August 2023

Pharma Industry's DNA Imparts Quality

CRAWFORD
INVESTMENT COUNSEL
Est. 1980

At Crawford Investment Counsel, we view *Dividend Integrity* as a vital piece of our investment philosophy. Companies that exhibit *Dividend Integrity* are better equipped to withstand macroeconomic headwinds, maintain earnings, and sustain and raise their dividends over time. We believe investors benefit from investing in stocks of this nature because they demonstrate a positive risk/return tradeoff, enhanced visibility, and a stable, and often growing, income stream.

To build our clients' portfolios, we start at the company level with a rigorous fundamental, bottom-up research process. But often, industry forces can be just as important as company attributes. Competition, economic cyclicality, government regulation, and seasonality can impact portfolio returns just as much as company attributes, such as quality of management, superior products, or financial condition. Companies in the pharmaceutical industry have a history of utilizing a balanced approach to capital allocation where they both invest significantly in new product development AND pay sustainable dividends with consistent share repurchase activity. There are various forces at play within the industry that make this possible.

First, the pharmaceutical industry addresses a limitless market. This is not simply the $1.5 trillion spent globally by consumers on medicine in 2022. The better point of reference for the total market includes all health and well-being related issues. The industry is addressing diseases and illnesses today that were previously thought incurable. New healthcare problems create new markets. Only in the very distant future might humans have the ability to solve all health-related problems. Until then, cancer, depression, obesity, and a host of other maladies provide ample growth areas for the pharmaceutical industry.

To solve these health-related problems, the pharmaceutical industry creates new medicines through a costly and complex research and development (R&D) process. The top fifteen pharmaceutical companies spent $130 billion in R&D in 2021, a 45% increase over five years. Additionally in the same year, $47 billion, across more than 2,000 transactions, was raised for start-up and smaller companies, much of which will be spent in new medicine development. The industry lobbying group estimates it costs $4 billion to bring a new drug to market. The Congressional Budget Office estimates this cost is between $1 billion and $2 billion. Either estimate presents a tremendous capital barrier to entry. But the greatest barriers are the scientific knowledge and human capital needed to complete the development process. In investing, we typically refer to barriers of this nature as moats, like those that protected castles of old. Moats can signify long-term durability and consistency in operations for the pharmaceutical industry.

Because of the value to society that medicines bring, governments reward pharmaceutical companies

with exclusivity periods, or patent protection. For taking the risk to develop a new medicine, almost every developed country rewards the developing company with little or no competition for a limited time. During this period, companies enjoy "rent" on their products. Economically, rent means charging a higher price for a product than what is necessary. These higher prices lead to greater profitability and cash flows, which ultimately are reinvested back into R&D. In other words, a well-run pharmaceutical company creates a virtuous cycle of extended profitability and growth.

Lastly, companies within the pharmaceutical industry have a long history of developing, acquiring, and divesting ancillary businesses. Although pertinent, we are not simply referring to the purchase of smaller companies to build pipelines. The industry has nurtured and developed many of the ancillary healthcare businesses. Eli Lilly, Merck, and Pfizer were leaders in creating the animal health industry. Johnson & Johnson, GlaxoSmithKline, Pfizer, and Novartis have all held substantial consumer products businesses, although most are now divested. Going further back, pharmaceutical companies have held leading positions in diagnostics (Roche still does), pharmacy benefit management, and medical devices. The embedded science-driven culture within pharmaceutical companies has benefitted shareholders over the long term through creating or growing businesses that become more valuable when divested.

These four traits – large markets, ability to reinvest in new products, patent protection, and nurturing ancillary businesses – are the main reasons that pharmaceutical companies generate excess cash. While much of this excess cash goes back into growth, there is often a large percentage returned to shareholders through sustainable and growing dividends. Over the last 30 years, pharmaceutical companies have experienced periods of significant outperformance, mainly around scientific advancement with products in new disease areas, but also during times when the economy lagged. When bubbles burst, regardless of the cause, pharmaceutical companies have typically outperformed and continued to pay and increase their dividends, providing client portfolios with stability and income.

At Crawford Investment Counsel, we focus on building portfolios for our clients that include high-quality, dividend-paying stocks. While every single investment makes it into a portfolio on its own merit, we appreciate industries that are uniquely positioned to cultivate high-quality companies with sustainable operating profits and consistent and growing dividends. The environment we are facing suggests a heightened level of uncertainty and challenging business conditions for the foreseeable future, and we believe this only increases the importance of investing in industries that foster *Dividend Integrity.*

Crawford Investment Counsel ("Crawford") is an independent investment adviser registered under the Investment Advisers Act of 1940, as amended. Registration does not imply a certain level of skill or training. More information about Crawford, including our investment strategies, fees, and objectives, can be found in our Form ADV Part 2and/or Form CRS, which is available upon request.

The opinions expressed are those of Crawford. The opinions referenced are as of the date of the commentary and are subject to change, without notice, due to changes in the market or economic conditions and may not necessarily come to pass. There is no guarantee of the future performance of any Crawford portfolio. Crawford reserves the right to modify its current investment strategies and techniques based on changing market dynamics or client needs.

Material presented has been derived from sources considered to be reliable, but the accuracy and completeness cannot be guaranteed.

CRA-23-150