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Where to put your money

High Return on Drugs

With scores of patents due to expire soon, companies with strong research and development departments and manufacturing capabilities are poised to grow

By Trish Saywell

If there's one lesson investors can take away from the outbreak earlier this year of Severe Acute Respiratory Syndrome, it's this: Health-care stocks are good bets over the long term. It's not just infections and other diseases that will keep the health-care services and drug-discovery and vaccine industries humming. Demographic trends dictate that the world's ageing population will require more medical treatment — particularly drugs — in the years ahead.

In Asia, Indian pharmaceutical companies are among the best placed to prosper from the growing market in cheaper generic drugs. Currently about 20% of the generic drugs sold in the United States are manufactured in India. And this percentage is only likely to grow as drugs with sales of nearly $60 billion are expected to go off patent in the next five years. India's drug makers are also challenging patents in the US and exploring more partnerships abroad**. "Nobody can put in place the kind of capacity that India has to make cheap pills — it doesn't exist anywhere else," notes Jon Thorn, who manages the $55 million India Capital Fund from Hong Kong.**

The US Food and Drug Administration has approved 61 manufacturing plants in India — the highest number of any country outside the US. Indian companies are setting up factories at about one-tenth the cost of building a similar plant in developed markets. Meanwhile, wages are a fraction of what they are in the US and Europe and prices of generics in the developed world are about seven times higher than they command in India.

But their strengths don't just lie in churning out cheap generic drugs or the active ingredients that go into making finished drugs. Increasingly, companies in India are channeling more money into research and development to discover new drugs and conducting clinical trials as well.

Ranbaxy, one of the more liquid drug counters, also has a fan in Swee-Kheng Lee, a fund manager who watches emerging markets at Morely Fund Management in London. She says that with a return on equity of 35%, she ìhas made quite a lot of money from the stockî and likes its expansive drug portfolio that earns revenues in both developed and developing markets. Lee disagrees with some analysts who argue that the stock, which trades at 23 times fiscal 2005 earnings, is overvalued "When you're talking of 15–20% growth per year over the medium term it's not expensive,î she says. ìIf you compare Ranbaxy with generics makers in the US it is not that badly valued."

Equally if not more interesting, fund managers and analysts say, are India's mid-cap stocks or those whose market capitalization is less than $500 million. **Thorn of the India Capital Fund is loading up on Nicholas Piramal, India's fifth-largest drug maker with one of the largest distribution networks in the country. Its share price this year has more than doubled to 575 rupees ($12.57), up from 250 rupees in January. Since March, Thorn has increased his fund's position in the stock by about 25%.**

Nicholas Piramal posted an 82.4% increase in second-quarter net profit to 476.9 million rupees, compared with 261.5 million rupees during the same quarter last year. An acquisition spree has given Nicholas Piramal one of the widest product portfolios in India; its major acquisitions include the Indian operations of Roche, Boehringer and Rhone Poulenc. It is also investing in R&D and has announced plans to kick-start clinical-trial capabilities. Thorn also likes Nicholas Piramal because unlike other Indian companies like Ranbaxy and Dr Reddy's, it doesn't challenge the patents of the big pharmaceutical companies and therefore stands a better chance of partnering with big multinationals in the years ahead.

Singapore-based Dydasco, who runs the $816 million New Asia Fund at T. Rowe Price International, likes Divi's Laboratories. The Hyderabad-based company has focused its efforts on supplying generic players with bulk drugs or active pharmaceutical ingredients. Divi's is among India's most profitable mid-cap companies with operating margins of close to 30%. Exports accounted for about 91% of its 2.5 billon rupee revenues in the fiscal year ended March 31. About 70% of its revenues come from the supply of active pharmaceutical ingredients and the rest from emerging businesses. These include conducting R&D to find new compounds or molecules that multinational companies can use in new drug discovery.

India may have the lion's share of pharmaceutical companies in the region, but fund managers looking outside South Asia also see value in Malaysia and Australia. Tan Pye Sen, head of research for JP Morgan in Kuala Lumpur likes integrated health-care company Pharmaniaga. The company, which is 31% owned by United Engineers, has registered double-digit profit growth on an annual basis since it listed in 1999. "Its key contract is that it's got a 15-year exclusive concession to distribute medicines to hospitals in Malaysia," says Tan, adding that under the government's Eighth Five-year Plan 5.5 billion ringgit (1.4 billion) has been allocated to the pubic-health sector. ìGovernment spending on heath care is growing and if you want to get a play on it, there's no better one than Pharmaniaga.î

In Australia, Mark Edwards, a portfolio manager at T. Rowe Price in Hong Kong, likes the Mayne Group, a diversified hospital and pharmaceutical group that is in the process of ìselling off its hospitals, which are low return, and deploying the returns into higher-return, higher growth generics.î The company makes vaccines and specializes in cancer.

Samir Mehta of Lloyd George Asset Management in Hong Kong also likes Australian stocks such as Cochlear, which makes hearing aids. It's a bit expensive but "it's a phenomenally good company," he says. It delivers double-digit earnings growth of about 15% year after year. "It's well-managed, they spend a lot of money on R&D and they keep coming out with new variants of the technology." Cochlear controls about 60–65% of the global market.

Mehta also likes CSL, which makes children's vaccines and sells them in Australia. It also works in plasma-protein or blood-derivative products with facilities in Europe, Australia and the US. CSL has been growing by acquisition and Mehta anticipates further consolidation in the industry. "In the past couple of years the industry has been plagued by overcapacity and pricing was decimated," he says. "I reckon consolidation is very likely and we might see rationalization in the process. I'm extremely positive and am adding to my position."