BY JOHN KINGHAM

DIVIDEND HUNTER

WAS WOODFORD RIGHT TO SELL GLAXOSMITHKLINE AND HOLD ASTRAZENECA?

AstraZeneca (LON:AZN) and GlaxoSmithKline (LON:GSK) are the two pharmaceutical giants of the FTSE 100. They are also both high yield dividend stocks with yields of more than 4%. Another notable fact is that both companies have been long-term holdings of a certain Mr Neil Woodford. But no more. Following a 15-year holding period, Woodford sold Glaxo earlier this year, partly due to fears about the dividend's sustainability. Meanwhile, AstraZeneca remains in Woodford's equity income portfolio with a hefty 8% weighting. So is AstraZeneca really a better bet than Glaxo? Let's take a look.

AstraZeneca: A company facing a difficult period

- **Share price: 5284p**
- **Dividend yield: 4.1%**

In many ways, AstraZeneca and Glaxo are very similar. Their core business is to develop new and better medicines and then sell them all over the world. The process of developing better medicines can be hugely expensive. It can take vast armies of scientists beavering away in laboratories for years on end, all hoping to develop the next "blockbuster" product. Once developed and approved by various regulatory bodies, it would then be extremely easy for competitors to manufacture exactly the same medicine, without all that pesky upfront R&D expense. Medicine prices and profit margins would be driven down to the point where AstraZeneca or Glaxo would struggle to make a decent return on their original R&D investment. If that were allowed to happen, there would be little financial incentive to develop newer and better medicines in the first place.

The answer to this conundrum is to use patents and intellectual property law. These effectively block generic competitors (i.e. low cost manufacturers who specialise in manufacturing existing medicines at low cost, rather than developing new medi-

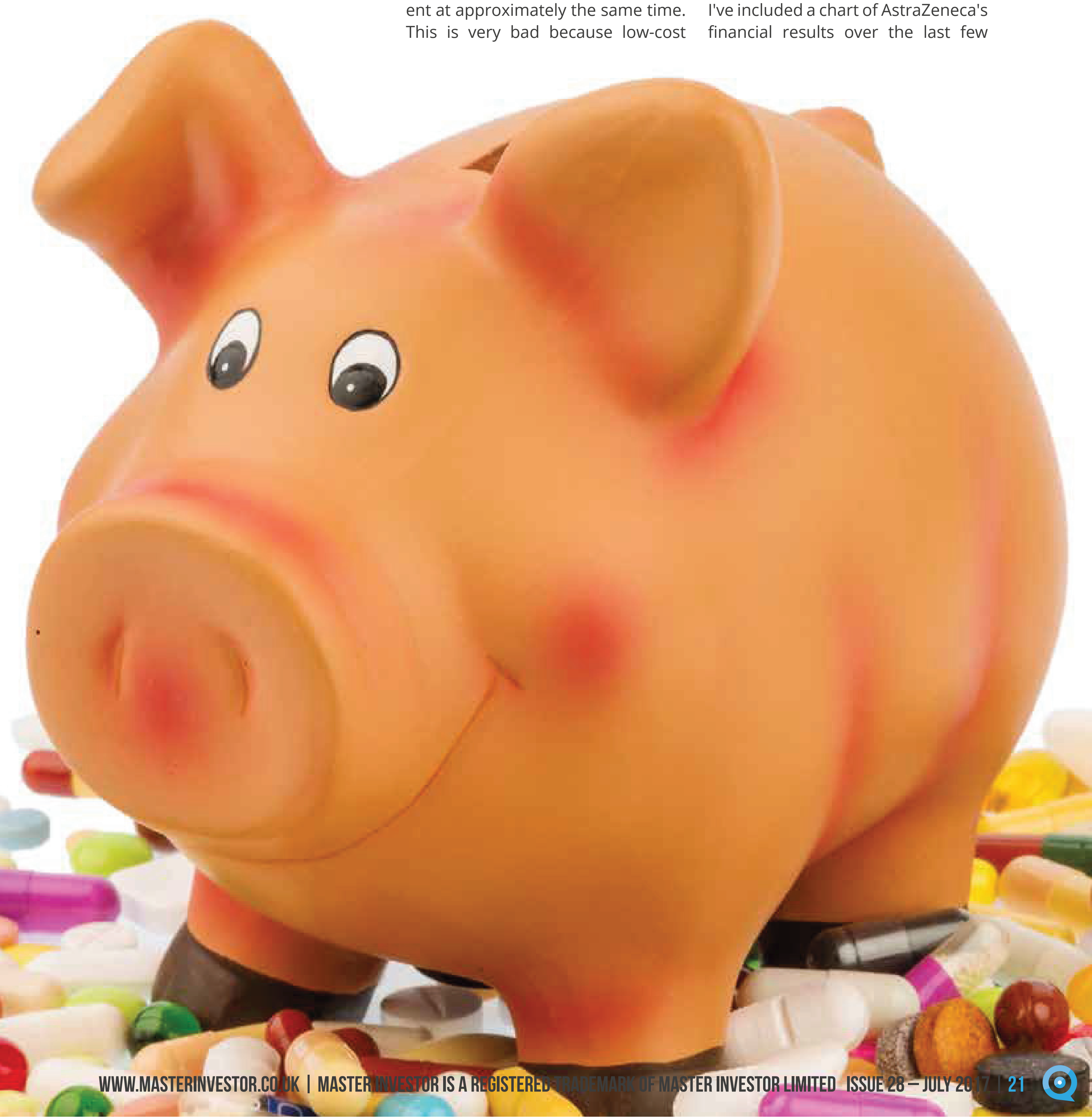
"IN RECENT YEARS BOTH ASTRAZENECA AND GLAXO HAVE SUFFERED FROM THE TYRANNY OF THE 'PATENT CLIFF'."

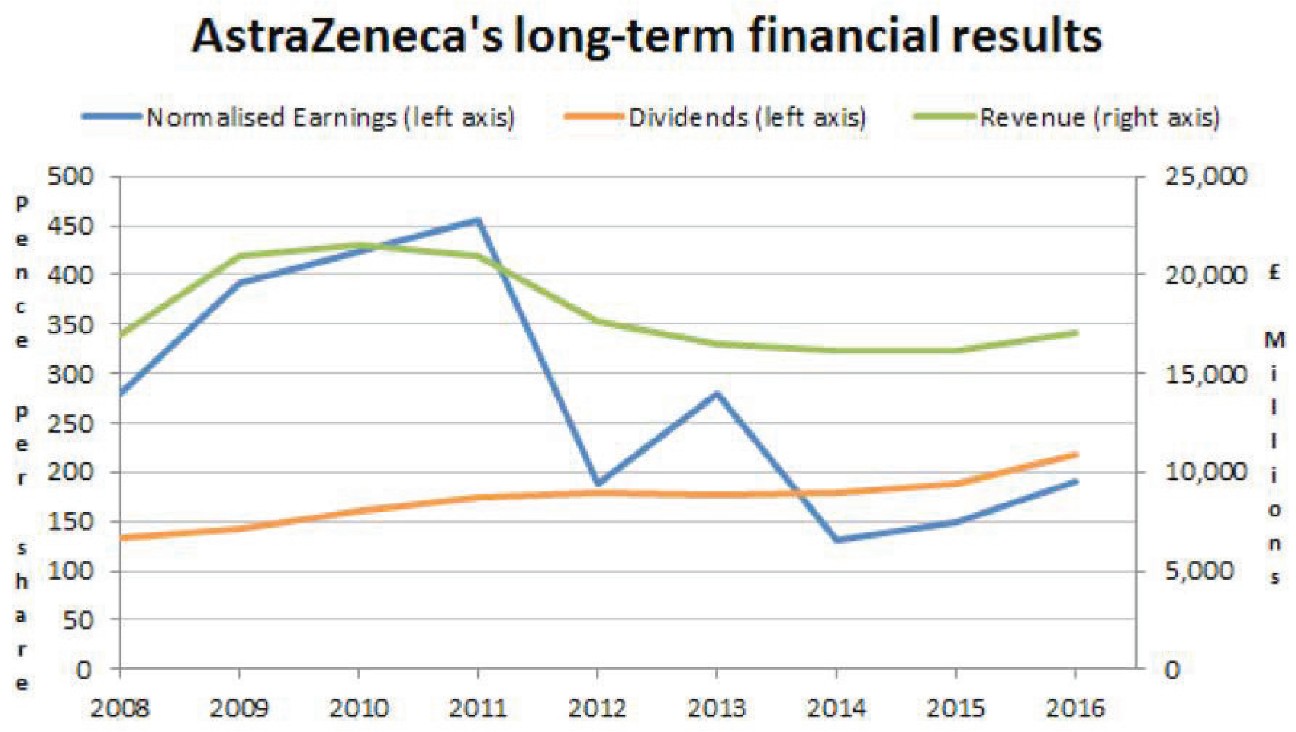
cines) and allow the original developer of a medicine to charge higher prices. Companies like Glaxo and AstraZeneca can then generate the profits they need to make the original R&D investment worthwhile.

However, patents do not last forever, and in recent years both AstraZeneca and Glaxo have suffered from the tyranny of the "patent cliff". This is a period where several blockbuster medicines go off-patent at approximately the same time. This is very bad because low-cost competitors will be able to produce the same medicine at much lower prices, driving higher margin companies like Glaxo and AstraZeneca out of the market. To replace those lost revenues and profits, Glaxo and AstraZeneca must then invent new medicines to replace the old, which entails a lot of expense with no guarantees of success.

Financial performance has suffered from the patent cliff

I've included a chart of AstraZeneca's financial results over the last few





years and the impact of the patent cliff is clear to see.

There has been a small decline in revenues in recent years (thanks to the patent cliff) and this has led to a substantial decline in profits. Despite this, the board have chosen not to cut the dividend.

I look for three things when first investigating a company. These are: 1) long-term growth (averaged across revenues, earnings and dividends), 2) long-term growth quality (i.e. consistency) and 3) good long-term profitability (i.e. above average return on capital employed).

Here are the relevant numbers for AstraZeneca, compared to those of the FTSE 100:

- **Growth rate: -3.7% (FTSE 100: 2.5%)**
- **Growth quality: 71% (FTSE 100: 50%)**
- **Profitability: 15% (FTSE 100: 10%)**

So from a high level, and somewhat simplistically, AstraZeneca has negative growth, reasonable growth quality (mostly thanks to its progressive dividend) and good profitability.

That isn't exactly a brilliant track record. Woodford must believe that AstraZeneca's future will be better than its recent past, but its future depends almost entirely on how it deals with its ongoing patent cliff. Will revenues and profits continue to decline, or will Astra be able to offset the loss of old medicines with new and better ones?

AstraZeneca is struggling to turn its patent cliff around

AstraZeneca has been in the grip of its patent cliff for more than five years, a period where up to half of its revenues were expected to be at risk from competitors as patents expired. Fortunately, the end of this patent cliff is in sight. The patent for Crestor (which helps patients lower their cholesterol levels) has just expired in the US, and Crestor is the last of AstraZeneca's old blockbuster drugs to go off-patent. This will drive revenues and profits lower, but it also marks a potential turning point for the company.

Now all eyes are on the company's pipeline of new drugs, which it has been investing in heavily, and upon which its future prospects, dividend and share price depend.

In some ways the picture is rosy, at least according to the CEO who recently said, *"Three years ago we had a lot of money and not enough projects. Now we have a lot of projects and not enough money to fund all of it"*. He also said, *"2017 has the potential to be a turning point for our company as we near the end of our patent-expiry period and bring new medicines to patients across the globe."*

"IF ASTRAZENECA CANNOT SUCCESSFULLY REPLACE PROFITS LOST FROM CRESTOR, THEN IT MAY HAVE TO REDUCE OR SUSPEND THE DIVIDEND IN ORDER TO KEEP ITS LENDERS HAPPY."

But these are just words. The reality is that nobody really has the faintest idea whether these new medicines will perform as hoped. There is quite simply an enormous amount of uncertainty.

When there is a lot of uncertainty, it's best to have a strong balance sheet with little or no borrowings. Unfortunately, AstraZeneca has not followed that basic principle. Instead, its debts are currently over £13bn. That's almost six-times the company's recent average profits and generally I'm not happy if that debt ratio is above five. This adds another layer of risk. If AstraZeneca cannot successfully replace profits lost from Crestor, then it may have to reduce or suspend the dividend in order to keep its lenders happy.

Overall, I think AstraZeneca is a good and highly profitable business, but its dependence on patents makes it risky, despite the defensiveness of its individual products. I think AstraZeneca's dividend is under threat and so its share price would need to reflect that, otherwise I don't think it would be worth the risk.

At what price is AstraZeneca good or fair value?

Given that Woodford still holds AstraZeneca he must think it is at least reasonable value at its current price of 5284p.

And he could be right. The shares have a dividend yield of 4.1% compared to the FTSE 100's yield of 3.7% (and more like 3.2% from an index tracking fund), so it's clear that investors are demanding an above average yield to offset the above average risks.

For me, good value and fair value are defined primarily by my stock screen, which ranks stocks according to their combined growth, income, quality and value characteristics. If a company is in the top quartile (top 50, more or less) then it's good value, if it's close to halfway down the list then it's fair value, and if it languishes towards the bottom it's poor value.

Today, AstraZeneca is in position 108 out of 222 dividend-paying stocks, so it's very close to but slightly better than the halfway point of 111. The implication is that it's priced below but very close to fair value.

- **Fair value for AstraZeneca: Approx. 5300p**

If I was Woodford then I might continue to hold AstraZeneca at this price, but I certainly wouldn't want to open a position at this price. I would also probably halve its position size from 8% to 4% in order to reduce risk.

To be good value (and a potential buy), AstraZeneca would need to be substantially cheaper. To get into the top 50 stocks on my stock screen (which is where I typically search for new investment opportunities), the share price would have to fall below 3500p.

- **Good value for AstraZeneca: Below 3500p**

At 3500p AstraZeneca would have a yield of 6.3%, which I think is a more attractive yield given the uncertainty about the company's future and its dividend.

So broadly, I agree with Woodford so far. I think AstraZeneca is a weak hold if it's already in a portfolio, but it isn't something I would want to buy today. And if the share price went up by another 20% or so with no improvement in the fundamentals, I would almost certainly sell.

GlaxoSmithKline: Big pharma with a consumer defensive twist

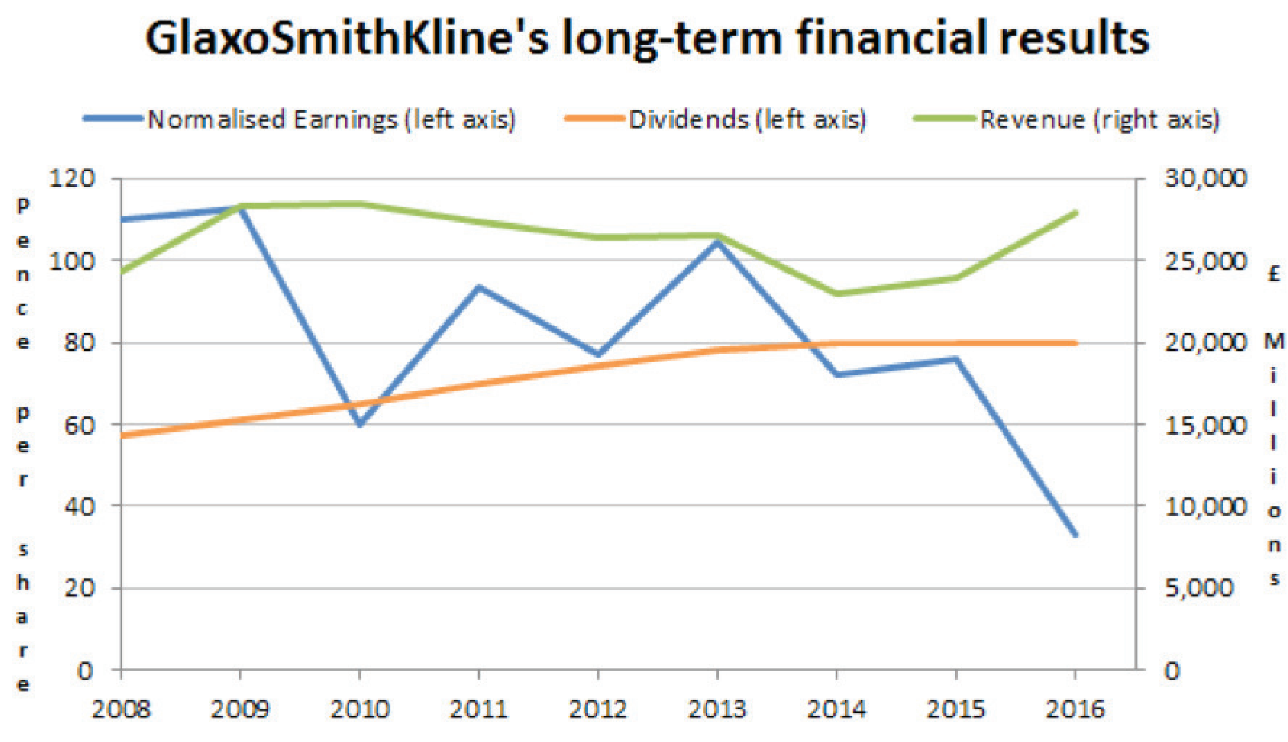
- **Share price: 1685p**
- **Dividend yield: 4.7%**

Glaxo's core business is very similar to AstraZeneca's. It invests heavily in R&D in the hope of inventing novel (and patentable) medicines which will improve peoples' lives.

But they're not identical. Glaxo also has a significant consumer healthcare and wellness business, selling products such as Panadol headache tablets, Sensodyne toothpaste and even Horlicks the bedtime drink. This part of Glaxo, which generates 26% of the company's total revenues and 14% of total pre-tax profit, is very defensive. Most people will use Horlicks, Panadol or Sensodyne regardless of whether there's a recession or not. This gives Glaxo a stabiliser that AstraZeneca lacks, which could help Glaxo cope with its own long-running patent cliff.

In recent years Glaxo has flatlined

With many of its leading products going off-patent in recent years, Glaxo has struggled to move forward against



this headwind. If you look at Glaxo's chart, you'll see that revenues and earnings have been declining for most of the last few years. Even management have had to face up to this reality and as a result they've held the dividend flat for several years.

Here are my big three numbers for Glaxo, based on the last few years and again compared to those of the FTSE 100:

- **Growth rate: -1.3% (FTSE 100: 2.5%)**
- **Growth quality: 63% (FTSE 100: 50%)**
- **Profitability: 14% (FTSE 100: 10%)**

Glaxo's results are very similar to those of AstraZeneca: Negative growth, reasonable growth quality (mostly thanks to the dividend) and good profitability. On the face of it there isn't much to choose between the two in terms of their accounting results, so why is Woodford more negative about Glaxo than AstraZeneca?

Glaxo: A highly indebted jack of all trades?

There are many potential reasons, not least of which is Glaxo's patent cliff. On that gloomy subject, Advair (a treatment for asthma and Glaxo's biggest seller for many years) is already off-patent and could see more than £1 billion of revenues evaporate over the next few years as generic competitors enter the market.

But there are other problems too. In particular, I want to focus on the company's enormous debt pile and its potentially inefficient combination of pharmaceutical and consumer healthcare businesses.

For many years, Glaxo has carried borrowings of around £15 billion. That was a lot, even when the company was earning close to £5 billion. More recently, the company's average profits have fallen below £3 billion and today the company's debts stand at more than six times its recent average profits. Woodford called the balance sheet "stretched", but I think it's simply too much debt for this company. Yes, if things go well for Glaxo then its debt mountain could be sustainable, but if Advair's revenues collapse and there isn't a good replacement then dividend cuts or suspensions could be unavoidable.

As if that wasn't bad enough, the company also has a near-£20 billion pension liability and a £2 billion pension deficit. This is effectively another debt and pushes up the ratio of debts to profits to more than seven, which is well above my preferred limit of five-times.

Another potential problem, which Woodford is famously negative on, is the company's mix of businesses. Put simply, a developer of cutting edge medicines (which is Glaxo's core business) may not be the best owner of a toothpaste and bedtime beverage manufacturer (i.e. Glaxo's consumer healthcare business).

The company's line is that these different businesses benefit from shared corporate infrastructure, global supply networks and R&D. But many others, including Woodford, think Glaxo would be better off splitting into several highly focused companies, and I tend to agree. Glaxo's diversity does make it a more stable company, but the price of that stability could be an inability to compete with more singularly focused competitors.

Of the two companies, I would agree with Woodford. Glaxo looks riskier because of its higher debt levels, large pension obligations and relative lack of focus. Even so, if the price were low enough it could be worth hanging on to.

Good value and fair value for Glaxo

Glaxo has a higher yield than AstraZeneca, which makes sense as it's a potentially riskier investment. According to my stock screen though, this additional yield is not enough to offset Glaxo's weak financial track record.

Glaxo currently sits at position 119 out of 222 stocks on my screen, slightly worse than AstraZeneca's position at 108 and very slightly worse than the fair value halfway point of 111. As with AstraZeneca, Glaxo is basically at fair value:

- **Fair value for Glaxo: Approx. 1650p**

Good value, i.e. where Glaxo becomes one of my top-50 dividend-paying stocks, requires a much lower price than that:

- **Good value for Glaxo: Below 1000p**

AstraZeneca wins, but neither offers compelling value

To paraphrase Gordon Brown, I agree with Neil. I think AstraZeneca is the better choice, but it's a very close run thing. I also think neither company is obviously good value at their current prices. Despite this, I remain a shareholder in both companies, although both of them are fairly close to being kicked out of my portfolio, with Glaxo being slightly closer to the exit than AstraZeneca.

About John

John Kingham is the managing editor of UK Value Investor, the investment newsletter for defensive value investors which he began publishing in 2011. With a professional background in insurance software analysis, John's approach to high yield, low risk investing is based on the Benjamin Graham tradition of being systematic and fact-based, rather than speculative.

John is also the author of *The Defensive Value Investor: A Complete Step-By-Step Guide to Building a High Yield, Low Risk Share Portfolio*.

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