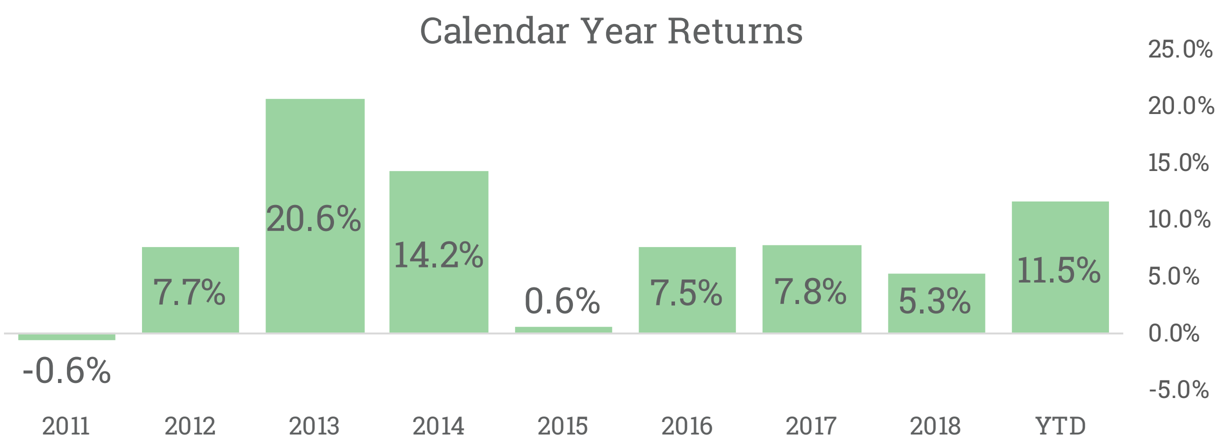
The Drug Oligopoly

The Value Fund has gained +11.5% year-to-date (as of July 31, 2019). During this period the S&P/TSX Total Return Index (including dividends) gained +16.6% and the S&P500(CAD) gained +16.3% (measured in Canadian dollars – the Value Fund's reporting currency). Currency movements lowered our returns by 3.3% year-to-date. Our currency strategy remains unchanged and has been written about at length.

In frothy markets like the present, we tend to lag given our conservative positioning and willingness to hold cash when attractive opportunities are scarce. This is the price we pay for being prudent and patient. When the tide goes out - like it did in Q4 of last year – we tend to outperform and react by putting our idle cash to work.



Two of our largest contributors year-to-date are stocks that we bought during last year's Q4 selloff: **Facebook** (FB) +48.2% and **Apple** (AAPL) +35.1%. Our long-term compounders **Visa** (V) +34.9% and **American Express** (AXP) +30.5% were our other top-performing stocks through July 31.

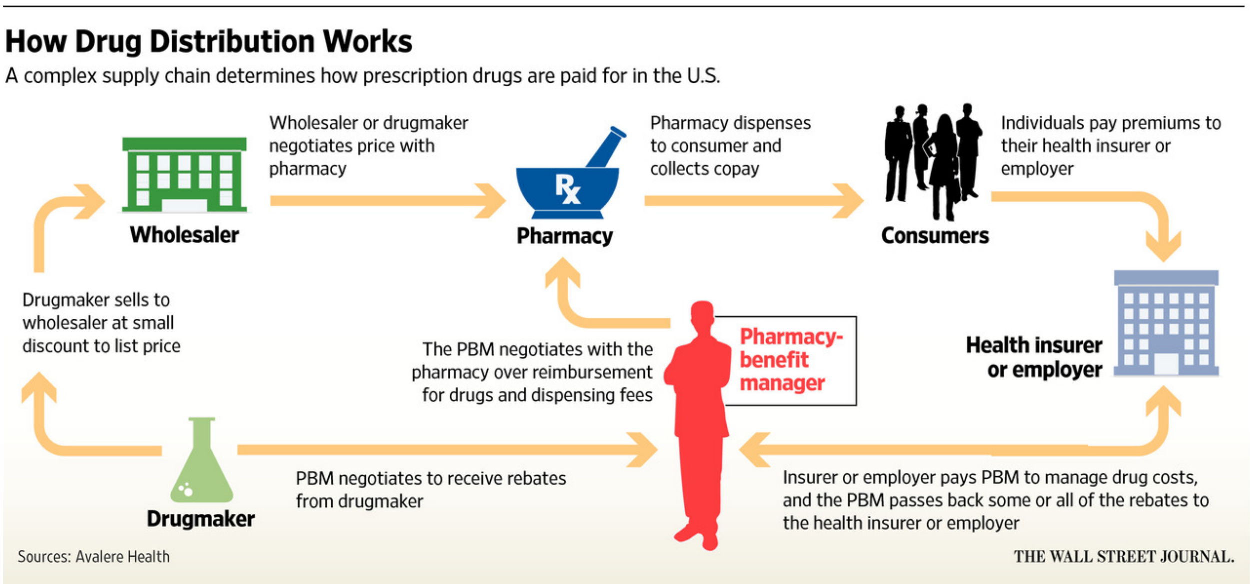
Only two portfolio holdings were down year-to-date and they were small holdings representing about 2.0% of the portfolio: **Tapestry** (TPR) -8.4% and **Sanofi** (SNY) -3.9%. Given our concerns about the economic cycle and the challenges facing both companies in the current environment, we recently exited both holdings.

We did not initiate any new positions during the first half of 2019. We opportunistically added to five of our existing holdings and trimmed our position in **American Express** (AXP). We loaded up on AXP shares when the company lost the Costco business in 2015 and are still big fans of the company. But given the significant run up in the shares they are now closer to fairly-valued and AXP was becoming too large a position in the portfolio. It remains a core holding with a 6.0% weighting as of June 30.

The Value Fund's historical portfolio turnover has been low by industry standards. In other words, we hold stocks for a long time (over 5 years on average). This benefits clients by minimizing transaction costs and deferring the triggering of capital gains. Many of the stocks that we own are also "compounders" that increase their intrinsic value over time through growing earnings, dividends and share repurchases. Like many value investors, our biggest challenge is finding attractive entry points for these great businesses – especially in an expensive market.

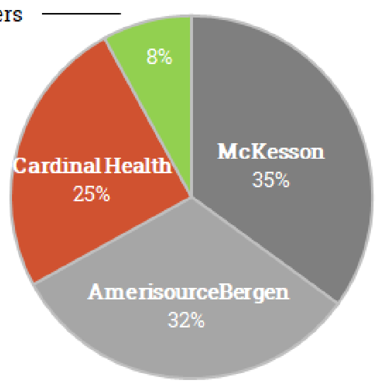
Drug Distribution

When most people walk into their local pharmacy to fill a prescription, they probably don't think about how those drugs made their way from the manufacturer to pharmacist. We do. Wholesale pharmaceutical distribution isn't a sexy business. But it is a good one and during the selloff in late 2018 we initiated positions in the two largest U.S. distributors - **McKesson Corporation** (MCK) and **AmerisourceBergen** (ABC). They are controversial and hence cheap when purchased.



We like to invest in industries with long-term tailwinds and pharma distribution checks that box. An aging population will lead to increased drug utilization, drug price inflation increases revenues as does the introduction of new drugs. The "Big 3" - McKesson, AmerisourceBergen and Cardinal Health – are a distribution oligopoly with over 90% market share in the United States.

We believe that these dominant distributors will be very difficult to displace due to multiple sustainable competitive advantages (moats):



Source: Drug Channels Institute estimates (2017)

Regulation: Drug distribution – like the rest of the drug industry – is heavily regulated making entry difficult for newcomers.

Customer switching costs: Pharmacies typically enter into multi-year distribution agreements with a preferred wholesale distributor.

Scale: The massive scale and volumes of drugs distributed by the Big 3 allow them to operate profitably on razor-thin margins. For example, last year McKesson's U.S. distribution revenue was $168 billion while its operating profit was a slim $2.5 billion (1.5% operating margins are normal).

The Big 3 have slightly different business models but at their core, they are identical. We will discuss the largest (McKesson) in greater detail to illustrate our investment thesis.

McKesson Corp (MCK)

In addition to its core U.S. distribution business, McKesson also operates related businesses including distribution operations and retail pharmacies in Europe and Canada (Rexall) and a medical-surgical distribution business.

Given its scale, McKesson consistently generates significant free cash flow which it uses to make acquisitions, increase dividends and repurchase its shares. The company also recently spun out a minority stake in a non-core business – Change Healthcare (CHNG) – into a separately traded public company. McKesson should spin out the rest of CHNG to its shareholders tax-free within the next 12-18 months.

McKesson will generate $3 billion of free cash flow this year. At our average purchase price of $114.50 we acquired MCK shares with an owner earnings yield [1] of close to 14%. We also indirectly received about $14.30 worth of CHNG shares for free.

[1] Earnings yield is the inverse of the P/E ratio. A 14% earnings yield is equivalent to a P/E of 7.1x

Based on MCK's current earnings estimates, we paid less than 8x earnings for this high-quality business. Drug distributors like MCK have historically traded at around 14x earnings. So, what's the catch? There are three major concerns currently weighing on the shares, two of which we believe will prove unfounded.

Politics and Regulation. Drug price inflation is a political piñata in the U.S. with plenty of heated rhetoric and an upcoming election. Various proposals are being floated by the Trump administration and Congress to get healthcare spending under control. We believe that drug distributors will be able to adapt to whatever changes are made and be paid fairly for the critical distribution function that they play in the U.S. drug supply chain. There will be challenges and given the political climate, investor sentiment will likely remain bearish. We believe this will pass in time.

New competition. Amazon's recent purchase of online pharmacy PillPack has many speculating that they plan to take on the wholesale distributors given Amazon's success in other areas. Our view is that while Amazon has disrupted retail and other industries by undercutting incumbents, those industries didn't run on 1.5% operating margins or have customers that were under multi-year contracts. Again, we believe this threat to be overblown.

Opioid Litigation. The opioid epidemic in North America is tragic and there is plenty of blame to go around. Manufacturers like Purdue marketed their products aggressively while playing down the risks. Many physicians wrote countless scripts for personal gain that "pill mill" pharmacies were happy to fill. The distributors should have done a better job of flagging and reporting pharmacies that were purchasing inordinate volumes of opioids relative to the size of their communities. Finally, the FDA had the data from all industry participants but failed to act. All players bear some blame for the human suffering and addiction resulting from these failures.

The participants are being sued for billions of dollars via thousands of lawsuits filed by State Attorneys General, cities and private citizens. The drug distributors clearly have exposure. For example, MCK recently settled with West Virginia – a hard-hit area – for $37 million payable over five years. Bloomberg recently reported that the Big 3 proposed a $10 billion settlement and that the National Association of Attorneys General countered with $45 billion.(2) The drug distributors will incur liability, even if they are less culpable than others. Plaintiffs usually target deep pockets and the Big 3 fit the bill.

The opioid litigation reminds us of the tobacco master settlements from 20 years ago. Plaintiffs will need the Big 3 to keep operating in order to receive damage payments as drug distributors don't carry much in the way of fixed assets or excess cash. Society needs the distributors to continue to distribute drugs nationwide (albeit in a more responsible manner). Our best guess is that this will take years and plenty of hard-fought litigation to resolve (MCK is spending $150 million on opioid-related litigation this year alone). We believe that a global settlement is the most likely outcome.

(2) https://www.bloomberg.com/news/articles/2019-08-06/opioid-distributors-propose-10-billion-to-end-state-lawsuits

The distributors will likely end up paying something up front and the balance over time out of their prodigious cash flows. Let's assume that MCK alone ends up paying $10 billion. That would represent about a $53 loss in per share intrinsic value. The more likely scenario is a lesser reduction of intrinsic value due to the payout being made over many years.

Applying a normal 14x price-to-earnings ratio and adjusting for the CHNG shares and the litigation exposure we derive a fair value of over $142 per share for MCK which is where the stock is currently trading. We aren't adding to our position at current levels, but at our purchase price of $114.50 we figured that we had an adequate margin of safety even if our estimate of the litigation exposure turns out to be low. We also conducted a similar analysis for ABC and bought shares as part of a pharma distributor "basket". Given the potential risks and uncertainties we kept our position-sizes modest. We plan to closely monitor the situation and react as things unfold.

Outlook

Markets have been good for a very long time and we are getting late in the economic cycle. The Value Fund is well positioned as the companies that we own are of high quality and should continue to increase their intrinsic value over time.

In addition, many of the companies in our portfolio are aggressively repurchasing their own shares (e.g. Apple repurchased $75 billion last year and are on track to do the same again this year). Lower prices help long-term investors as these corporate cannibals retire more shares for each dollar deployed as prices decline. Berkshire Hathaway is currently sitting on a $120 billion cash hoard and just itching for a chance to put it to work.

> "The big money is not in the buying and selling … but in the waiting."
>
> Charlie Munger

Markets are bullish, valuations are dear and almost every stock is up. Time to be cautious in our minds. But to be clear, we have no idea when a real market correction or an economic recession will materialize. In fact, we do not believe that either can be reliably predicted *by anyone*. But whenever opportunity arrives, we are ready to take advantage.

Michael P. McCloskey

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