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ValueLine: Health stocks

By Roger Montgomery

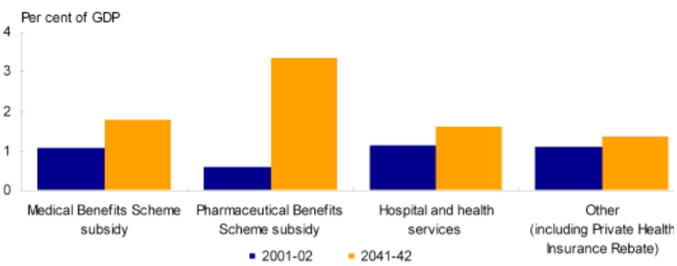
PORTFOLIO POINT: Not all health stocks are created equal. Here's why.

Healthcare is in the headlines. As the ValueLine portfolio is unchanged this week and continues to outperform the market, why don't we take a little detour through the businesses of wellbeing?

Government numbers show that spending on healthcare is expected to nearly double as a proportion of GDP over the next 40 years. With fewer babies being born and people living longer, it is inevitable that the population is ageing. In the next 30 years, the proportion of the population aged over 65 will double to 22% and in 40 years, the number of Australians aged 85 and over is expected to increase from 1.8% of the population to 5.1%.

Government estimates show this will exact a heavy toll on the cost of providing health. The following chart reveals where those costs for the government and opportunities for healthcare companies lie.

How health costs are expected to rise



Using government estimates for GDP growth, the above chart suggests the government will spend $38 billion on Medicare and $68 billion on the PBS in 2040. Figures such as these have provided the large community of buy-and-hold investors with a sound investment theme to pursue. But in some cases this theme has led to some extremely irrational pricing, as we will discover.

But before determining whether any value exists in Australian healthcare stocks, let's summarise how the Australian healthcare system works.

It provides patients with some of the best care in the world. However, it is administered by a complex web of federal, state, public and private services and insurances. And while most people who need to use its services generally recover, those who are required to understand how it functions might be left reeling in confusion.

At first glance, this might seem like a reason that the federal government is putting forward a plan to control a larger segment of the system. But after a couple of policy announcements and a televised debate on the matter you may recall that it's an election year and some things never change.

There are more than 20 healthcare stocks listed on the ASX, including businesses engaged in a wide range of services, but essentially they fall into two different categories.

■ The provision of care and related services. This can mean pathology companies such as Sonic Healthcare, private hospitals such as Ramsay Healthcare, and providers of specialist ancillary services, such as software provider iSoft (a company on Negative Watch in the ValueLine portfolio).

■ Research and development. This can mean companies that produce generic pharmaceuticals, such as Sigma, or research into and development of cancer drugs, such as Sirtex.

Like another exploratory industry, the mining sector, the size of these companies can vary from the very small, such as Capitol Health with a market cap of just $15 million, to global blood products and plasma giant CSL, which has a market cap of about $20 billion.

The ideal combination of characteristics for a healthcare company that an investor would seek out is no different to those that should be sought more generally; a very high quality balance sheet, stable performance, a high return on equity, little or no debt and a discount to intrinsic value. The table below contains a summary of my findings.

Using a combination of 15 financial hurdles, the best quality companies but not necessarily the cheapest in the sector are CSL, Cochlear, Sirtex, Biota and Blackmores. ValueLine already has shares in CSL, which are up 15.4% and Cochlear which is up 20.5% so I won't repeat the analysis I have already done on these companies.

I should point out that each of the remaining three – Sirtex, Biota and Blackmores – is generating high returns on equity and has manageable or no debt.

The lowest ranked by quality are Primary Health Care, Sigma, Australian Pharmaceuticals and Vision Group. I won't be buying these at any price and their returns on equity are less than those available from a risk-free term deposit. Alchemia, which manufactures a generic treatment for deep vein thombosis and pulmonary embolism, Phosphagenics, with its patented transdermal insulin delivery system, and Capitol Health are also low in terms of quality and also highly speculative because they are yet to report profits. Analysts however are forecasting profits for all three in 2011 and 2012 and Alchemia is forecast to earn more than 30% returns on equity after a loss in 2010.

In between this group are companies whose quality is neither compelling nor frightening; these are businesses that I might buy only if very

Australia's listed healthcare stocks

Company	Market cap ($)	ASX	Notes	ROE (%) FY1	ROE (%) FY2	ROE (%) FY3	Net (%) Debt	Price ($)	Value ($) FY1	Safety Margin (%)
Alchemia Limited	125,564,357	ACL	Highly Speculative - Yet to make profits. ROE based on analysts forecasts.	-22.0	31.8	41.4	0.0	0.64	0.00	n/a
ChemGenex Pharmaceuticals Ltd	196,857,964	CXS	Speculative - Yet to make profits. ROE based on analysts forecasts.	-12.6	38.4	53.4		0.44	NVA	n/a
Phosphagenics Limited	70,271,168	POH	Highly Speculative - Yet to make profits. ROE based on analysts forecasts.	-4.5	6.0	8.4	0.0	0.09	0.00	n/a

Company	Market cap ($)	ASX	Notes	ROE (%) FY1	ROE (%) FY2	ROE (%) FY3	Net (%) Debt	Price ($)	Value ($) FY1	Safety Margin (%)
Acrux Limited	380,316,781	ACR	OK Quality, Poor Recent Performance, Un-Stable, No gearing	84.5	69.9	25.3	0.0	2.27	8.90	74.49
Biota Holdings Limited	424,178,966	BTA	Good Quality, Excellent Recent Performance, Un-Stable ROE, No gearing	49.5	20.1	11.2	0.0	2.38	8.81	72.99
Vision Group Holdings Limited	43,697,413	VGH	Poor Quality & Recent Performance, Low ROE, High Gearing	9.8	9.8	9.9	77.1	0.60	1.04	42.31
Halcygen Pharmaceuticals Limited	99,310,803	HGN	Speculative - Yet to make profits. Stable ROE > 24% based on analysts forecasts.	26.6	28.9	24.8	0.0	0.72	0.82	12.80
CSL Limited	20,788,009,761	CSL	Good Quality, Excellent Recent Performance, Stable ROE > 20%, No gearing	21.4	22.7	22.6	0.0	35.25	28.77	-22.52
Blackmores Limited	349,407,724	BKL	Good Quality, Average Recent Performance, Stable ROE > 34%, Moderate gearing	35.4	35.6	34.5	57.4	21.13	14.98	-41.05
Sonic Healthcare Limited	5,329,257,885	SHL	OK Quality, Poor Recent Performance, Low Stable ROE > 13%, Moderate gearing	12.8	13.9	14.8	47.4	13.85	9.56	-44.87
Primary Health Care Limited	2,022,801,190	PRY	Poor Quality, Poor Recent Performance, Poor Stable ROE > 7%, Moderate gearing	7.0	7.6	8.4	57.3	4.26	2.79	-52.69
Cochlear Limited	3,977,262,826	COH	Good Quality, Excellent Recent Performance, Stable ROE > 38%, Low gearing	39.1	38.5	39.7	29.8	70.60	45.78	-54.22
Sirtex Medical Limited	345,762,443	SRX	Good Quality, Excellent Recent Performance, Stable ROE > 30%, No gearing	31.7	35.2	NFA	0.0	6.08	3.90	-55.90
Healthscope Limited	1,366,950,485	HSP	OK Quality, Poor Recent Performance, Low Stable ROE > 9%, High gearing	9.3	9.5	10.5	74.8	4.38	2.76	-58.70
Sigma Pharmaceuticals Limited	1,060,763,914	SIP	Poor Quality, Average Recent Performance, Low Stable ROE > 7%, High gearing	7.0	7.4	7.7	289.0	0.90	0.56	-60.71
Pro Medicus Limited	68,190,400	PME	Good Quality, Good Recent Performance, Stable ROE > 20%, No gearing	20.2	20.0	23.0	0.0	0.68	0.40	-70.00
SDI Limited	27,339,071	SDI	OK Quality, Good Recent Performance, Low ROE, Low Gearing	8.3	9.1	9.7	23.6	0.22	0.12	-83.33
Ramsay Health Care Limited	2,760,429,902	RHC	OK Quality, Very Poor Recent Performance, Low Stable ROE > 13%, Highly Geared	14.2	13.7	14.6	147.9	13.61	6.79	-100.44
Australian Pharmaceutical Industries Limited	273,344,894	API	Poor Quality, Average Recent Performance, Low ROE, Low Gearing	4.3	5.2	5.6	0.3	0.57	0.20	-182.50
iSOFT Group Limited	524,186,981	ISF	OK Quality, Average Recent Performance, Low Stable ROE > 5%, Low gearing	5.1	6.4	6.5	21.2	0.54	0.14	-282.14
Capitol Health Limited	14,882,613	CAJ	Highly Speculative - Yet to make profits. ROE based on analysts forecasts.	6.2	7.3	8.1	31.4	0.05	0.01	-390.00

large discounts to intrinsic value were presented. Sonic, Ramsay, iSOFT, Pro Medicus, Healthscope, Halcygen Pharmaceuticals, ChemGenex, Acrux and SDI fall into this band.

Making your own diagnosis

I have ranked all of the healthcare companies by their safety margin: a measure of their discount or premium to the current year's intrinsic value. This reveals that some companies are trading at discounts to intrinsic value. As an investor you need to be satisfied that the companies you choose also meet your quality criteria, which should mimic your tolerance for risk.

Take a close look at Biota, for example. Its price of $2.38 is significantly lower than the estimated intrinsic value, however you will also see that the return on equity is forecast to fall from 50% to 11%. There will be a commensurate decline in intrinsic value in coming years and the apparent discount will no longer exist, meaning that unless return on equity improves considerably in a few years it will cease to be a good investment.

The ValueLine portfolio is index-unaware. That means that when I began to construct the ValueLine portfolio I did so without consideration for benchmark weighting, unlike many fund managers who look at sector and or stock weightings and take positions based on them.

If my portfolio approach were to include some exposure to healthcare then my first choices would be CSL and Cochlear. These are both well managed, large-cap businesses with stable returns on equity and zero or low levels of gearing.

My next preferred exposure would be pathology and radiology operator Sonic, alternative medicine distributor Blackmores, and liver cancer treatment marketer Sirtex.

Finally, if I was comfortable speculating on stocks then the companies I would seek to conduct further research on would be the two pharmaceutical minnows, Halcygen and cancer drug developer Chemgenex. Both companies are forecast to generate attractive rates of return on equity in 2011 and 2012 and have little or no debt. Halcygen is also currently trading at a discount to its estimated intrinsic value. ◆

Roger Montgomery is an independent analyst and managing director at rogermontgomery.com.