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The Prescription for Pharma Is Revenue Growth

Despite the hullabaloo about health-care reform, investors still reward revenue growth by pharmaceutical companies. But that growth requires organic and acquisitive reinvestment.

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The pharmaceutical and biotechnology industry has lost much of its pizzazz over the past decade and finds itself at an inflection point. Patent protection is ending for many of the best-selling drugs and the future of health care is as uncertain as it has ever been. Many of these life-sciences companies continue to be cash-generating machines, but how can they manage to create new shareholder value for their owners going forward?

Industry behemoths Eli Lilly, Pfizer, and Bristol-Myers Squibb have lost 45%, 33%, and 25% off their peak historical share prices, respectively, as of April 2, despite each of them delivering record revenue in 2011. Blockbuster drugs have produced tremendous sales and cash flow, but expiring patents will attract intense competition and those measures will likely decline. This market dynamic seems to be already priced into the companies' shares.

On the other hand, patent expirations have led to rising profits and a tripling of share price over the past 10 years for generic-drug company Teva. And biotechnology giants Biogen Idec and Celegene have continued to carve out very strong franchises in key therapeutic areas, and have delivered some of the strongest share-price performances in the space.

But with the debate over health-care costs and regulations intensifying in the United States and other nations, there are questions about the future profitability of life-sciences firms. What will it take for these once-great companies to get back on track?

A Dollar of Revenue Is Worth More

To determine the true drivers of shareholder value in this industry, Fortuna Advisors studied the growth, profitability, returns, capital-deployment practices, and share-price performance of the 24

largest players. To ensure the study wasn't biased by any one particular macroeconomic cycle, we evaluated two adjacent five-year periods — 2002 to 2006 and 2007 to 2011.

The prescription for better share-price performance is revenue growth. To deliver that growth, life-sciences companies must successfully invest both organically and via acquisitions. Continuous top-line growth mitigates patent cliffs and produces cash flow that can be redeployed into building or buying the next generation of drugs.

This industry is not resource constrained. Last year the 24 largest companies generated nearly $200 billion in earnings before interest, taxes, depreciation, and amortization and held more than $160 billion in cash and equivalents at the end of 2011.

We grouped the companies into high and low buckets based on revenue growth and found a strong correlation with total shareholder return (TSR). From 2002 to 2006, the high-revenue-growth companies grew by 19% per year; the low growers grew only 7%. The high growers generated a median TSR of 26%, while low growers generated a TSR of 2%. The same relationship held true in the 2007 to 2011 period. The high-growth group grew 18% versus 7% for the low-growth group, and the TSR performance was 43% for high growers and 11% for low growers.

Why is revenue growth so important in life sciences? It's one of the world's most profitable industries, so each dollar of growth adds more profit and value than it does in most other kinds of businesses.

To demonstrate, we use a measure called Residual Cash Margin (RCM) to determine the comprehensive profitability of a business based on cash earnings (after tax) less a charge for the use of gross assets in the business. In this analysis, we capitalized R&D as an asset.

Across the entire 10 years (2002 to 2011), the average RCM for a life-sciences company was 29% of revenue after covering operating costs, taxes, and the cost of capital. This is very impressive and helps to explain why revenue growth is ultimately so valuable to shareholders.

Deploying the Profits

What differences in capital-deployment strategies explain the disparity in revenue growth rates? The high-growth companies have clearly aligned their capital-deployment strategies with growth investments. They have done this instead of trying to achieve a balanced capital-allocation strategy that sacrifices reinvestment in exchange for greater dividends, buybacks, or cash accumulation.

Using a measure we call the “reinvestment rate,” we found that from 2002 to 2006 the high-growth life-sciences companies put nearly 100% of their cash earnings back into the business via R&D, cash acquisitions, capital expenditures, and net working capital. That compared with a reinvestment rate of only 58% for the low-growth companies. In addition, from 2007 to 2011 the high-growth companies increased their reinvestment rate to 114% versus 59% for their low-growth peers.

What were the biggest differences in reinvestment strategy between the high- and low-growth companies? The answer lies in the basic corporate-strategy question of “build versus buy.” That is, did the high-growth, high-investment companies deploy more cash earnings into organic growth (R&D and capital expenditures) or acquisitive growth (cash acquisitions)?

The answer may be surprising. From 2002 to 2006, the high-growth companies spent 29% of their cash earnings on acquisitions versus only 5% for the low-growth companies. In the subsequent five years, the high growers invested 48% of their cash earnings in acquisitions versus 16% for the low growers. These gaps are materially greater than the difference between the groups’ organic reinvestment rates, which were separated by four to six percentage points.

Rather than invest money back into the business, the low-growth group took a more balanced approach to capital deployment. In aggregate, they distributed much of their cash earnings to investors in the form of dividends and share repurchases. In both periods, low growers distributed 30% or more of their cash earnings — twice the level of the high-growth companies. However, their shares performed worse.

In an industry where revenue growth is so critical to creating value, distributions have done little to boost shareholder returns over time. Yet many life-sciences companies seem preoccupied with paying big dividends and buying back as much stock as possible.

With such industry uncertainty, history can only serve as a limited guide to the future. But despite the clamor over health-care reform, investors will still reward revenue growth by life-sciences companies. That requires organic and acquisitive reinvestment. Most low growers would better serve their investors by slowing down distributions and deploying their capital in acquisitions to improve the overall growth rate of the company.

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