GLOBAL IDEAS

29 April 2013

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Pfizer – Jumping safely over the patent cliff?

Investment thesis

- Pfizer is one of the world's biggest pharmaceutical companies with a current market cap of over $216bn.
- The company boasts a solid stock price performance (up c. 20% YTD) and a largely solid financial position with reasonable debt levels (at 0.46 its debt/equity ratio is below the industry average) and expanding profit margins.
- Over the past year Pfizer has sold its nutrition business to Nestle and spun off its animal health operation, Zoetis into a separately listed entity. In 2012 it cut about $4.5bn in costs from its Research & Development (R&D), sales and administration.
- A big setback for the company was the patent expiry in November 2011 of its biggest-selling drug Lipitor, which is prescribed for the treatment of elevated LDL-cholesterol levels in the blood. The company's FY12 revenue was negatively impacted by c. $7.7bn, or 12% because of Lipitor going off patent. .
- Nevertheless Pfizer still maintains a few blockbuster drugs including its pain drug Lyrica and pneumococcal vaccine Prevnar 13, while it also added five new drug approvals to its arsenal in 2012 including the anticoagulant (and potential blockbuster) Eliquis.
- Although the share price might be edging towards fully valued territory in the short-term at the moment (following its stratospheric run over the past year [+35%]) and the company's earnings growth forecasts are not shooting the lights out Pfizer has a strong pipeline of new products that could help it rebound from plunging Lipitor sales. The group has also had steady positive cash flows and consistently paid dividends over the past decade. We believe Pfizer is an excellent addition to any long-term portfolio.

Pfizer vs peer group:

	Market cap ($bn)	12M trailing P/E	12M forward P/E	12M fwd DY
Pfizer	**216.2**	**13.6**	**13.3**	**3.2**
GlaxoSmithKline	120.7	19.6	14.2	4.6
Merck	147.3	12.8	13.5	3.5
Novartis	186.2	18.3	14.2	3.4
Sanofi Aventis	139.9	22.4	14.3	3.5
Roche	207.1	20.5	na	3.4

Source: Bloomberg, Anchor Capital

Pfizer's metrics are as follows:

Spot ($)	30.09
Mkt Cap $bn	216.2
12M trailing P/E	13.6
12M fwd P/E	13.3
10-year average P/E	34.2
FYE	31-Dec
P/Book ratio	2.7
12M trailing DY	3.0
12M fwd DY	3.2

Source: Bloomberg, Anchor Capital

Global Ideas is a newsletter published four times a week (Monday, Wednesday-Friday) and available only to clients of Investor Campus and Anchor Capital. Once a week we also feature an in-depth analysis of a company on our focus list. The key objective of this newsletter is to provide ideas for investment in the global investment universe.

We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watch-list, which is continually reviewed and updated.

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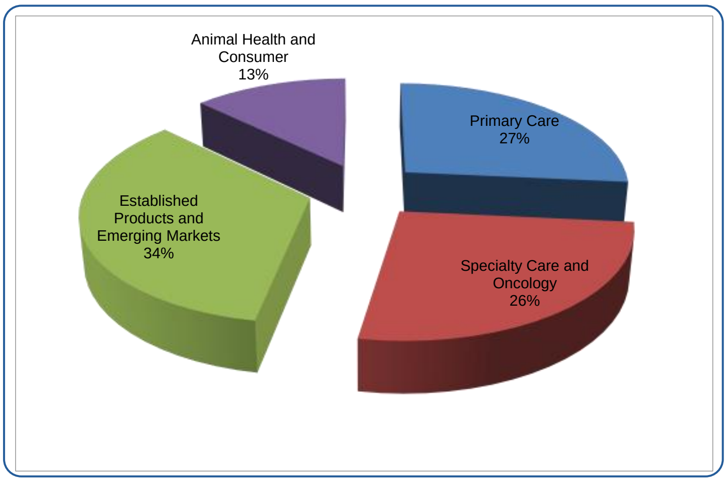
What it does

Pfizer Inc. (NYSE:PFE) is a research-based, global pharmaceutical company that discovers, develops, manufactures and markets medicines. The group has been a stalwart in the healthcare industry for decades and with breakthrough medicines such as Zoloft, Zithromax, Norvasc, Cardura and Dilflucan (referred to within the company as the Big 5) the company grew dramatically. It followed these up with Viagra, Lipitor and Celebrex. From its early reliance on physician-focused sales teams to what was at the time a groundbreaking public advertising campaign for Viagra, Pfizer also set the standard for pharmaceutical marketing. The company currently has a market cap of above $216bn, putting it among the top-20 largest US companies and among the largest drug companies in the world.

Over the past few years Pfizer has endeavoured to spin-off its non-pharmaceutical operations in a bid to focus on its core business - the development of new prescription drugs. On 30 November last year Pfizer completed the sale of its Nutrition business to Nestlé for $11.85bn and on 6 February it completed the sale of approximately 19.8% of its stake in its animal health business, Zoetis through an IPO. Zoetis raised $2.2bn, the biggest IPO since Facebook in May 2012. Pfizer still controls c. 80% of Zoetis but has said it may in future make “a tax-free distribution to shareholders of all or a portion of its remaining equity interest”. Also in November 2012 Pfizer approved an additional $10bn in share repurchases, after having repurchased almost $6bn in shares in 2012 (through an earlier $10bn authorisation). The company is now effectively a pure drug play with its sheer size providing it with a competitive advantage in terms of research, manufacturing and distribution of its products. Pfizer manages its operations through five business segments: Primary Care; Specialty Care and Oncology; Established Products and Emerging Markets (from where the bulk of its FY12 revenue was generated [c. $20.2bn]); Animal Health and Consumer Healthcare.

Pfizer FY12 revenue by unit:

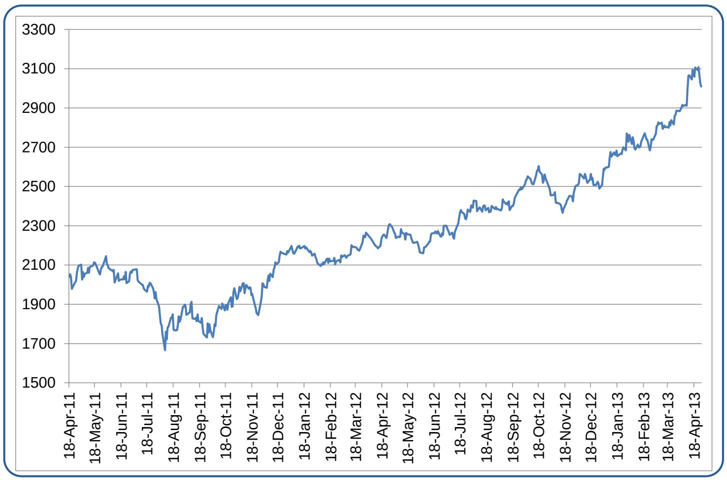


Source: Company reports, Anchor Capital

Price performance:

Pfizer’s share price has risen c. 20% YTD, reaching a 52-week high of $31.08 on 23 April, largely due to a turnaround in its long anaemic drug pipeline. From lows of $19.84 in December 2011 Pfizer’s share price has soared almost 57% on investor hopes of new drug approvals and the broader use of its current drugs. Over the past 12 months Pfizer’s share price has risen by nearly 39%.

Pfizer share price performance (USc)



Source: Company reports, Anchor Capital

P/E and dividend yield

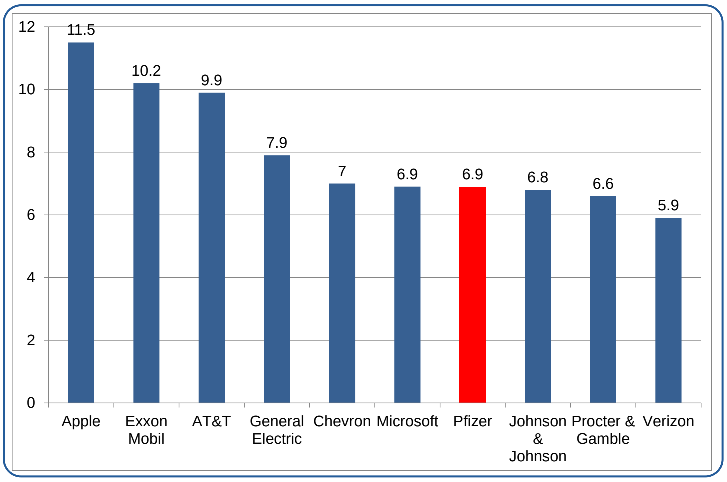
Although Pfizer's P/E has seen upward momentum over the past two years or so its P/E, at around 13x currently, is nevertheless still far below its average 10-year P/E of 34.2x.

Pfizer P/E ratio

Source: Company reports, Anchor Capital

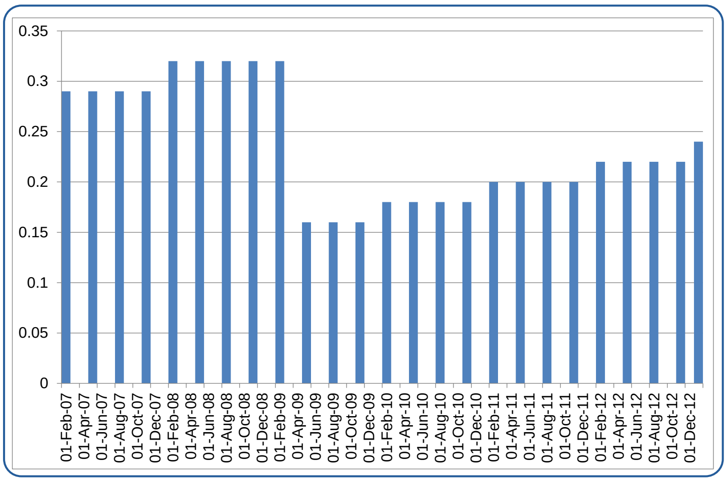
Pfizer has consistently paid and increased its dividend - only cutting back during the global financial crisis (GFC) between 2008 and 2009. Pfizer currently has a dividend yield of c. 3.1% (above its 10-year average of 2.7%) with a 12-month forward DY of 3.2%. The company returned nearly $15.0bn to shareholders through dividends and share repurchases during 2012. Pfizer also features among the top-10 biggest dividend payers globally over the next 12 months with $6.9bn being paid back to shareholders.

The 10 biggest dividend payers—next 12 months ($bn)



Source: S&P Dow Jones Indices

Pfizer quarterly dividend payments ($)



Source: Nasdaq.com, Anchor Capital

Pfizer results:

In FY12, on the back of the loss of exclusivity of its blockbuster cholesterol-fighting drug, Lipitor in most major markets (including the US) and final-year terms of Pfizer's collaboration agreements in certain markets for Spiriva, the company's revenue was negatively impacted by c. $7.7bn, or 12%. In total the group reported a 10% decline in revenue to $59.0bn in FY12 (vs $65.3bn in FY11). In FY12, Lyrica, Lipitor, Enbrel, Prevnar 13/Prevenar 13, Celebrex and Viagra each delivered at least $2bn in revenues, while Norvasc, Zyvox, Sutent and the Premarin family each surpassed $1bn in revenue.

However, its quarterly (4Q12) results were better than expected helped by rebounding sales in emerging markets (EM), with quarterly earnings quadrupling to $6.32bn (vs 4Q11's $1.44bn), or USc86/share (vs USc19/share in 4Q11). The 4Q12 results were also favourably impacted by the gain on the sale of its nutritional products business to Nestle for c. $12bn in November 2012 and by lower overall costs. Results were unfavourably impacted by the loss of exclusivity on certain products and higher restructuring charges. Global company sales fell 7% to $15.1bn in the quarter hurt by generic competition for its Lipitor cholesterol fighter, although sales still came in well above expectations of $14.4bn.

Looking ahead Pfizer is forecast to record double-digit YoY earnings growth in FY13 (vs FY12) before earnings growth for FY14 and FY15 drops to the mid-to low single-digits. FY13 growth is on the back of the company coming off a very low, Lipitor-induced base in FY12 with its robust product pipeline (in 2012 the FDA approved two cancer drugs as well as the rheumatoid arthritis drug Xeljanz and blood thinner Eliquis) and the benefit of a full-year contribution from Zoetis adding to the positive momentum in FY13 earnings. The introduction of new patent-protected drugs such as Prevnar 13, Sutent, Tofacitinib, Eliquis and Tafamidis over the next few years should generate a strong earnings stream. It is estimated that the company's new drug pipeline is roughly c. 30% of its FY12 revenue .However, the company also has several high revenue-generating drugs going off patent in 2014 including Celebrex and Detrol which could stymie earnings growth. The company's earnings forecast for FY14–FY15 might be relatively unimpressive but we believe in the long run management will deliver returns to shareholders as the company's core drug business improves (CEO Ian Read has already cut costs significantly and divested from the company's non-drug units) and new products coming onto the market start generating significant revenue from 2015 onward.

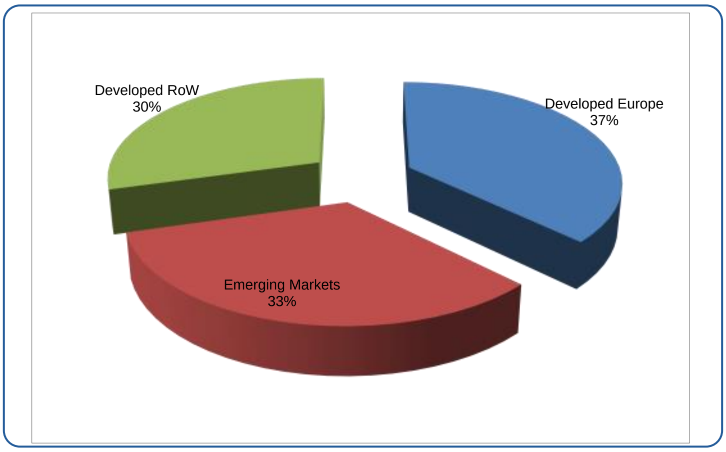
We also note that for the more risk-averse investor until the company's earnings growth accelerates Pfizer shareholders still have a healthy 3.2% dividend yield on which to fall back.

Pfizer forecasts:

Pfizer				
Dec y/e	**2012**	**2013F**	**2014F**	**2015F**
EPS ($)	1.96	2.27	2.40	2.49
% growth		16%	6%	4%
DPS	0.88	0.95	1.01	1.05
P/E	15.4x	13.2x	12.5x	12.1x
DY		3.2%	3.4%	3.5%
Share Price	$30.09			
12M Fwd P/E	13.3x			

Source: Bloomberg, Anchor Capital

FY12 revenue by geography:



Source: Company data, Anchor Capital

Key drivers:

The following are what we believe to be the key growth drivers for the company going forward:

- **Product pipeline:** Pfizer's 2013/14 product pipeline has the potential to reinvigorate the company and to help it rebound from plunging Lipitor sales. Pfizer said in its FY12 results presentation that it was entering 2013 with one of the most robust pipelines in its recent history. Approval of Xalkori for lung cancer, Inlyta and pneumococcal vaccine Prevnar 13 have proved to be a boost for Pfizer while, looking ahead, the steady progress of its late-stage pipeline (with 22 projects in phase III and 11 under registration) should be a huge source of confidence for the company. The group, which in 2012 was the leading pharma company in terms of FDA approval (five approvals), seems to be on a roll with the following recent product pipeline announcements:

    ◊ Analyst estimates indicate sales of blood-clot preventer Eliquis which Pfizer developed in conjunction with Bristol-Myers Squibb and which was approved in December, has the potential to eventually record sales of $5bn plus p.a.

    ◊ A pill for rheumatoid arthritis, Xeljanz, was approved by US regulators in November 2012 and in mid-April it was approved for use in Japan (this saw shares of Pfizer hit a new [at that stage] 52-week high). Analyst estimates expect the drug to reach peak sales of $1.9bn p.a. by 2020/21 for rheumatoid arthritis alone. (It should be noted here that last week this drug was rejected by European regulators—a decision Pfizer will be appealing).

    ◊ Pfizer also has a growing cancer-drug portfolio and US regulators granted a "breakthrough therapy" designation (enacted as part of the 2012 FDA Safety and Innovation Act, it is intended to expedite development and review of drugs for serious or life-threatening conditions) to an experimental treatment for breast cancer called Palbociclib. Analysts forecasts indicate that the oral medicine could also generate sales of $5bn or more p.a. (with potential for $3bn p.a. in first-line metastatic breast cancer alone) if it is approved (news of this approval buoyed Pfizer's share price).

    ◊ Extremely promising for future growth is its pneumonia vaccine, Prevnar 13. The drug received a boost in January when the FDA approved expansion of its use to children aged 6-17 years. The US Center for Disease Control and Prevention (CDC) has also recommended it for adults aged 19 years or older with impaired immune system and the vaccine received World Health Organization (WHO) qualification (meaning that WHO member countries can now use the vaccine for older patients) for use in adults aged 50 years and above. Analysts expect revenue of the product to hit $6.75bn by 2018 (in 2012 it recorded $3.72bn).

    ◊ Its pain drug Lyrica received approval for broader use to treat neuropathic pain from spinal cord injury opening up a larger market for the drug. Sales of Lyrica rose 13% to $1.13bn in FY12.

    ◊ On 13 August 2012, Pfizer announced it had entered into an agreement with AstraZeneca for the global over-the-counter (OTC) rights for Nexium, a leading prescription drug to treat symptoms of gastroesophageal reflux disease. Pfizer

- **No significant drugs losing patent protection in 2013**: Pfizer's revenue took a hit from Lipitor going off patent but it doesn't face any significant drugs losing patent protection in 2013 with the US patent for Celebrex only expiring in 2014. The company won a patent case over the generic version of its pain drug Lyrica, which has given Pfizer exclusive sales rights of its second-biggest selling drug until 2018. Pfizer also settled two lawsuits with Mylan and Impax over the generic version of its bladder control drug Detrol, delaying the generic competition until next year.

- **Strong sales in other medicines as Lipitor sales fall:** Although Pfizer's global sales of Lipitor plummeted after it came off patent, the company does have other so-called blockbuster drugs to rely on including its pain drug Lyrica (4Q12 sales of $1.13bn and over $4bn in FY12 revenue), pneumococcal vaccine Prevnar/Prevenar 13 (4Q12 sales up 19% YoY to $993mn) and Celebrex (4Q12 sales rose 12% to $750mn), which helped offset its Lipitor loss.

- **EMs:** Pfizer is looking towards EMs for growth and believes the best growth prospects lies in it partnering with local companies. Pfizer has set up a JV with China's Zhejiang Hisun Pharmaceuticals to develop generic drugs and also has a minority stake in drug distributor, Shanghai Pharmaceuticals. The company is hoping this collaboration will also boost sales of its Prevnar vaccine. EMs also have growing incomes (because of the rapid economic growth of emerging economies such as China), improved access to medical treatment for previously underserved communities and patients, increasing obesity levels and an aging population (in both emerging and developed economies) which should drive growth of the company's products.

- **CEO Ian Read** - Despite a 10% drop in revenue to $59bn, due to lower sales of some of its key drugs including cholesterol treatment Lipitor, Pfizer shares rose c. 16% in 2012. A clear indication investors have confidence in not only its product pipeline but also its management. Here Chairman and CEO Ian Read plays a key role. Read has been CEO since 2010 and is currently the highest-paid CEO in the pharmaceutical industry. Pfizer's board has cited Read's leadership and expertise as a major factor in guiding the company forward.

- **Growth in the global pharma market:** According to a *Marketline* study, globally, the pharmaceutical market is expected to grow from more than $782bn in 2011 to a value of just over $971bn by end-2016. This is a CAGR in excess of 24%. The Americas comprise over 42% of the world pharma market value while Pfizer is responsible for a c. 9% share of the industry's total revenue.

- **Dividends:** In general, pharma stocks have lucrative dividend yields making these stocks a favourite of investors. Given this emphasis on dividend income, the large yields that pharma companies like Pfizer pay will likely remain a big draw card for investors for many years.

- **Restructuring efforts:** Pfizer has implemented a new marketing strategy, coupled with focused organisational, financial and R&D restructuring efforts which (in its last results) seem to have also compensated for losses caused by Lipitor's patent expiry. By all accounts the company operates efficiently thereby creating a more-flexible cost base while the turnaround of its R&D division is also now at an advanced stage.

Risks:

Below we highlight the real and possible risk factors facing Pfizer:

- **The global economic environment:** The biggest obstacle for Pfizer (and also one beyond its control) is the state of the global economy. In addition to the industry-specific factors Pfizer, like other businesses, continues to face the effects of the challenging economic environment. This has been especially so in countries using the euro, where its has seen the impact on the performance of its products such as Lyrica, Enbrel, Prevnar 13/Prevenar 13 and Celebrex. In a challenging economic environment patients or consumers will likely switch to generic products, delay their treatments, skip doses or even use less effective treatments in order to reduce costs. Challenging economic conditions in the US have increased the number of patients in the Medicaid programme under which the sale of pharmaceuticals is subject to substantial rebates and, in many states, to formulary restrictions limiting access to brand-name drugs.

- **The patent cliff**: The so-called patent cliff is always a concern for any pharmaceutical company with a revenue-generating drug, especially so where the company has a blockbuster drug such as Lipitor in its arsenal. In November 2011 Pfizer lost the patent for Lipitor, its biggest-seller. This resulted in the group's FY12 worldwide revenue from the sale of Lipitor plummeting 59% to $3.9bn compared with FY11, dragging down Pfizer's overall sales and profit (when stripping out special items), as the company felt the impact of this loss of exclusivity and the continuing effect of an intensely competitive global generics market. Geographically, in the US, branded Lipitor revenues were $932mn in FY12, a decrease of 81% vs FY11 while in international markets branded Lipitor fared slightly better with revenue of $3.0bn, a 34%YoY decrease. Last year Pfizer also lost patent protection of another blockbuster drug, Enbrel.

- **Delays in approvals:** Pfizer has in the past faced some setbacks pertaining to its product pipeline with the approval for its billion dollar potential anti-clotting drug Eliquis, running into delays. The FDA also rejected its application for orphan central nervous system drug, Tafamidus, requiring more data and clinical trials to prove its efficacy. A pharma company's sustainability depends on its ability to drive new products to market and ensure a steady stream of revenue flows while at the same time investing in R&D to prepare for any regulatory challenges that may arise in future.

- **Product safety issues or controversies:** These types of issues can pop up in the pharma industry at any time. In April this year Pfizer's lung-cancer treatment drug Xalkori, was rejected for use by Britain's National Health Service (NHS). Recently a US District Judge in New York scheduled a pre-trial conference for a shareholding lawsuit alleging Pfizer's top executives misled investors about the safety of Celebrex and Bextra pain-relieving drugs.

- **Consumer expectations:** The consumer environment is getting more stringent as healthcare consumers impose new cost constraints on healthcare providers and scrutinise the value of medicines more closely. Consumers want new therapies that are better (and cheaper) than existing alternatives.

- **Currency fluctuations:** Pfizer operates globally and it therefore follows that dollar weakness could have an impact on its results as changes in exchange rates for foreign currencies can adversely affect the prices of its products. This in turn can result in decreased international demand (if prices go up significantly the consumers may opt for generics or lower-priced competitor products).

- **Regulatory requirements:** Changes in regulatory requirements can have a detrimental impact on any company and the imposition of new or more onerous government controls in countries where it operates could significantly impact Pfizer's profitability. Pfizer has experienced pricing pressures in various markets globally, including developed European markets, Japan and in a number of EMs due to government-mandated reductions in prices for certain pharmaceutical products and even government-imposed access restrictions in certain countries.

- **Increasing R&D costs.** The costs of R&D has increased exponentially and in order to remain competitive, pharmaceutical companies will be have to abandon the more traditional approaches in their R&D divisions in favour of new and cost-effective R&D models.

Conclusion

As mentioned a major issue for all drug companies is the expiration of drug patents and last year Pfizer was hit by the expiration of its patent on Lipitor, the biggest-selling drug ever to go off patent. However while this has impacted Pfizer, it now appears to have a decent pipeline of new drugs in development while its share price has performed exceptionally well showing that either the market had priced in the loss of Lipitor or the impact on the company's revenue was not as severe as was expected or its current products and product pipeline are sufficiently impressive to assure investors. The company's annual dividend disbursement has been increased every year since it was cut in 2009 during the GFC and it currently trades at a 12-month forward dividend yield of 3.2%.

Pfizer's strengths can be seen in multiple areas (solid share price performance and product pipeline, consistent positive cash flow for the past decade with reasonable debt levels, expanding profit margins etc.). For those risk-averse investors looking for a safe, dependable, long-term share paying a good dividend yield, Pfizer is a definite buy. However, for those looking for aggressive short-term share price growth, we believe at present Pfizer with its meteoric share price increase over the past year, offers limited further share price upside potential in the near-term.

Pfizer will release its 1Q13 results on 30 April 2013.

Marco de Matos

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