with 39 hospitals and 12 clinics across the country. Although 2017 was a turbulent year for Spire as NHS activity fell, following the removal of the 18-week waiting list target, this provides an attractive entry point into a high-quality business with solid long-term prospects.

Relieving respiratory ailments

Chronic Obstructive Pulmonary Disease (COPD) aka 'smoker's cough' is the fourth leading cause of death worldwide with increasing prevalence particularly in the elderly. The development of inhaled drugs requires the interplay of the following three factors: the drug, the formulation and the device; thus, it is a complex field, in which Vectura Group is a global leader with a very strong track record.

Vectura's technology is embedded in half of new inhalers launched from 2012 to 2016, demonstrating it is the partner of choice for targeting airways. While shares have been weak, it has a strong business model and high revenue visibility.

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