



with Roger Montgomery

THE SHORT CUT

COMPANIES in the health-care sector are receiving increased attention from investors as the population ages.

A favourable market is a desirable trait for any company — it can provide a stable environment to invest in, with the prospect of creating sustainable competitive advantages.

Indeed, there are many companies in the health-care sector that may sound appealing, but a quick look under the bonnet may defy expectations.

Sigma Pharmaceuticals is one company with a business model that may not align with your expectations, as research is not its core focus.

For most of the 20th century, Sigma operated as a pharmaceutical company that manufactured prescription medication. Sigma became a full-line wholesale and distribution business at the turn of the century by acquiring the pharmacy brands, Amcal and Guardian, and also merging with Arrow Pharmaceuticals in 2005.

The company was forced to sell its manufacturing division in 2011 as a result of financial distress but has retained its wholesale and retail arms.

As a wholesaler of generic medicine, Sigma's drivers of long-run value are different to pharmaceutical companies that focus on research. Research-based companies can generate long-term value for investors by controlling the rights to life-saving medication. Obtaining this intellectual property can come at a high price, but over the long term it can generate lucrative returns.

By contrast, Sigma's competitive position is reliant upon the scale and efficiency of its supply chain. Even though Sigma is handling a product that is in demand, it is still exposed to the challenges faced by any wholesaler.

In order to maintain pricing power, the manufacturers and the pharmacists must be reliant upon Sigma to help sell a product — yet Sigma appears to be vulnerable at both ends of the supply chain.

Sigma was shaken when Pfizer, a major research-based pharmaceutical company

in the US, announced that it would distribute its drugs directly to pharmacies. At the time, Pfizer accounted for 15 per cent of Sigma's revenues. While Sigma management has stated that no other manufacturers are likely to bypass the wholesalers, it has set a dangerous precedent and demonstrates the power that lies with the party that controls the intellectual property.

Sigma's bargaining power also appears to be weakening with its retail clients. Chemist Warehouse is one of Sigma's largest customers, and as the pharmacy chain grows, so too does its ability to negotiate prices. The majority of the price reductions by the PBS in recent years has been absorbed by the pharmacists, so Sigma may be forced to accept lower margins — unless it can create further value for its clients.

Sigma is hoping to ease this pressure by ramping up marketing efforts in the Amcal and Guardian chains. The strategy is intended to improve customer loyalty, which in turn will contribute to sales and profit growth. If pharmacists are able to earn a higher margin on products as a result, they will be more capable (but perhaps not more willing) to absorb further reductions in prices.

The issue with this strategy is that it aligns Sigma's growth prospects with the dynamics of the retail sector, which is inherently cyclical. It is challenging to maintain a competitive edge, advantage in the consumer discretionary sector, particularly if sales are not a core competency of your staff. As such, it is difficult to imagine that pharmacists can do a better job at selling perfume than department stores.

As you can see, Sigma Pharmaceuticals' ability to generate sustainable returns may be questionable even though the industry in which it operates provides constant demand (customers will require medication in any economic cycle).

Sigma's business model is materially different to research-based companies like Pfizer, and its return on equity of 9 per cent reflects this competitive position.

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Table with columns: Last Sale, Move, Buy, Sell, 12 month High, Low, Sales 100, Div P/E. Lists various stocks including 21stCenFox, A1 Invest, AAC Ltd, etc.

Table with columns: Stock Name, Price, Change, Volume, etc. Lists stocks like Bluestone, Buglass, BoartLong, etc.

Table with columns: Stock Name, Price, Change, Volume, etc. Lists stocks like Compumed, Consegna, Consegna Group, etc.

Table with columns: Stock Name, Price, Change, Volume, etc. Lists stocks like ERMpower, Eseryglo, EthanePIF, etc.