An Example of Investment Thesis: AstraZeneca plc (AZN)

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The recent acquisition of Alexion Pharmaceuticals provides an opportunity to affirm our AstraZeneca investment expectations. Developing a set of differentiated fundamental expectations that are codified in an investment thesis for each company is an important component of the Crawford Investment Counsel investing process. AstraZeneca remains one of our preferred stocks in the BioPharma sector and Healthcare industry, primarily because the company's management team gives us confidence that our expectations will materialize and result in superior shareholder returns. Specifically, our expectation is that over a three-year timeline, AstraZeneca should have the highest revenue and operating profit growth in large-cap BioPharma, reaping the rewards from overinvesting in research and development for at least the last six years. With no more significant product losses and a slightly improving valuation gap, our annual total shareholder return of 12.5%-15.5% over the next three years is one of the highest expected in the BioPharma industry.

AstraZeneca is a long-held position in several Crawford Investment Counsel portfolios, with the initial purchase in early 2016 for higher income-oriented strategies. Our initial thesis was simple: AstraZeneca's significant dividend (>4.0%) could be sustained through an upcoming difficult operating period. From 2015 through 2017, AstraZeneca was losing significant revenues from patent expirations on several large products, most notably Crestor, Nexium, and Seroquel. The market had negative sentiment towards this, but the shift in thought that led to our initial investment was a capable management team combined with promising clinical results and early launch feedback from a new trio of oncology products.

Investing is largely a fluid process and not an on-and-off switch. As our familiarity with AstraZeneca increased, we felt the company's pipeline would be significantly larger than Consensus and even our initial expectation. From there, our next step was determining if AstraZeneca would be a fit for other portfolios such as those seeking a more balanced combination of growth and income. For this we needed to shift our perception from a company that simply provided a sustainable above-average dividend to a company that could produce consistently higher returns and growth. The answer was discovered in the mindset of AstraZeneca's management.

In a series of meetings in 2016 and 2017 with AstraZeneca, it was very difficult to get a satisfactory answer regarding the dividend. Initially, this was perceived to be a risk. At Crawford Investment Counsel, we use steadily growing dividends as an initial proxy to help identify what we believe to be higher-quality companies. It was clear AstraZeneca could afford its current dividend. It was also clear that AstraZeneca was going through a transformation that could significantly accelerate cash flow, but management was adamant it would not be increasing the dividend.

This is where flexibility in thought took precedence over strict investment rules. With AstraZeneca, we recognized that management was resolved to grow the franchise. With each quarter, research and development spending was trending up faster than we expected, a "problem" because it appeared the company was missing our internal forecast. With each quarter, sales and marketing costs were trending higher which was also a "problem" as the company was falling behind our projections. But through this early phase of ownership, patience and a number of outside performance metrics showed the potential for a better company than our early numbers suggested. We came to realize AstraZeneca's management was not managing the business for each quarter or even the current year. We had discovered a management team focused on providing the best long-term return to investors, not massaging quarterly results or managing for the short term.

Management was not satisfied with just a handful of oncology drugs and expanded its plan rapidly. The result is that today AstraZeneca has ten recently launched products across the oncology, respiratory, endocrinology, and cardiovascular therapeutic areas. AstraZeneca has forged forward in China at a faster pace than any other outside pharmaceutical company, capturing the growth in the Chinese market as it becomes more developed. But the hallmark and sometimes controversy with AstraZeneca amongst investors remains its bold and aggressive use of capital in business development.

When we think of AstraZeneca's business development, the company has pursued three types of transactions. First, AstraZeneca cannot be all things and thus has divested older, slower growth products that do not fit its therapeutic focus. Second, AstraZeneca has been prescient in partnering to bolster its focus franchises. A good example is a partnership with Merck to market Lynparza, an oncology drug that was not initially praised. However, Merck's ability to significantly increase revenues for Lynparza including further clinical development has proven this to be a mutually beneficial partnership. Lastly, AstraZeneca has aggressively brought in new assets to develop. These range from the underappreciated Lokelma (for high potassium levels) to the very flashy Enhertu (a next-generation drug antibody conjugate), and others which contribute to the platform expanding.

And this brings us full circle to the recent Alexion acquisition. The majority of analysts and investors see Alexion and worry about its lead therapy, Soliris. Soliris treats a rare red blood cell disease, and despite losing patent protection in two or three years, AstraZeneca sees opportunity. Part of this opportunity includes extending the franchise's life cycle with Ultomiris. We tend to agree and like the risk/reward of this endeavor.

Our view is that it will take hard work and time, but our investment thesis remains firmly intact. We think in three years' time, investors will no longer be worried about Soliris because Ultomiris will have replaced it. In three years' time, it is possible that Ultomiris will have additional indications and be larger than current projections. Within three years' time, AstraZeneca has likely expanded Alexion's base products globally, especially in China. It is not a stretch that in three years' time AstraZeneca's third-generation complement inhibitors will be closer to clinical reality. And we believe that is how AstraZeneca will create a new disease-vertical center of excellence and sustainable growth. They identified something that most pharmaceutical competitors have discarded because of a flaw and then proved that the flaw was only a minor part of the longer-term success. Because in three years' time, we feel AstraZeneca will be strengthened by the contribution from the Alexion transaction as it begins to see competition against some of its current therapies.

The other necessary components of the Crawford Investment Counsel equity research process are quality and attractive valuations.

Why do we view AstraZeneca as QUALITY? AstraZeneca's pharmaceutical roots go back to 1913, and the company has paid a consistent dividend since the merger of Astra and Zeneca Group in 1999. AstraZeneca is committed to basic research, having launched ten new products in the last five years in areas such as oncology, respiratory, and cardiovascular. Earnings consistency, balance sheet strength, and profitability all indicate a very high-quality business. This is non-negotiable in the Crawford Investment Counsel process.

How do we view AstraZeneca's VALUATION? Because of AstraZeneca's higher growth rate and improving financial profile, the company trades at a deserved premium to other BioPharma companies and the Healthcare sector. In our view, this company is an example where paying a modest premium is worth the risk. Our expectation is for faster growth that should be more sustainable and lead to higher returns.

Why is AstraZeneca in the portfolio? On the most basic level, AstraZeneca has the highest revenue and operating profit growth of any of the large-cap BioPharma companies due to a very strong recent product launch schedule and a lack of products losing patents over the next five years. More importantly, we view AstraZeneca as a biotechnology company, not a pharmaceutical company, with the difference being an aggressive management team that is willing to invest significantly in research and development and actively deploy capital to sustain growth. We continually evaluate the AstraZeneca investment on the bases of current valuation, quality, and the investment thesis.

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