GLAXIT

Neil Woodford, 12 May 2017

The views expressed in this article are those of the author at the date of publication and not necessarily those of Woodford Investment Management Ltd.

Over a holding period of more than fifteen years, I have consistently believed that GlaxoSmithKline was capable of delivering growth and realising shareholder value. Neither has been forthcoming to the extent that I had hoped and expected.

Its core pharmaceuticals division has changed substantially but is still contributing broadly the same level of revenues as it was in 2004; the consumer healthcare division has delivered modest progress but its growth rate and margins have been well below that of its peers; Vaccines has performed well at times but growth has faltered in recent years; the one genuinely successful area has been the development of its HIV franchise, ViiV.

Put simply, investing in Glaxo has been a frustrating experience, with three out of the four business units perennial underperformers. Some investors remain hopeful of recovery but I am now less optimistic. I have become more concerned about the prospects for the one Glaxo engine that has been firing on all cylinders. ViiV's most important products, Triumeq and Tivicay, have been delivering robust growth over the past few years but that may now not be sustainable. There is a growing competitive threat in this market which could undermine Glaxo's franchise. US biotech company Gilead is currently conducting trials in a potential competitor to ViiV's Triumeq. Phase II data released in February suggested that this new treatment could undermine Glaxo's hitherto robust market position – phase III data is due later this year.

Over the past three years, ViiV has been responsible for more than half of Glaxo's growth. If the company's one remaining growth engine starts to falter, this could pose a threat to Glaxo's future revenue growth, earnings and cash flows. This new challenge for the company amplifies several other concerns that I have had and have discussed at length with the company on many occasions. The lack of a rich pipeline, for example, and the lack of strategic options which results from an already stretched balance sheet. These issues loom even larger for the company if ViiV's growth slows. Together, these concerns now make me less convinced that Glaxo's dividend is sustainable.

As investors will know, we take our role as stewards of our investors' capital very seriously. Engaging with company management teams is a critical part of our investment approach. We always seek to ensure that the executive and board of a company are aligned with us as shareholders and that the course they set for the business looks capable of creating long-term shareholder value. If we fear this alignment does not exist, or we feel an alternative strategy is more optimal, then we encourage the management of that business to consider change.

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We have long been concerned such a misalignment exists between Glaxo and its shareholders. Throughout his nine years as Chief Executive, we consistently challenged Sir Andrew Witty on a number of issues, as we had his predecessor, Jean-Pierre Garnier. Primarily, these conversations have concerned Glaxo's corporate structure. I have long believed that value could be created for the company's shareholders if it split itself into separate, more specialised business units. The sum of the parts is significantly greater than the whole.

Furthermore, a more focused Glaxo would be the driver of better performance – the conglomerate structure has allowed management to disregard the parts of the business that have underperformed. For example, if future success pivoted on the richness of the pharma pipeline, it would have to pay a lot more attention to that pipeline. Instead, the growth delivered by other parts of the business have been seen as a hedge against the underperforming pharma division – management has never had to live or die by the pharmaceutical sword and as a result, that part of the business has not received enough attention.

The company has consistently argued that being diversified is a strength and there are synergies between the business units, particularly between the pharmaceutical division and consumer healthcare. Shareholders have never seen tangible evidence of this. Indeed, the structural underachievement of both the consumer healthcare and the pharmaceuticals unit suggests that these synergies simply do not exist. Splitting the group in to more focused units would allow dedicated management teams to independently realise the full potential of these businesses.

My viewpoint, and that of other like-minded institutional investors, has been heard but ultimately ignored – repeatedly. Andrew Witty has now gone, with Emma Walmsley commencing her tenure as Chief Executive in April. Even before taking her seat she has been keen to portray herself as a 'continuity candidate' and the prospect of a Glaxo breakup now looks more remote than ever.

In the event of a breakup being pursued, I would have viewed a dividend cut as a tolerable consequence of such a positive outcome for shareholder value more broadly. My base assumption now, however, is that Glaxo remains a healthcare conglomerate with a sub-optimal business strategy, and shareholders face a cut to the dividend. These characteristics do not appeal to me as an investor. That is why I have recently sold the fund's position in Glaxo.

As with all investment decisions, there have been many things to triangulate. A year ago, it would have been more difficult to replace Glaxo's income stream with other opportunities in which I had conviction the dividend was sustainable. That too has changed. In an ever-changing investment landscape, there is now a compelling selection of high-quality stocks where valuations and expectations are far too low. The strong yield characteristics of these new holdings has allowed me to sell Glaxo without endangering the income generating capacity of the portfolio. In fact, the prospects for income growth have improved. So, in some respects, selling Glaxo feels like the end of a chapter – but the rest of the story is becoming more exciting.

What are the risks?

- The value of the fund and any income from it may go down as well as up, so you may get back less than you invested
- Past performance cannot be relied upon as a guide to future performance
- The ongoing charges figure is charged to capital, so the income of the fund may be higher but capital growth may be restricted or capital may be eroded
- The fund may invest in other transferable securities, money market instruments, warrants, collective investment schemes and deposits – some of these security types could increase the fund's volatility and increase the level of indirect charges to which the fund is exposed
- The fund may invest in overseas securities and be exposed to currencies other than pound sterling – as a result, exchange rate movements may cause the sterling value of investments to decrease or increase
- The fund may invest in unquoted securities, which may be less liquid and more difficult to value, because they are generally not publicly traded – the lack of an open market may also make it more difficult to establish fair value

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