Magellan – In The Know: Episode 40

The weight loss drug shaping-up as a gamechanger

Announcement (00:00):

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Host: (00:14):

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Emma Henderson (00:20):

If we assume that say around 7% of the total US population is on these drugs by 2030, in line with some of the work Wilson's done, and that those patients cut total calories by 20 to 30%, we're looking at a fairly modest one and a half to 2% reduction in total calories consumed in the US by 2030, and then that means a smaller annual headwind here. So, this is clearly not a positive for food or restaurants, and there are going to be some categories and sub-segments that are disproportionately impacted. If the financial impact is that this or a similar magnitude, it's something we actually think will be quite manageable from companies rather than a materially disruptive force to their business models over time.

Host: (01:04):

That's Magellan Investment Analyst, Emma Henderson, moderating expectations that a new weight loss wonder drug will significantly disrupt the consumer sector. Welcome to Magellan - In The Know. In this episode, portfolio manager Nikki Thomas and investment analysts, Emma Henderson, Wilson Nghe and Tracey Wahlberg, discuss glucagon-like peptide one or GLP-1 and its potential investment implications on sectors in the market. Every now and then a new product comes onto the market that revolutionises an industry, but could also have wider implications across sectors. Is GLP-1 shaping up to be one of them? Stay tuned for a fascinating exploration of the investment landscape considering all key factors at play: What are GLP-1s? What's all the hype about? And what are the implications for our healthcare and consumer sector investments? But first, here's a warm welcome from Nikki Thomas.

Nikki Thomas (02:03):

Welcome everyone. Thank you for listening in today to our podcast. My name's Nikki Thomas. I run the global strategy with Arvid. And joining me today are three of our franchise's healthcare team members, Tracey, Wilson and Emma. Maybe if I just start with you, Wilson, what we're going to talk about today is GLP-1. So, I'm going to start with the easy question. Can you just frame this up for it? What is it? What does it do? How should people think about GLP-1s?

Wilson Nghe (02:30):

Thanks, Nikki. So, GLP-1s or glucagon-like peptides, there are a class of drugs that are primarily used to treat Type 2 diabetics with insulin resistance. So, the way it does this is it actually targets a hormone in

your stomach that essentially manages your blood sugar levels. Most of us know GLP-1s as Ozempic, which has been quite big on pop culture as of late, or the active ingredient called semaglutide, which is just one of a number of GLP-1s available on the market. So, GLP-1s have actually been around for quite some time, but why they've gained a lot of attention over recent years is Ozempic is part of a later series of GLP-1s where we've actually seen a very significant and important side effect weight loss. So, the patients using some of these GLP-1s, including Ozempic, they've been able to see up to 20% reduction in body weight.

Nikki Thomas (03:24):

How does that come about? Is it something that the person who takes it does that means that they lose weight?

Wilson Nghe (03:29):

So, what the drug does by targeting your hormones is actually suppresses appetite and it's through a combination of signalling your brain as well as targeting the hormones in your stomach.

Nikki Thomas (03:42):

So, essentially people are eating less when they take this drug.

Wilson Nghe (03:44):

You essentially feel full compared to what you previously would've felt.

Nikki Thomas (03:48):

Okay, well let's come back to that obviously where one of the big implications of these drugs comes from. Perhaps before we go to there, the market's obviously got very excited about GLP-1s and what it means, and I think that largely reflects the fact that there's an enormous addressable market. So, can you just frame up the addressable market that we're talking about here?

Wilson Nghe (04:06):

What we're starting to see is the GLP-1 usage is actually starting to shift from being primarily a Type 2 diabetic drug to probably one of the biggest anti-obesity medication discoveries in history. So, in terms of the market size, if you look at the US market alone, about 40% of adults are classified as obese. So, this is where you have a BMI of 30 and above, and there are studies out there that are expecting this percentage to grow closer to 50% by the end of 2030.

Nikki Thomas (04:33):

So, 50% of Americans will be obese. What's that mean in terms of number of people?

Wilson Nghe (04:38):

So, as of today, there are about a hundred million adults that are obese and this will edge closer to 150 million adults. After we overlay some healthcare coverage and access considerations and patient take up views, we actually estimate GLP-1 use by patients for weight loss increase from about one million patients today to about 20 million by 2030. So, that's less than the 1% of the adult population today increasing to over 7% of the population by the end of the decade. Putting some context around this, heart disease, which is the highest prevalence disease state in the us, that only affects a smaller 80 million number of people.

Nikki Thomas (05:18):

So, it's of double the size of heart medication opportunity. Wow. So, no one of the market's looking at this pretty closely. And there's obviously flow on implications of when people start taking these drugs lose weight and that can affect other disease states that that would have because of their carrying extra weight. Am I right in thinking that?

Wilson Nghe (05:37):

Yeah, so the one big benefit with targeting obesity is there are clearly a range of comorbidities that affect patients who are classified as obese or severely obese. And you might've seen from a landmark study that came out earlier this year that treating obese patients with GLP-1s has shown about a 20% reduction in a range of cardiovascular risks.

Nikki Thomas (05:58):

Okay, wow. All right, so we've got a couple of really big things going on here that we can dig in on. One is people are eating less when they take these drugs and it's going to be potentially a lot of people eating less. And secondly, we are going to maybe start influencing some of these other diseases in a positive way and making people less sick around heart and other diseases. So, let's touch on this one that we've raised first around people eating less and appetite suppression. Tracey, can you kind of frame this up, what the market's been watching for, what we're seeing in terms of evidence around this, how it's influencing consumption patterns?

Tracey Wahlberg (06:33):

Yeah, It's an interesting one that we've been tracking because certainly the risks are worth understanding as they impact volumes in the food and beverage industry. And in history, we have examples where companies who were particularly adversely positioned when popular diet fads swept through the US, they actually went bankrupt and equity shareholders had to wear that pain. So, it's something that rightly so the market has started to pay attention to. So, I'd like to just bring up why we've gained so much interest in the recent months. We've started to really see data, small sets of data, come out from different sources. So, first I'd highlight Mounjaro. The drug that's manufactured by Eli Lilly. In patients who were taking Mounjaro in clinical trials showed a reduction in calories at lunch and dinner by up to 49%. So, that's a large reduction in caloric intake and certainly indicates a headwind to volumes in food and beverages.

(07:35):

Another survey then came out from Morgan Stanley, and it was a small survey, but it also showed caloric reduction of about 20 to 30% across its survey respondents. And then this was confirmed by Walmart, so, one of the US' largest retailers who is also uniquely positioned with a pharmacy and a retail footprint, so they can see patients who are on anti-obesity medication and also shopping in Walmart before and after taking the medication, understanding what changes in purchasing habits are, and it's certainly indicating that not only are people reducing caloric intake, but they're buying more fresh food and they're reducing consumption in sugary refined carbohydrates.

Nikki Thomas (08:19):

Okay, so on that note, more fresh food. What are we thinking in terms of our restaurants? We obviously cover the big QSRs and people like Chipotle, are they talking about this? Are we seeing people eating less of that fast food?

Emma Henderson (08:31):

So, we're not seeing any material financial impacts today. But we have spent a lot of time trying to think through how this potential reduction in calories and a potential further shift towards a healthier lifestyle could impact the sales and earnings growth for the restaurant companies. So, what we're really thinking through is could this drive fewer visits to your local restaurant and how could this change consumer behaviour in terms of what you purchase from a restaurant when you go there? So, Tracey has covered off on some of the consumer shifts that we've heard. What might be interesting for me to add, Nikki, is that in the restaurant space relative to packaged food, there are also a couple of litigants that we're thinking through to make sure that we're not overreacting to some of this news. So, you've got-

Nikki Thomas (09:14):

As the market has a tendency to do as.

Emma Henderson (09:16):

As the market sometimes has a tendency to do. So, when you think about what drive your decision to go to a restaurant. So, it's not just the food that you eat when you're there. There's a social and experiential element to restaurants that are likely going to be enduring even when people are on the drugs. Companies like McDonald's or KFC, they might just be the most convenient way for you to eat, whether that's on the way to or home from your job or on a long drive, so, a convenience factor there we still think is going to be really enduring. And these restaurants also offer really strong value for money and often the cheapest way to feed your family. So, we're trying to balance what are going to be the kind of appetite and the implications on how much calories people are eating, but also try and think through what are the other reasons people go to restaurants and are those also going to be enduring after this shift?

Nikki Thomas (10:03):

I think for the listener, I am just going to highlight something here. So, we sat down in our franchises healthcare team meeting actually early this year, and Wilson started talking to us all about GLP-1s. And the team did a huge amount of work around this before the market had even started talking about it because we went, "Wow, could this change the long-term?" We weren't focused on the short-term, Magellan focused on the long-term, and so we were focused on the long-term.

(10:27):

And it's worth noting that in the portfolio, we took a decision around Pepsi much earlier this year on a couple of reasons. The stock looked pretty expensive because we could see a slowdown in volume, but it's also a business that sells soft drinks and snacks. And so as we thought about the longer term opportunity in this business on a stock that looked pretty expensive to start with, it just felt like it was time for us to take our profits and move on. So, the value that comes from our internal discussions on these things that are moving slowly but will potentially impact the long-term for us is fantastic for us as PMs. So, given the work you've done around this and we've done a lot of work, what's your sense of the volume risk that we could see say in five years time? And I think Wilson, you have told me there's an issue around supply for these drugs at the moment. Am I right?

Wilson Nghe (11:15):

Yeah. So, why we're seeing so little people on the drug today, so, just to give you some numbers around that, there's currently less than one million patients today using GLP-1s purely for weight loss. This is obviously in addition to the 4 million who are using it purely for Type 2 diabetic treatments. And the key reason to this, as you've touched on is supply constraints. There's just not enough supply to meet the wave of demand that we're currently seeing.

Nikki Thomas (11:39):

So, when do we get the supply?

Wilson Nghe (11:40):

Yeah, so a lot of this currently is driven by the manufacturing constraints around the injectable pens, because as many of us know, this is how you administer GLP-1 is through an injection. The pharmaceutical companies, Eli Lilly and Nova who are producing the current series of GLP-1s have invested in additional manufacturing facilities, and we should see this come online over the next few years and that should alleviate some of the pressures. An additional point to actually help some of these supply pressures is the development of oral versions of the drug. But specifically when I talk about oral version of the drug, it's the development of a non-peptide based oral drug. Why this is important is this will be a small molecule drug, which means a manufacturing is a lot easier and a lot more efficient.

(12:24):

So, think paracetamol tablet production, albeit with slightly more nuances and complexities to that. Eli Lilly is currently leading on this front in terms of developing a non-peptide oral drug. They've got a drug called orforglipron, which is currently going under clinical trials and the data readers are looking fairly competitive in terms of weight loss. The launch expectations for this drug are around 2026, which does coincide with the timeframe of when the manufacturing facilities should start to fuel supply.

Nikki Thomas (12:54):

Okay, so that's important. So, '25, '26, we start to get supply issues being resolved and we get a really easy to take medication that's like popping a Panadol instead of having to do an injection. So, this could really probably start to take off in a couple of years in terms of major use factors. So, then that's what we've been thinking about when we've framed it up around what's going on in the food space, our snack exposures, our restaurant exposures. So, what have you found when you've done the analysis and what we know to date and the size of the tam, and then how big this could be for our businesses and what we need to take into account?

Emma Henderson (13:29):

Sure. So, let me try and frame up what this could mean from a total food or calorie consumption perspective. So, with the caveat, it's still early days, but if we assume that say around 7% of the total US population is on these drugs by 2030 in line with some of the work Wilson's done, and that those patients cut total calories by 20 to 30%, we're looking at a fairly modest one and a half to 2% reduction in total calories consumed in the US by 2030. And then that means a smaller annual headwind here. So, this is clearly not a positive for food or restaurants and there are going to be some categories and sub-segments that are disproportionately impacted.

(14:09):

If the financial impact is that this or a similar magnitude, it's something we actually think will be quite manageable from companies rather than a materially disruptive force to their business models over time. Another interesting consideration here is that these companies are going to have time to adapt their businesses and their menus for this change. As Wilson said, it's going to take a number of years for the uptake to reach this kind of high single digit penetration levels. So, we believe the companies that we invest in that have really strong management teams, really strong track records of adapting their businesses to consumer preferences, we'll have some time here.

Nikki Thomas (14:44):

Thanks, Em. That's really helpful framing that up. One of the things Tracey said earlier was about people really moving their calorie intake towards fresh food as they go on these drugs. Hopefully they're also exercising a bit more too, so, good for our athleisure wear companies. But in terms of exposure to the food that people are eating at home, Tracey, in terms of the stocks we look at closely, obviously we don't own Pepsi anymore, we do have Nestle in the portfolio, how would you frame up the risks there? What are the pieces that we need to be thinking about with a business like Nestle?

Tracey Wahlberg (15:15):

Yes. So, for companies that produce food at home, one of the things that we've really considered is that a lack of diversification in profit sources could really expose the company to more risk, and that diversification needs to come from not only categories but also regions. So, the regions that we geographically consider at higher risk are those regions like North America, the UK, Australia, where BMI across the population is higher, and so we know that there is more incidents or propensity to end up going on the drug. So, as you mentioned, we still own Nestle and the way we really think about Nestle, so first of all, a large exposure for Nestle, 25% of its operating profit is exposed to pet food. I'm pretty sure that no dog is going to end up taking a GLP-1, so there will be different drivers of demand in pet food category. So, that 25% I would say is not exposed.

(16:12):

Another about 20% of operating profit is exposed to what's called nutrition and health science. So, this category for Nestle comprises baby food, infant formula and also vitamins, minerals and supplements. So, as in the case of dog and cat food, I don't think many babies are going to end up on GLP-1. So, I think different drivers there for demand for baby food and infant formula. And then where I see vitamins and minerals and supplements as really benefiting here, a key tailwind for Nestle in this category could be the fact that when people severely reduce their caloric intake. So, I think there's a nice tailwind that's forming in that business and I actually really like how Nestle has developed the Nestle health science business. And then if I come back to that geographic diversification piece, about 60% of Nestle's sales are generated outside of those key regions of risk I mentioned earlier.

(17:07):

So, when I combine all of those data points, I'm left with about 20% of their operating profits that I think are potentially exposed to volume headwinds. But keep in mind the fact that over the last decade, Nestle has managed their portfolio of brands and changing consumer habits immensely well. So, the portfolio shape is different than it was 10 years ago, and their positioning within each of those developed market regions that we've highlighted is also different. And one brand I might even call out within that 20% I highlighted of potential risk is a brand we know well here called Lean Cuisine. That could also benefit from a really nice tailwind where it plays into that weight loss or weight management category offering convenience. So, all in all, we're watching Nestle and we've dug into the risk. We're really working with the company to understand what their innovation pipeline looks like and how they're responding here. But over the course of time, I think management have proven to keep on top of these changing trends.

Nikki Thomas (18:10):

Thanks, Trace. I must say whenever I sit down with the team and we talk about these sort of issues, it always reminds me the amount of in detail work that we do to make sure we are thinking about long-term dynamics and not jumping around at what's going on in the short term in markets. And so it gives me confidence that we're going to nail this in terms of understanding where the risks are going to come from. The other thing I'd add is I actually know some dogs that probably should take GLP-1. Okay, let's move on. I want to talk to you just quickly on Chipotle. Em, you and I both are a bit of a fan of this

business. I think we share a view they're fantastic managers and they've got a really unique place to play. But there would definitely be some people who would think Chipotle will be in the headlights of something like this. What are your thoughts around that?

Emma Henderson (18:53):

Sure. I think earlier on when we were thinking about this risk, there are a couple of reasons why you might think Chipotle could be at a pointer end of this. It's a hundred percent developed markets business. So, from doesn't get the geographic diversification that Tracey mentioned. It also has quite a health conscious consumer. So, if there is a new diet drug out there, intuitively you might think, "Hang on, this business is going to be at the pointy end here." But like Nestle, Chipotle is a company we've done a lot of work on internally, spent time with the company trying to understand what is their positioning here. And after that work, I think where I've got to is that Chipotle is actually on the right side of a lot of these changing preferences that we are seeing.

(19:35):

So, let's just start with thinking what Chipotle offers. So, it's a Mexican fast casual menu. It's built on fresh rather than frozen ingredients. It offers these Mexican bowl products that are highly customizable and they're pretty well suited for consumers that are looking to increase their protein uptake and to switch towards fresher from say less healthy foods. So, that menu positioning I think that positions them really well. It's also a business like Nestle that has proven itself as being highly adaptable to consumer changes over time. If you think about Chipotle in its earliest days, for the first 10 years of its business, all it sold was burritos. But consumers do change what they're looking for. And today actually 70% of its menu are these customizable Mexican bowls. So, they've already proven that this is something that they are strongly attuned to what consumers want.

(20:24):

And even in the most recent years they've taken that to the next level with a product line that they released called their Lifestyle Bowls. And this is really trying to show to consumers that are health conscious that are up with the relevant diet trends that Chipotle has something for them. So, now on their menu you'll see things like balanced macro bowls, Keto bowls, Paleo bowls. So, I think this is a business that has product that's going to resonate well with an increasingly health conscious consumer and other businesses that we own, they have really strong pricing power and great management. So, if they have to adapt their pricing architecture or their portion sizes as we see how this plays out, it's a business that we have a lot of confidence that they can really adapt to these changes.

Nikki Thomas (21:04):

Thank you. Couldn't have covered that better. I don't think it's absolutely addressing the issues that we're trying to think about. The thing that jumped out at me when you talk about Chipotle is this is an innovative company. And when I'm thinking about what we've got in the portfolio and what we might look to put in the portfolio, really strong management teams and innovation are things that I'm always looking for. So, I'm going to go off in a different direction here. When I think about innovation, I think about one of the portfolio holdings we have more recently added to the portfolio and that really is a lot around innovation and a super cycle of innovation that this company is talking about. It's also a stock that got a bit too cheap because people got excited about a risk around GLP-1s. And obviously Wilson knows what stock I'm talking about, so, we are thinking in the MedTech space here. So, maybe Wilson, can you just share with us your thoughts around the MedTech risk from GLP-1s and then we might dig a little bit in on Striker. Let's see.

Wilson Nghe (22:02):

Yeah, so as you pointed out, we have seen some acute impacts in the healthcare space from this GLP-1 trend. Majority of these impacts have been on the medical device companies. So firstly, the more immediate first order impacts we have seen have been on companies that are essentially trying to achieve the same patient outcomes as what the GLP-1 drugs are doing. So, this is essentially treating Type 2 diabetes and weight loss. So, these include some companies like diabetes management medical device companies, as well as some selling bariatric surgery surgical equipment. A more second order impact has also come via healthcare companies that are looking to treat the range of comorbidities associated with obesity. So, we touched on earlier the clinical trial that showed a meaningful reduction in cardiovascular risks. Outside of cardiovascular risks, we've also seen kidney disease and associated dialysis services companies be impacted, sleep apnea medical device companies have also been impacted.

(23:00):

But as you touched on where we have seen a lower impact or even a net neutral impact has been on orthopedic medical device companies like Stryker. Why this is the case is there are patients who will slow the progression onto being diagnosed with knee osteoarthritis as they move down the BMI scale and lose weight. But there are actually important offsets that we need to think about here. There is a subset of the obese population with knee osteoarthritis currently that actually are unable to obtain surgery purely because of the heightened health and surgical risks associated with their weight. Aside from this, we're also seeing patients where as you come down the BMI scale, activity levels actually increase. So, this over time should put pressure on the joints to actually spur additional orthopedic volumes.

Nikki Thomas (23:48):

So, really the market overreacted to this risk in our view. There's a few small pockets where businesses could be a little bit disrupted, but across MedTech, it probably plays in both directions. And overall these businesses will come through this in good shape.

Wilson Nghe (24:03):

Yeah, so as you noted, it's such a long dated risk given the supply constraints and the current costs and affordability issues that I think there was just a general market fear about what this thing could do, so.

Nikki Thomas (24:15):

You just mentioned then affordability issues, so we haven't fleshed that out. Can you just give us a sense of, obviously at the moment you are telling me these products aren't actually that affordable. How does that change, how do we get the cost of these and maybe what do they cost today? And then could you explain a little bit about the reimbursement structure in the US? It's quite different to what we have here, and so how that works would be important to understand.

Wilson Nghe (24:39):

Yeah, so affordability remains an issue primarily in the US currently for two key reasons. Firstly is as you touched on the cost of the drug today, and second point is just general reimbursement. Firstly on the cost of the drugs, many people might've seen headlines on the out-of-pocket expenses relating to these weight loss drugs as being quite high. So, Wegovy, which is the weight loss version of Ozempic, it has a list price of over 1000 US dollars per month in the us. And as we know with GLP-1s, you need to take these for the rest of your life in order to maintain that weight loss over time. We do expect the prices of

these drugs to come down over time, and this is for a variety of reasons, including just new innovations from the two key pharmaceutical players, a bunch of the earlier GLP-1 drugs coming off patent, as well as new entrants from smaller biotech's working on similar products.

(25:32):

So, we expect the net prices to come down at about 30% cumulatively by 2030. But on your second point on reimbursement, this will be the bigger driver in actually catalysing demand. Because essentially even though prices come down, majority of the population need this to be reimbursed by health insurance or governments in order to encourage use. So, as of today, the payers have been quite reluctant to widely reimburse GLP-1 for weight loss. This is purely because of the sheer cost of the programme. We spoke about earlier, the number of people that are obese and will likely take up this drug.

Nikki Thomas (26:09):

What about in Australia? Are Medicare reimbursing this for anyone?

Wilson Nghe (26:12):

We've heard from care opinion leaders that this has the potential to essentially bankrupt a lot of government healthcare systems around the world. Currently in Australia, Medicare reimburses for Type 2 diabetes use, but similar to other health systems around the world, GLP-1 access for weight loss is rather more restrictive, and that's purely from a cost perspective. We have seen some health systems like the UK move first in terms of introducing weight loss coverage for GLP-1 use. But what's happened is it's a rather restrictive criteria that there are applying to patients. So, it's essentially targeting the more vulnerable obese patients, the higher up the BMI curve as well as more evidence of comorbidities. And we think that's the model that a lot of health systems will follow suit in order to stagger the cost of this drug over time.

Nikki Thomas (27:04):

Okay. So, watching the NHS is going to be interesting in terms of how this evolves is probably a good lead indicator on where we might go. It's going to be a big out-of-pocket if you want to go down that path.

Wilson Nghe (27:14):

Yes.

Tracey Wahlberg (27:14):

Well, actually what I've heard is that some private health insurers in Australia will cover it for weight loss, particularly Mounjaro, which was just approved by the FDA for weight loss, so it's on label therefore.

Nikki Thomas (27:26):

Right. So, once you end up on label, then the private health insurers start to step in. Is that the same in the us?

Wilson Nghe (27:30):

Yeah, so the US we have seen commercial coverage steadily improved. So, there is a subset of the commercial population currently being approved for coverage for weight loss drugs. And that should

continue over time. Medicare and reimbursement in the US will take a lot longer just given there are statutory barriers that need to be repealed. But our estimates is that by the end of the decade we should see a considerably high number of reimbursement.

Nikki Thomas (27:55):

It feels to me like a bit of an inevitable, to be honest. Given the early clinical trial data we've seen from Eli Lilly and how much getting people's weight down actually helps with these other comorbidities, it just seems crazy that the governments and private insurers won't adapt. They might have to move some of their budgets away from say cardiac diseases and towards helping people take these drugs because it has such broader implications. Does that seem reasonable?

Wilson Nghe (28:23):

Yeah, so the steady price declines we talked about, and rebates and discounts, these will help the coverage conversation over time. But the bigger drive and what we've seen the pharmaceutical companies like Eli Lilly and Novo do is this continual buildup of evidence to actually prove that treating obesity isn't purely an aesthetic benefit for patients. It's actually touching on a whole raft of other comorbidities where there are high prevalence rates, like as you mentioned, cardiovascular risk and kidney disease.

Nikki Thomas (28:53):

You said something earlier, Wilson, that sparked a question in me. You said that people have to stay on this drug forever. So, you take it, you get thin, your results start to look good. Do you think people are going to stay on it forever?

Wilson Nghe (29:08):

Yes, in order to maintain weight loss and the benefits of this drug, you need to actually stay on it for the rest of your life. What we have seen from clinical trials relating to GLP-1s and as well as what we know from just general pharmaceutical usage for array of other disease states is patient compliance isn't great. So, our view and the market's view is over the longer term, average duration should be about eight months out of a year where patients are on this drug.

Tracey Wahlberg (29:40):

So, just jumping in on Wilson's point where compliance is low and people go off of the drug, I think there's an element of consumer behaviour here we also should pay attention to in terms of how it will translate to the food and beverage space, in that consumers might believe that the weight loss will stay off. And unless they've permanently adopted a healthier lifestyle and they don't transition back to old lifestyle habits, they will gain the weight back. Consumer behaviour tends to trend towards old lifestyle habits. Old habits die hard as the saying goes. So, it's still early days. We don't have enough concrete data to say definitively, but there is a world where this presents as another yo-yo dieting fad.

Nikki Thomas (30:24):

Okay. And that gets me then across to just thinking about this 20 to 30% reduction in calories that we've been talking about, maybe even bigger than that. So, I guess if we're reducing calories, we're eating less, that must be a volume hit for our companies. How have we tried to model that when we've thought about our restaurant and food franchises that we own in the portfolio?

Emma Henderson (30:48):

Yeah, let me take this for how we're thinking about it for the fast food chains that we own. I'm really thinking about this in two different ways. There's the developed markets, so North America, Canada, the UK, Australia, and I think these developments rightly should make us cautious how we think about volume over the longer term. And then I'll come back to emerging markets later. But just for some context. So Nikki, as you know, a typical US fast food restaurant targets to grow its kind of same store sales or sales from existing stores by two and a half to 3% each year. There's a small portion of that that's volume. So, maybe about 1% is transaction growth every year. And then what they're also using is their pricing lever. So, these are businesses with really strong pricing power that take two to 3% price each year. And then they're also using other levers like managing what's on their menu, the mix of products. So, the combination of those things drive our growth forecasts here.

(31:42):

If we do see this increasing uptake in GLP-1 drugs and consumption come down or there's a shift to healthier lifestyles, I do think we need to be cautious about that volume metric, if it might be challenging to get to one, maybe it gets to neutral, maybe it goes slightly negative. But what we have confidence here is that there are other levers. So whether it's price, whether it's being really clever with how you restructure what you're offering on your menu to help mitigate that, there are some offsetting factors that we are taking consideration when we are looking out on the long-term here. The other key consideration, and Tracey mentioned it earlier, was geographic diversification. So, when it comes to markets like China and Africa and India, we aren't modelling volume headwinds here from GLP-1.

(32:26):

In these markets, the demand that consumer food companies and the restaurant companies are benefiting from are driven by different structural tailwinds. We're benefiting from urbanisation, rising middle class incomes, and these are growth drivers that we think will be sustained. So, I think geographic diversification's in a really important consideration. And just to give you an example, Yum brands, which is a fast food chain, it's important to remember that today this business generates 60% of its earnings and more of its growth from outside of the US, and has a really strong and healthy diversified emerging markets, which is a really strong pillar to our thesis. So, yes, we are being conservative when we're thinking about volume for developed markets, but also considering the geographic diversification.

Nikki Thomas (33:09):

Thanks, Em. That's helpful. I think the one thing that we haven't touched on here around GLP-1s really comes to the two big guys who are making it at the moment. So, Eli Lilly and Novo Nordis obviously have been incredible stock performers in the last one to two years as the market's woken up to this opportunity, and the fact that they're really the only guys in town at the moment with the pipeline on GLP-1s. Can you tell us what your thinking is around these businesses? Have we missed the boat here or should we be chasing after it? What are your thoughts?

Wilson Nghe (33:44):

Yeah, so I think from our discussion, it's clear that Eli Lilly and Novo are currently the two clear winners from the pharmaceutical industry in this space. And if we look at what's currently on market in terms of drugs and what's in the pipeline, it looks like that will remain the way for quite some time. Valuation has been a key consideration for us. And in order to justify the valuation for these two names, as you've said, there's been significant share price moves over the recent year. To justify the valuation as long-term investors, I think we need to have high conviction that this will remain as a durable duopoly over the long-term. The risk I'm thinking about is competitive drug entries outside of Eli Lilly and Novo. We

know the pharmaceutical industry is highly competitive. We know all the big competitors are investing heavily in this space.

(34:31):

And what's more interesting is there are a range of biotechs out there, including Zealand Pharma, which have published early data that looks fairly competitive in terms of weight loss potential and patient efficacy. So, pricing risks with new entrant is something I'm certainly thinking about with these two names. The other consideration is, and this is something we've always thought about in terms of our investment criteria for healthcare companies, is we've always had a strong preference for pharma companies with diversified drug assets. So, this is where no single drug asset accounts for the material proportion of group earnings over the long-term. And what this does is it actually mitigates any scientific risk that is involved in actually forecasting individual drug assets.

Nikki Thomas (35:15):

We've had changes recently by the US government on the back of the inflation reduction act that look, even though it's not what they've said they're doing, in effect, they've reduced the patent life on about 10 drugs, I think. Do you think these guys are going to come up for discussion around things like that where the US government is going to start actually capping the opportunity for this whole massive tam?

Wilson Nghe (35:38):

Yeah, that's a really good point, Nikki. So the US government introduced the IRA with the primary purpose of decreasing the cost of drug spend by Medicare. And what that's actually done is it's one of the more monumental changes in pharma legislation where Medicare is actually able to negotiate drug prices for the first time. And as we talked about earlier, the size of the obese patient population is large and is continuing to grow. And if we think about how many people might actually get on this drug, this could potentially be a very big spend for Medicare once reimbursement and coverage comes through. So, you are very right to point out the fact that this will likely be in the cross hairs of the US government and the IRA.

Nikki Thomas (36:18):

It feels like a pointy opportunity for them if they're trying to reduce healthcare costs in the US. Obviously pharmaceutical companies have an amazingly powerful lobby group, so we don't want to be too sanguine about that, but certainly something that we will have to think about when we think about our coverage in the pharmaceutical space.

Wilson Nghe (36:35):

Yes. And there are drugs certainly in the pipeline by Novo and Lilly, which have promising potential to actually achieve better weight loss than the current Ozempic like drugs on market.

Nikki Thomas (36:46):

Em, is there anything in your coverage area that you think's worth just bringing out in terms of our discussion around GLP-1s? I touched a little bit about athleisure wear and people getting out and exercising, but anything interesting in the broader coverage universe that we're thinking about that could actually get affected positively or negatively by how this evolves?

Emma Henderson (37:07):

Sure. So, we spend a lot of time talking about food and beverage and restaurants, but elsewhere in the consumer sector, this also could have some interesting flow on consequences that we're looking out for. So, you mentioned athleisure or sportswear, this is a category that over the last decade has already been gaining share of total apparel spend or share of wardrobe just supported by an increasing consumer focus on health and wellness, as well as casualization and work from home trends. What we've learned from consumer surveys like the Morgan Stanley survey is that when consumers start taking these drugs, at least on a self-reporting basis, they're noting a material step up in the amount of exercise that they're doing. So, this could actually be a really nice additional structural tailwind for that category. So, that's sportswear.

(37:53):

Another interesting and perhaps less obvious beneficiary here could be fashion apparel. So, Wilson said before that people are losing potentially up to 20% of their weight. Not only may you want to go out and buy new leggings or new joggers, but you're probably going to have to refresh a large part of your wardrobe. And if you think about a key staple item like jeans, we could also see some extra waves of demand coming through from here. So, obviously very early days, but yeah, it's going to be really interesting to see what other parts of the consumption landscape could either be winners or losers here.

Nikki Thomas (38:25):

Interesting. And Tracey, was there anything in your area that you thought would be interesting to bring out?

Tracey Wahlberg (38:30):

Yeah, One of the things we haven't talked about so far is coffee. It remains unclear the volume headwinds we should expect from the coffee industry. And the reason I bring this up is because back to our Nestle conversation, they remain quite exposed to coffee. It's a great business with a lot of structural growth. They've built these really nice brand ladders with Nespresso and Starbucks at Home and Nescafe. And they over-indexed to coffee in the US and its Nespresso's growing double digits there as an example. So, what we know from early studies is that heavy drinkers of coffee, let's say you have three coffees per day, have actually reduced to one coffee per day, and light drinkers of coffee have actually reduced their coffee consumption altogether.

Nikki Thomas (39:16):

Is that about weight loss or health or?

Tracey Wahlberg (39:19):

We're not certain. We're not certain if it extends to other kind of habits and rituals that someone might have. Maybe that can kind of correspond to the alcohol reduction as well. Or is it the sugary or fat content that corresponds to the coffee?

Nikki Thomas (39:33):

Goes in your coffee?

Tracey Wahlberg (39:34):

That's right. So, is it the milk and the sugar? And then could people then prefer an espresso or a piccolo and the coffee consumption alters? So, it remains unclear, but that's an area that I'm watching.

Nikki Thomas (39:47):

You just touched on alcohol. So, people are drinking less alcohol when they go on these drugs?

Tracey Wahlberg (39:51):

Yeah, significantly. So, what we mentioned before in the Morgan Stanley data that came back, and again, that sample set was quite small, but significant reductions in alcohol consumption by survey respondents. And so what we know from that surveys is the number of respondents who said, "I've reduced my consumption of alcohol," was rather overwhelming, up there with the number of respondents who said, "I've reduced my consumption of cookies and baked goods and carbonated sugary drinks." So, these are really the categories that stick out at the pointy end of the spectrum, so to speak. There are other categories such as rice and grains and instant soups or frozen meals, but that was more of a let's say 50/50 or 40% of respondents had really reduced their consumption there.

Nikki Thomas (40:39):

Thanks, Trace. Look, I'm an optimist at heart and I must say this conversation fills me with optimism, partly because I feel like our companies are really well positioned, but more importantly because I think this isn't a magic pill. There's no magic cure here. But we are genuinely hearing about people moving in a healthier direction, a positive change for humanity around getting healthier, thinking more about what they're consuming. And so if this helps galvanise a shift in that direction, we are going to see better disease and comorbidity and morbidity statistics over time, and we're going to see a healthier population. So, I feel like this is a cause for great optimism. I'm looking forward to the detailed work that we've been doing around Eli Lilly and Novo and understanding just how we frame up that seriously massive opportunity that's clearly looking out in front of us, and how that will play out over the next few years. But thanks, guys. I really appreciated your insights on each of these topics that we've covered off here today and look forward to the next one.

Host: (41:44):

That was Magellan Portfolio Manager, Nikki Thomas in conversation with Magellan Investment analysts Emma Henderson, Wilson Nghe and Tracey Wahlberg. We trust you've enjoyed this episode. Join us in 2024 for our new series of Magellan - In The Know. For more information on previous episodes, visit magellangroup.com.au/podcast where you can also sign up to receive our regular investment insights programme. Thanks for listening.