Investors' Chronicle | Alpha

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Alpha shares analysis

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The world according to GARP

Not the 1982 Robin Williams film but Growth at A Reasonable Price, the methodology devised by investment guru Jim Slater, has long been a reliable strategy for picking stocks that can outperform. Our GARP screen has thrown up three very different stocks, each beating positive paths through their respective end markets. A reasonable price does not always mean a low PE or EV/Ebitda if the fundamentals are strong, re-orientation or reinvention can augment the market drivers, large distributions can be foreseen, risk is very well-contained or the ESG case is very positive. Our three picks all have a strong investment backstory, but strong recent share price rallies have consumed much of the near-term value or sought to overlook risk.

Beating their own drums

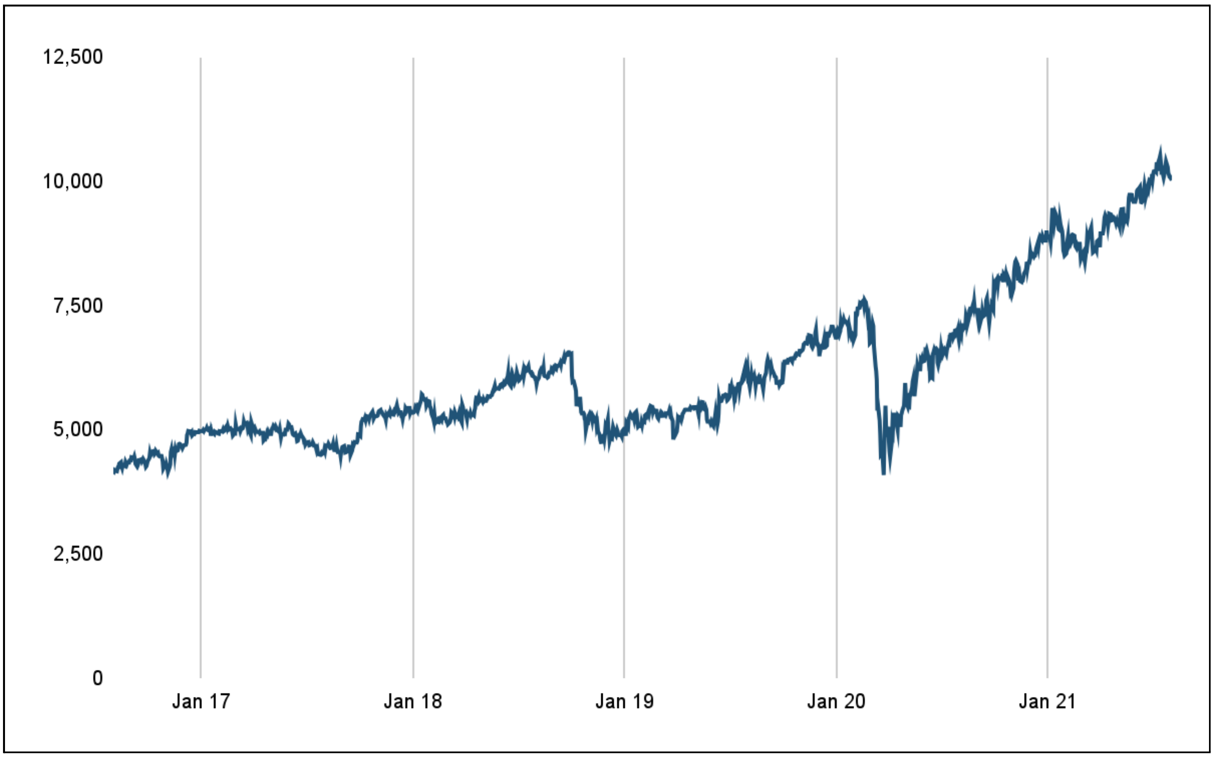
- **Ferguson** – the transition to a wholly North American business is almost complete with the only question now being will Ferguson delist from the UK? A business transformed from an aggressive acquirer and branch opener into a smart user of technology and logistics to grow. This liberates the high free cash flow to make high returns, albeit with a bias to buy-backs. After a long overdue re-rating, however, the shares are now likely to mark time.

- **Smart Metering Systems** – green generation is just part of the story in the transformation of the UK's electricity space. A clearer and more granular understanding of demand via smart metering plus localised distribution and storage from renewables spark revolutionary change. SMS is a key provider running term, indexed contracts with the largest players giving great visibility into long-term growth – a hefty 65x PE, but in context that is not demanding especially when stood against 2020's collateralised sale at 16x passing revenue.

- **Hikma** – an ageing and long living global population heightens the need for access to affordable complex medicines. Hikma is well positioned to ride the near double-digit expansion in the generic/off-patent pharmaceuticals market, with strong margin growth driven by the very profitable injectables segment. Hikma offers 12 per cent EPS CAGR, but a near 60 per cent rebound post-Covid slump leaves the year two PE at 16.5x and the shares would look better value closer to 2,300p, but there is still good long-term attraction here.

Analyst: **Robin Hardy**

Ferguson – bringing technology into a low tech world



Source: FactSet

Now wholly focused on the still fragmented US market

Ferguson (FERG) is a market leader across a wide range of materials supply and distribution within the US construction market. After a decade of rationalisation, it finally honed its focus to be wholly North American (95 per cent USA and 5 per cent Canada) after the sale of its remaining UK businesses to private equity in early 2021.

Ferguson is market leader in four of its nine market segments and in the top four in all bar one of the remainder. But the markets in which it operates remain highly fragmented with many smaller, strong local players. In the key $50bn heating, ventilation and air-con (HVAC) market, for example, it is the number three player nationally, but controls just 4 per cent market share. However, in its core residential market there is less fragmentation and Ferguson's market share is closer to 15 per cent. This type of market structure presents, at the same time, a light and dark side. On the positive side, there are immense opportunities for expansion, with even dominant local players being very small against Ferguson. The flipside, however, is that very long tail market segments can be highly competitive and while the group has always had a very strong focus on customer satisfaction to drive sales, construction industry customers are not strong on supplier loyalty. How best to make money from this type of market structure has long been at the heart of the group's strategy, but how it executes has seen significant change (see later).

Bias towards the housing market

Within the US market, Ferguson is biased towards the residential sector, with this segment driving 54 per cent of sales, with around one-third targeting commercial construction and the balance split evenly between infrastructure and industrial buildings.

The US housing market can look concerning with some commentators worrying that the market is a bubble ripe to burst. The market there has had many parallels with the UK in 2020, with a combination of low mortgage rates, rising demand as buyers looked for more space by moving out of urban areas and supply remaining very tight in both new build and existing stock. While in the UK these factors (and the suspension of Stamp Duty) drove prices up 10 per cent, the average US house price has risen over 23 per cent in the past 12 months. Some nervousness is understandable, but mortgage rates remain low and demand, thus far, shows little sign of abating. However, it is probably wise to be circumspect here.

This market climate in housing is a positive for Ferguson, however. Due to the inability of many people to move plus the abundance of land and relatively loose planning laws, many homeowners are choosing to stay put and expand their existing homes. American house construction techniques (think lots of timber and nail guns) make adding extra space inexpensive. Also, millennials are held to be approaching their peak home buying years which is driving demand for larger or expanded homes. In addition, US housing does not age well (a typical lifespan may only be 40 years) so the large numbers of new builds from the mid-1980s boom and onwards increasingly require restorative investment. If buyers and/or mortgage lenders begin to baulk at today's elevated prices, then one might expect even more homeowners to improve rather than move.

Almost 60 per cent of the group's housing revenue comes from repairs, maintenance and improvement (RM&I), with a deliberate de-emphasis of low-margin, bulk supply to the new housing market that management has executed in recent years.

Other markets on the rebound

Commercial markets have been soggy overall in the past 18 months as demand for new office space has slumped due to Covid, but this segment is being buoyed by what Dodge Forecasting describes as 'explosive' growth in warehousing: in 2020 this sector grew 6 per cent while overall commercial building was down 24 per cent. Ferguson is well-positioned to benefit from this in a rather smart way. Rather than chase sectors or market segments (as UK builders' merchants are prone to do), Ferguson aims instead to align with the best contractors and it is they who naturally gravitate towards the best sources of work. It is increasingly able to win the hearts and minds of these large players by offering comprehensive end-to-end solutions, fast supply using its leading

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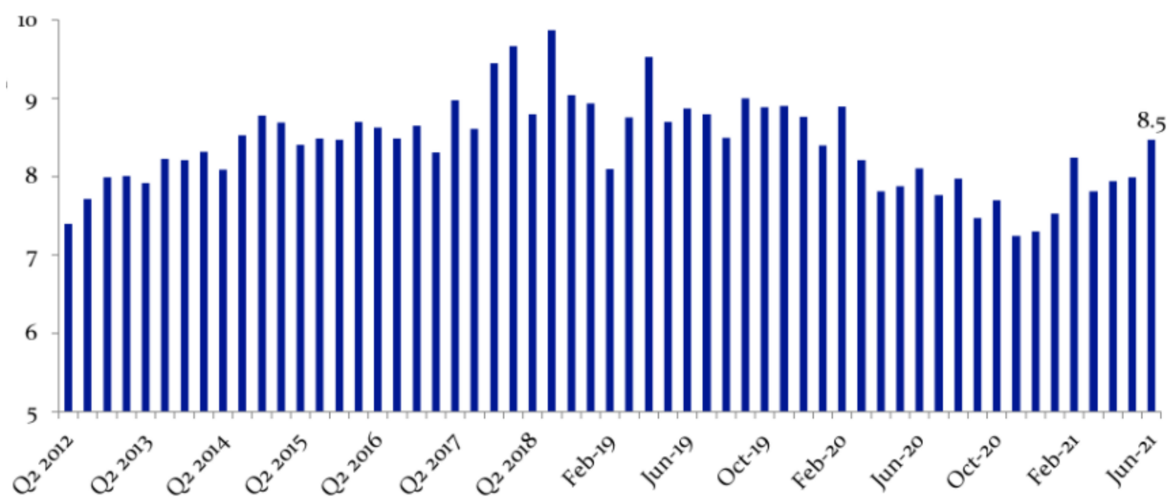
hub-and-spoke distribution network and leveraging its scale to keep pricing very keen. Also, by keeping lower stocks and regular drops at branches, product lines can be more dynamic and avoid over-stocking. By jumping into the contractors' workflows early in the cycle, Ferguson has far better intelligence on what to stock and when.

When looking at US businesses in construction, the Biden Infrastructure bill inevitably crops up. Historically, infrastructure spending was always 'heavy' (i.e. roads and airports) and most of Ferguson's sales would generally be considered to be 'light' in nature. But spending in this cycle is likely to be different. Green energy, education and water will feature highly and Ferguson is number one in materials for water with a 25 per cent market share. Historically, CRH might have been the first (perhaps only) call when considering infrastructure spending, but Ferguson should now also be in investors' minds.

Overall, workloads in US construction look to be on the mend after more than 12 months of decline, as shown below.

Figure 1: US construction order backlog in months



Source: Associated Builder & Contractors

A new approach

While Ferguson has a favourable market backdrop, its approach to maximising its position within it is very different from that of the past, especially in the Wolseley period. Back then, the policy was to expand physically, buying up every available local player and opening large numbers of new branch outlets year on year. It would then play the maturity or synergy cycle with the new additions as the driver of growth. This typically worked, but consumed a lot of resources even though the cash flow was typically strong enough to fund this and still pay a reasonable dividend.

Expansion today is very different with a heavy skew towards using its strong grasp of well-integrated customer/branch/warehouse/supplier technology (building materials and contracting are infamously low-tech) to drive sales and win new customers. Ferguson is the only US distributor to have really made hub-and-spoke distribution work strongly to its advantage, which means better service for manufacturers and customers plus growth at a lower incremental cost for Ferguson.

E-commerce in building products is worth around $18 billion per annum (total construction output is $800bn and total e-commerce spend is $430bn for contrast) of which Ferguson controls around $1.5bn. This is around 8 per cent of its total sales and growing faster than most other activities.

Freeing up cash flow

The significant reduction in hard capital expenditure means that far more of the free cash flow is available for distribution without harming potential growth. In the past three years Ferguson has committed $3.4bn to dividends and share buy-backs, but has only spent $1.4bn buying new businesses. It has also raised $1.5bn from business sales and rationalisations: another £308m was generated from the UK division sale, £298m of which was paid out as a special dividend. While special dividends create an illusion of shareholder value, the high and consistent distributable free cash flow from trading is capable of funding good, but not excessive, growth and solid distributions (dividends and buy-backs) equivalent to a yield of around 3.5-4 per cent, which are capable of growing well ahead of inflation.

Buy-backs at present seem to be preferred by Ferguson's management, but they are less attractive to smaller investors as they inherently swap income for capital gain by driving up the share price (same profit on fewer shares = higher EPS and at the same P/E the share price would rise). This likely makes Ferguson less attractive for passive income-seekers, but this is still a stock capable of making a good total return where investors are looking for Alpha. In the near term, however, the share price feels less likely to rise (before the impact of any buy-backs) following a very steep rebound since Q2 of 2020. The price dropped 46 per cent through Q1 of 2020, but is up by 146 per cent since the March 2020 low. That sell-off was doubtless overdone, driven by classic concerns that high gross but low net margin businesses such as builders' merchants could see margins implode in negative market conditions. A combination of relief that this never materialised, with the focus on the US gathering pace and with the poorly performing UK business exiting the long-apparent valuation gap between Ferguson and its US-listed peers was finally able to close.

That closing of the valuation gap leaves the shares now looking closer to their fair value and lowers their investment appeal for now with the bulk of any near-term total return to be driven by distributions, not the share price. At less than 2 per cent, the dividend yield cannot really offer a great fall back. The stronger position in technology could cause another, more modest, re-rating, but this is somewhat speculative. EPS growth and rising distributions can still be expected here, but with the reasonable pricing largely evaporated there is no great rush to buy the shares which look to have lost some momentum. Overall the stock may present better buying opportunities at a later date.

Homeward bound?

Investing in Ferguson has always presented some currency risk with the bulk of income coming from overseas, reporting historically in sterling and the share price also in sterling. In 2018, the reporting currency was shifted to US dollar which countered some of this, but there is a potential new pressure for UK investors. In 2020, Ferguson announced a secondary listing on the NYSE with growing speculation that this could, in time, become the primary (or sole) listing. While this may be unpopular with UK investors, it makes a lot of sense given the operational profile and that senior management is now US-based. This could cause a great deal of disruption with some investors (i.e. those with a UK or European fund) wanting or needing to sell out and many private investors may be nervous of holding dollar-denominated shares. This is likely to be a long-winded issue with little immediate prospect of action, but nonetheless now being in the open it will doubtless cast a shadow over the stock.

Smart Metering Systems

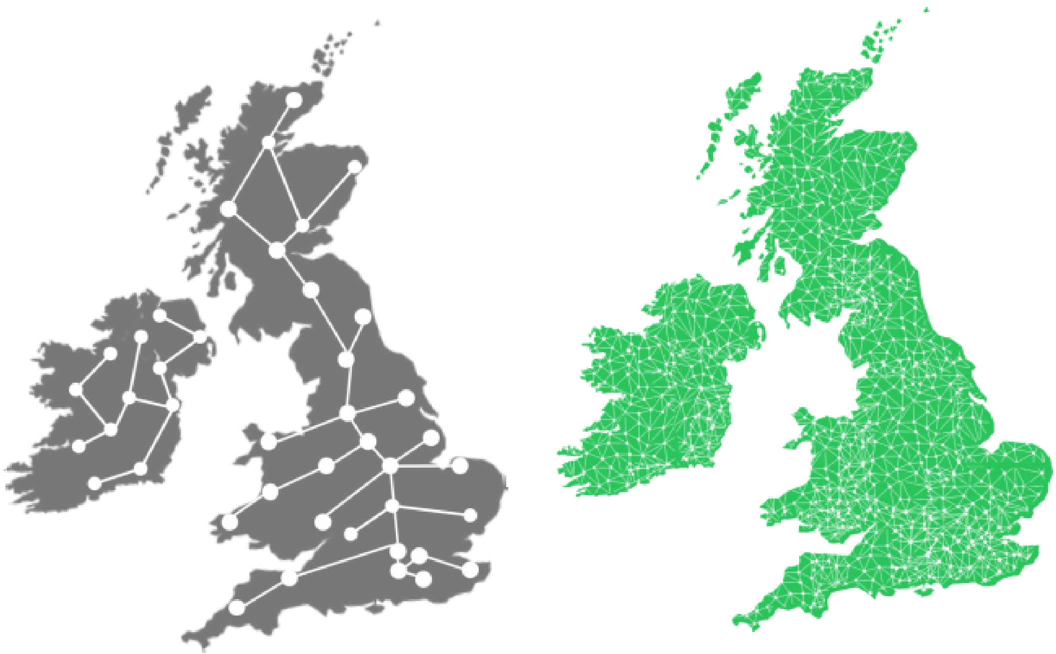
Source: FactSet

Taking CaRe of business

CaRe in this case is **Ca**rbon **Re**duction and this is **Smart Metering Systems' (SMS)** *raison d'être*. The name of this business does not fully explain or do justice to the businesses' aims and objectives. The first thought when hearing 'smart meter' is a domestic scenario where an internet-enabled gas, water or electricity meter helps the consumer to better understand their energy usage/profile and allows the utility to secure meter readings without having to visit the premises. That is part of the SMS' offering and does give it access to a large and still significantly incomplete market opportunity, but it also has a significant presence in an array of mechanisms aiming to make the entire UK (initially) power grid more efficient. Its products also help to drive revolutionary change in the UK's energy generation, transmission and local distribution. The old UK electricity set-up consisted of a small number of very large coal-fired (although many are now gas) power stations running down the UK's spinal coal seam feeding long UHT power lines, but this is rapidly changing to a mesh of local and micro generation, as illustrated in Figure 1 (below), connecting local demand to local generation. SMS offers hardware, services and consultancy vital to the delivery of this change in how power flows through to UK homes and businesses.

Figure 1: Historic and future electricity distribution in the British Isles

Historic	Now and future



Source: SMS PLC

SMS' presence in the energy market today falls into three categories, but half a dozen more are on trial in the UK also also in Ireland and Australia. The existing operations are as below:

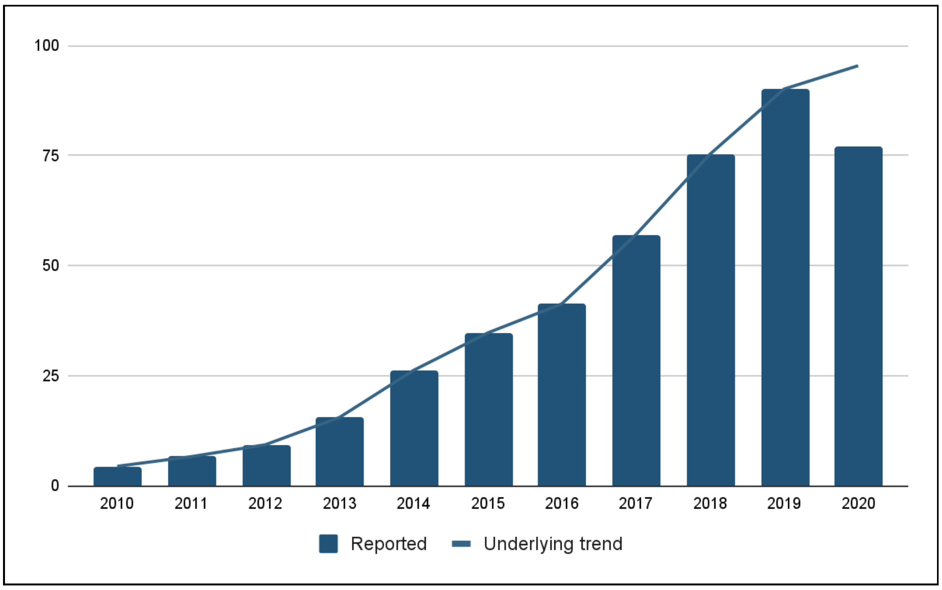
Meters

There is a mandated requirement under the UK government's zero carbon agenda that at least 85 per cent of all electricity meters (at the expense of the utility providers) are converted to smart, internet-connected devices by 2025: between 2030 and 2050 the remainder must convert. This covers both domestic and commercial installations, which are of roughly equal size, each at c.27-28 million metering points. To date, around 45 per cent have been converted meaning that just under 5m conversions per annum are required in each of the next five years. At the end of 2020, SMS was managing 3.8m meters (most of which it also installed) which provided a passing revenue (referred to as index-linked annualised recurring revenue or ILARR) of £78m. This comprised equipment rentals and data analysis provision to utilities.

The ILARR is a key factor here as it provides a highly predictable guide for future group revenues and delivers long-term visibility (typically five-year contracts run from inception, but rollover is likely at the contract end) and revenue is protected from inflation via indexation. As the income stream is essentially passive, there is minimal cost to SMS and margins across the life of the supply agreement can be as high as 95 per cent.

SMS' involvement is to install and maintain these metering devices, which is the mainstay of revenues and this has grown strongly for over 10 years, even managing to show an underlying increase of 6 per cent during 2020. During Covid, access to homes and business premises was restricted and this hampered the roll-out. The drop in headline ILARR in 2020 was due to a collateralised sale of £18.4m of passing annual revenue to Equitix Investment Management for £291m. This shows how reliable the income streams beyond the initial contract term are held to be by the investment community and would also drive substantial value for the group if extrapolated across the entire revenue stream.

Figure 2: Growth in SMS' ILARR - £m



Source: SMS PLC

Given the national roll-out rates and SMS' market share, the ILARR and, in turn, revenue here should readily increase by a low double-digit percentage through to at least 2025.

Energy data

Data on the scale and profile of energy usage is a natural spin-out from the use of smart meters. Today this data is primarily used at a low intensity for billing, but has scope to work much harder and help providers to manage better local distribution and networks. Today most meters report to the provider for billing a point-in-time reading only twice, four or 12 times a year, but by 2025 the standard will be reporting half-hourly: that would provide up to 9,000 times more data points than today. While merely informative for the customer (and actually little change as in homes devices and apps can monitor use in real time), this will provide invaluable data for the providers and network operators. Matching supply and demand while keeping the all important 50Hz frequency is highly complex, but such granular data down to single meter resolution should be able to refine and rationalise electricity generation and distribution.

Revenues from this source are today modest, but should increase materially given the potential revenue and capex savings that are available to utilities and network operators. As with the metering revenues, energy data would also be bound into long-term contracts and be able to deliver high net margins.

Grid-scale batteries

Think of rechargeable batteries the size of cargo containers and you have grid-scale battery devices which are capable of storing excess or intermittent (i.e. from wind farms) power generation and able to inject into a local or the national grid when required. Spikes in demand (such as the legendary surges during the half-time break of the FA Cup Final as the nation makes a cup of tea) can be very hard to manage as historically this has required large single generating plants to very briefly step up their output: this is a highly inefficient way to manage spikes.

Through the growth in renewables and locally stored energy (primarily wind and solar) these historic practices can be eliminated with batteries filling the temporary supply gaps, and able to do so both instantaneously and only where locally required. Such batteries can also be used to better manage delivery of a stable 50hz frequency. These infill requirements are increasingly frequent as more people work from home driving more irregular demand patterns. By allowing a more optimised supply and demand balance, there is also scope for the total generating capacity of the UK to be lowered and/or allow generating sources to have a longer operating lifespan: both potentially offer large capex savings to generators and carriers.

SMS has in-hand projects to deliver, manage and data-crunch 470MW of storage capacity across nine sites nationally but the total, as yet unaddressed market is estimated to be 25GW, around one-third of the total UK generating capacity. Provision of these storage and buffering installations will need to accelerate steeply as by 2030 some two-thirds of UK generation is set to come from more inconsistently generating renewables (39 per cent in 2020), rising to 82 per cent by 2050. As with other parts of the business, contracts are long term, often indexed and are undertaken with very large counterparties such as National Grid. Additional revenues can be obtained from offering data-driven optimisation strategies for carriers and also allowing greater flexibility/efficiency in the wholesale energy trading markets.

In all three of SMS' core trading areas, there is no exposure to end-user or wholesale energy pricing as these are pure service revenues.

Areas of future expansion are:

- **Behind-the-meter** – this is a more comprehensive evolution of the data analytics to help smooth out the peaks and troughs in generating capacity.
- **Australia** – using smart technology in water metering as part of a national water efficiency initiative.
- **Electric Vehicle (EV) charging** – 2020 saw c.160,000 pure/hybrid electric car sales and in May 2021 there were a short 800,000 such cars on the road. Via the banning of all but pure EVs by 2030, new EVs should total 1.8-2.0m per annum with approaching 10m EVs on the road. By the 2050 zero carbon date, there are likely to be closer to 18m EVs. According to EDF, there are 42,000 non-domestic charging points across the UK but by 2030, 600,000 will be needed plus 4.8m properly installed domestic charge points. These will require significant network and local distribution management such as SMS offers.
- **Energy efficiency** – consultancy to enterprises on the best options for the necessary £12bn of estimated capex required to raise energy efficiency by 2033.
- **Heat** – most social housing in the UK uses inefficient (and often inadequate) electric storage heating, but is set to swap and/or supplement today's cheap overnight electricity (economy 7 or 10) with surpluses and load balancing from core and local generation. This will need complex network management. Government is also targeting 5m district heating systems by 2050 and the ultimate banning of gas central heating will see a need to build a network of close to 20m heat pumps. These are all areas of potential revenue for SMS.

Overall, the trading environment looks very positive across an extended period within the existing business areas augmented by newer areas. Competition is likely to increase as green energy continues to move out from the fringe and on to the main stage, with that pricing, margins and contract terms may be squeezed. There are already a large number of capable competitors in the market that offer only part of the portfolio SMS brings who could broaden their offering. It also feels inevitable that Amazon, Google and Tesla at the very least will start to make more substantial moves into this space especially as the USA begins to take renewables as seriously as the rest of the world.

Trading is well positioned, and so is the balance sheet which was much improved by the collateralised sale in 2020: debt/Ebitda (earnings before interest, tax, depreciation and amortisation) was minus 0.8x (net cash) at the end of 2020. Steady capex is still required but having once tested the market with a sale of forward income streams, we know there is ample scope for similar asset recycling in future to keep finances robust. Green energy and carbon reduction (CaRe) are something of a stock market sweet spot, especially with the growing interest in and/or demands for higher ESG scores so equity fund raising (as already undertaken in 2016/17) is a viable option too.

The shares may look expensive at 65x year 2 EPS, but with such powerful market drivers, strong established positioning and scope to diversify, that should not be a total barrier: Tesla is trading on a PE over more than 115x. Our discussion is growth at a reasonable price: 3-4 times the market average PE can be a stretch but against the proposition here, the PE does not seem unreasonable. Also, this type of business may also attract the interest of the very well-funded private equity houses which could be adding something into the rating and we have an established value for the passing revenue streams via 2020's sale. Scale up the ILARR and apply the multiple achieved in that sale, the current market capitalisation looks strongly underpinned.

The dividend is also a positive attribute, especially for a growth stock. The yield is c. 3 per cent after a step change increase of 260 per cent in 2020 to 25p and the board is striving to deliver a 10 per cent annual increase through to 2024, which will drive the passing yield to 4 per cent. High growth with above average income in a hot market segment with scope for private equity interest is a powerful draw – perhaps it is all too good to be true and SMS could be squeezed by larger and more aggressive players or just find that maturity begins to soften returns but everything looks to be set very fair for now, and right through to the end of the decade.

As an Aim stock, SMS has the added attraction of protection from Inheritance Tax (IHT) and having a large market capitalisation (>£1bn) and a large free float (c.81 per cent) it is readily tradable, even for larger private investors and IHT-focused funds.

Hikma Pharmaceuticals

Source: FactSet

Enabling better access to good therapies

Hikma (HIK) is a pharma business but is unlike the 'big pharma' coterie of GSK, Astrazeneca *et al*. These other companies are involved in expensive research & development (R&D) to create new and improved drugs for major infectious diseases and chronic medical conditions. Spending hundreds of millions, if not billions, on a single drug these businesses rightly get to exploit their unique proposition during the lifespan of their hard-won patent in order to recoup the R&D and turn a profit.

When the protection of a patent ends (sometimes as long as 20 years later), drugs and medicines enter the generic phase where other manufacturers, such as Hikma, are permitted to make equivalent formulations subject to rigorous regulatory approval (Hilma endured a four year wait to have the FDA approve its generic version of Advair, Glaxosmithkline's blockbuster asthma inhaler) for sale. As the core R&D has already been expensed and the human/animal trials do not have to be repeated, these generic versions are significantly cheaper than the branded original - sometimes as much as 85 per cent lower and are typically subject to steady price erosion of 5-10 per cent per annum .

Generic drugs can be either:

'Generic substitution' is where the original and generic are identical on a molecular level and are typically at least as effective as the original. These will usually only come to market after patent expiry. Hikma operates primarily in this part of the market.

'Therapeutic interchange' is where an alternative is related at the molecular level, but not exactly the same. These typically come to market while the original is still in patent but have the downside that they may not match the efficacy of the original.

The obvious benefit of generic medicines is that they can be made available to a far wider range of patients, be available in poorer nations, enable cash constrained socialised health systems (such as the NHS) to prescribe the most effective treatments more widely and in the USA (Hikma's largest market) lower costs for patients and/or make hitherto inaccessible regimens available.

It is also good business for the generic pharma company where the lower pricing allows wider prescription leading to potentially significant volumes, thus manufacturing efficiency. In its most recent trading update, Hikma confirmed both better than expected revenues and sustained overall EBIT margins at around 20 per cent.

Fishing in a giant pool

The market for generics is substantial, although opinions differ on its actual size: at the more bullish end, BCC Research suggests a global annual market value of $411bn, while EMR estimates $370bn. Growth rate estimates vary between 6 per cent and almost 10 per cent. In the US, it is estimated that 89 per cent of all drugs prescribed today are generics rather than branded originals after patent expiry – the more expensive drugs are usually only given because of patient choice.

Hikma is a smaller player (just outside the top 10) in the field with revenues of c. $2.5bn (translated) indicating a still small market share but significant room to expand. The market still appears fairly fragmented with the top 3 players (Mylan, Teva and Sandoz) showing combined sales of around $32bn and the top 10 around $55bn. In the more complex injectables market, Hikma is more dominant with a market share of c.10 per cent.

The world population is both expanding and living longer meaning that ever greater numbers of people have acute medical conditions that arise with older age and those people will be sick for longer, placing growing burdens on health resources and funding. Generics help to bring effective treatments to a far wider population and, because Hikma has manufacturing in 11 countries across US, Europe and the Middle East & North Africa (MENA) in 31 facilities, it allows vital in-country supply. This not only shortens supply chains (a key issue in today's climate of freight shortgages) but also typically makes the approvals process less onerous. The largest centres of generic drug manufacturers globally are in India and China, which can make supply chains from these suppliers long and often cumbersome.

There is often mistrust of generic medicines by doctors and other prescribers especially for drugs coming from the lead manufacturing countries. Again, the local manufacturing capacity, especially in the USA, helps to alleviate this issue and allows Hikma generics to be prescribed with greater confidence. Hikma also has a stronger brand reputation than most other generics businesses.

Hikma's market presence

Hikma has a substantial catalogue of generic medicines with over 780 approved drugs on offer, but this makes the business still relatively small on the global stage. The world's largest generic company, Mylan, offers almost 10 times as many products and sells into more than 150 countries against Hikma's 65 countries.

Injectables – this is Hikma's largest segment (42 per cent of revenues) and its most profitable segment making Ebit (earnings before interest and taxes) margins in the high 30s per cent, almost double that of generics. The medications are designed for syringe and infusion (drip) administration with the drugs packed in liquid form in vials, ampules and suspension bags with others using inhalers or other more bespoke delivery mechanisms. Typically injectables are more specialist than oral or other medications and are clearly primarily for use in medical facilities and/or in more emergency or time critical situations, hence the higher pricing and subsequent margins.

According to research firm IMARC, the global injectables market is growing at 9-10 per cent CAGR; Hikma's revenues rose by 13 per cent CAGR before stalling in 2020, largely due to Covid and patients with other conditions having less access to hospitals. This is expected to be the fastest growing operating segment and, with the higher margin, should be able to help accelerate growth: consensus forecasts indicate that pre-tax profits will rise across the group by more than one-third by 2023.

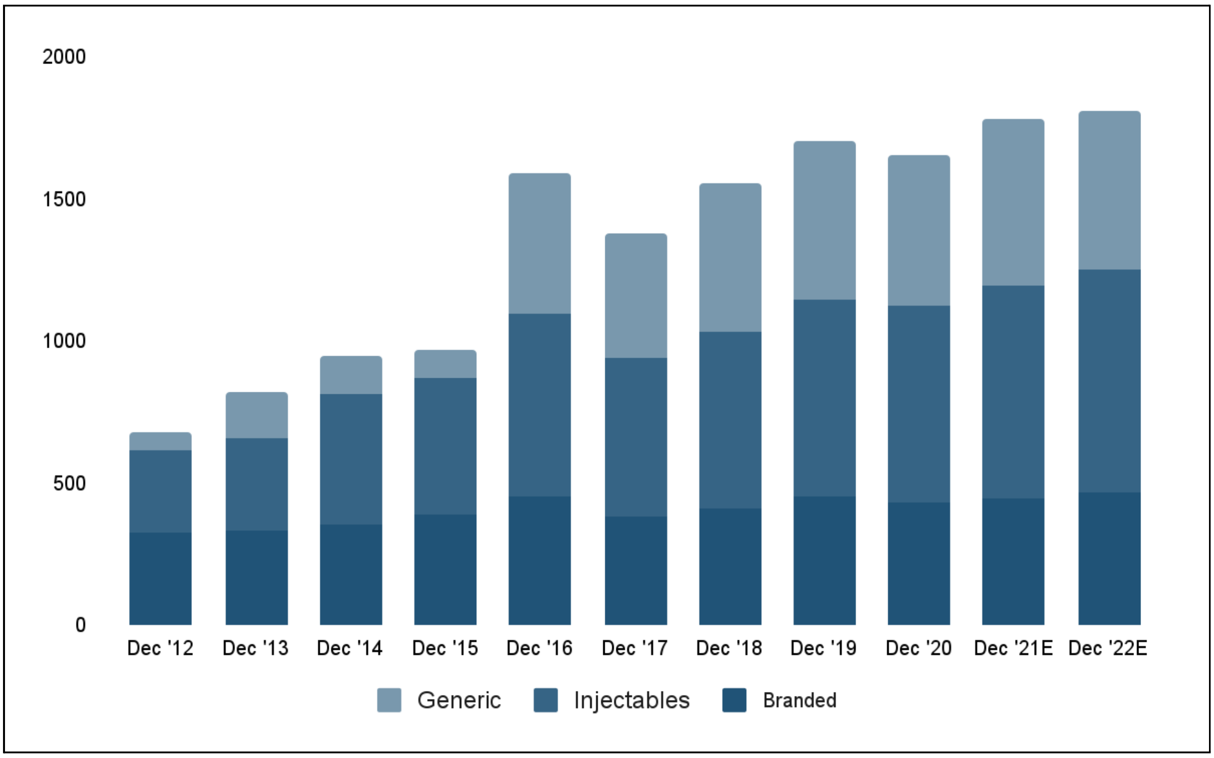
Hikma has a strong position in this market as other players have either pulled out, sold up or faced regulatory pressure. Even larger names such as Pfizer Hospira, Lupin, Sun Pharma and Rambaxy (the latter three all based in India) have also suffered from enforced plant closures due to contamination and other issues arising from under-investment.

Hikma also has strong interaction with its end customer and helps out with the likes of inventory control and tailoring of solutions whereas many of its competitors simply manufacture and wholesale their drugs.

Generics – also known as non-injectables, these are primarily tablets and other (primarily) oral medicines that are typically for out-patient, self-administration. This is a smaller segment for Hikma (31 per cent of revenues) and a much smaller proportion of profit having almost half the margins of injectables as the market is more competitive and the delivery mechanisms are less complex (plastic bottles or blister packs). It is also more mature and growing more slowly with Hikma seeing sales growth of only 4.5 per cent in the last decade. This segment also suffers from higher rates of price erosion. In a push to accelerate this part of the business, Hikma is looking to increase complexity in order to raise barriers to entry for new drug launches and having emphasis on blockbuster patent expiries and more focus on niche, complex delivery and so-called 'orphan' medications.

Branded – this, the smallest segment at around one quarter of sales but only one sixth of Ebit, operates a slightly different model and is only present in the Middle East & North African (MENA) territories. Here Hikma operates in the development and sales of branded generics and distributes licensed, patented products made by big pharma players especially from Japan and the UK who are reluctant to set up locally. It brings local manufacturing into markets with typically onerous regulation for imported drugs. Operating in such markets, that are often eschewed by larger generic manufacturers, has also been a passion project for founder Samih Darwazah, a Jordanian, seeking to ensure that these long under-supplied nations have access to the best medicines.

Figure 1: Hikma revenue breakdown - £m



Source: Factset

Positive outlook but humps in the road

The longer-term fundamentals for generic medicine are strong and Hikma looks to be capable of delivering a higher quality of earnings than many of its peers. However, there are potentially bumps in the road and some other more cautionary points to note:

Regulation – in 2017, the FDA decided to accelerate the process of approval for a wider range of off-patent drugs causing a surge of new products into the market via the 'Abbreviated New Drug Application' (ANDA) regime. This caused more intense competition and pressure on pricing. Similar actions may arise in future in the US or other markets as governments seek to lower the costs of healthcare.

Cost pressures – very recently, medical products and technologies business ConvaTec (CTEC) issued a cautionary trading statement that broad spectrum cost pressures were compromising margins and that global freight shortages were threatening the ability to ship from more remote manufacturing locations. The major sting was that the suggestion that these issues were likely to last until well into 2022. On this, in effect, profit warning ConvaTec's shares dropped by 20 per cent and other pharmaceutical companies came under the microscope. If any company is able to convince that it can counter these issues, a positive outcome could arise but as Dr Paul Cuddon at Numis notes, the market will be on high alert in this sector.

Free float – many investors look to avoid stocks where a large block of the register is held by a single holder, often the founder. That is the case here with the Darwazah family and connected parties holding over 26 per cent of the equity.

Tough comparables – Hikma did very well in the Covid crisis with hospitals globally increasing their inventories of injectable respiratory medicines. This creates a tough comparable period this year and possibly next and could also leave an excess of delivered drugs out in the marketplace. While this is well-understood and expected, results through 2021 risk triggering a cautious response by the market when growth presents a negative or muted trend

Dividend – while this is a growth business, it is not a fast growing business from which investors would be happy to see a lower dividend distribution. The yield is only 1.4 per cent, although a buy-back equivalent to 126p was made last year raising the total distribution to over 7 per cent. However, this could easily prove to a special payment which as often discussed is not something that truly adds to shareholder value.

Overall, a positive story but with a PE of 16.5x much of that is already reflected in the rating. The issues above should drag or discount the valuation to some extent leaving the effective PE ratio a little higher than this headline figure. The shares have rebounded 60 per cent from the Covid slump in Q2 2020 and feel more likely to mark time for now with the added risk that sector and stock sentiment are dented by more commentary akin to that from ConvaTec. This is worth a lot of consideration if there is any step back in the share price as the issues presenting elsewhere feel short-term against a long-term positive story here.

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