FRANK J. GAMBINO, CFA
Chief Equity Strategist & Portfolio Manager

JEREMY R. BAIER, CFA
Senior Equity Analyst & Portfolio Manager

Health Care: Dissecting Market Expectations Under an EVA Framework

The investable universe has nuanced exposure that covers a wide breadth of characteristics. Chief amongst these is the well-known disparity of profitability characteristics of constituents across the market cap spectrum. The notable call-out in this regard is within Health Care, which broadly speaking, contains a large contingency of companies with forward-looking binary outcomes (particularly in the case of Small Cap companies) sitting alongside those with proven histories of earnings and cash flow, whose forward-looking outcomes can be assumed to approximate that of a normal distribution. Forward-looking expectations are the bedrock of company valuation; while the formation of forward-looking expectations of the latter group is often straightforward, those of the former group are nothing other than uncertain.

Investors can use tools to judge what set of expectations are embedded in current share prices. One such tool involves using economic value to gauge the level of optimism/pessimism of a given company and then determine whether or not this sentiment is rational. Readers may recall our reasoning behind the use of Economic Value Added (EVA), which simply defined is after-tax net operating profits minus a capital charge for adjusted assets on the balance sheet. It measures a company's economic profit – the profit remaining after deducting all costs, including the cost of giving the stock's investors a full, fair, and competitive return on their investment in the business. EVA not only measures profit derived from the income statement, but also the degree to which a company is efficiently managing the assets on the balance sheet. Positive EVA indicates that a company has historically increased economic value; negative EVA indicates that a company has historically destroyed economic value. EVA consolidates income efficiency, asset management, profitable growth, and strategic retrenchment into a single, comprehensive net profit score.

Within the EVA framework, a stock's value can be decomposed into the following:

1. Capital invested into the business
2. EVA earned
3. Future Value Added (FVA)

"Capital" and "EVA earned" (current EVA divided by the Cost of Capital (i.e., zero-growth EVA perpetuity)) are observable figures. It follows that FVA is the "plug figure" that gets you to the current stock price. One can take the value of FVA as a percentage of a company's current market value to determine the level of future EVA growth that is required to justify the current stock price. This is also known as Future Growth Reliance or "FGR". Companies with high FGR have high expectations for future growth in this regard; those with low FGR have low expectations.

Within the construct of Health Care, one could surmise that the typical small Biotechnology or Pharmaceutical company would carry a high FGR. After all, many of these are non-earners who are, perhaps, investing heavily in a single product in hopes of developing a blockbuster down the road. To test our intuition, we studied the Russell 3000® Health Care constituents going back to 1995 and through 2021. Using the Global Industry Classification Standard (GICS), we segregated them into two groups: Biopharma and Other Health Care[1]. The first element we wanted to confirm was which types of companies typically had the highest FGR.

[1]The Biopharma group consists of two GICS codes – 35202010 (Pharmaceuticals) and 35201010 (Biotechnology). The Other Health Care group consists of the remaining six Health Care GICS codes. These include 35101010 (Health Care Equipment), 35101020 (Health Care Supplies), 35102010 (Health Care Distributors), 35102015 (Health Care Services), 35102020 (Health Care Facilities), 35102030 (Managed Health Care), 35103010 (Health Care Technology), and 35203010 (Life Sciences Tools & Services).

To do this, we sorted each year's constituents by FGR and separated them into five quintiles. Quintile 1 is the stratum demonstrating the lowest FGR values while Quintile 5 contains the firms with the highest FGR. The average breakdown of the two groups in each quintile (by company count) throughout the test period can be found in the table below.

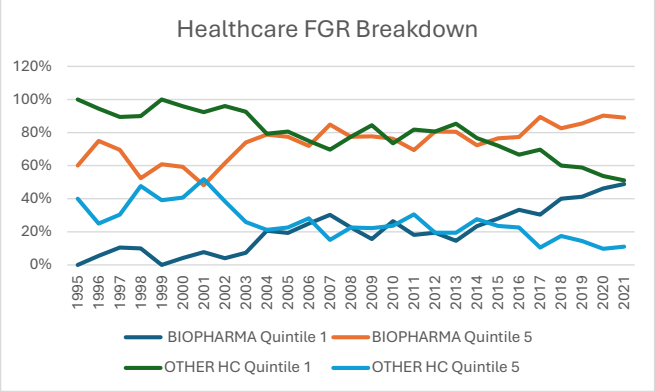
Table 1: Average Constituent Breakdown

Quintile	% Biopharma	% Other Health Care
1	20%	80%
2	15%	85%
3	22%	78%
4	56%	44%
5	74%	26%
Overall	38%	62%

Source: ISS EVA Investor Express

As expected, Other Health Care companies made up the vast majority of Quintiles 1&2 (the lowest FGR strata) while Biopharma companies populated the high FGR Quintile 5 at the highest rate. What is also interesting to note is that the breakdown in Quintile 1 has narrowed over time (as seen by the convergence of the green and dark blue lines in Chart 1 below) with more Biopharma companies creeping up into that stratum and representing half of Q1 constituents in 2021. However, the percentage of the 5th Quintile represented by Biopharma companies has increased over time (the orange line). It is true that the percentage of Biopharma companies in the Health Care universe has increased over the period (from 27% in 1995 to 55% in 2021), so it is no surprise that there are more of them that creep into Quintile 1. However, we think it is more telling that the percentage of Quintile 5 represented by Biopharma continues to rise. The highest FGR companies are Biopharma companies at a greater clip than ever.

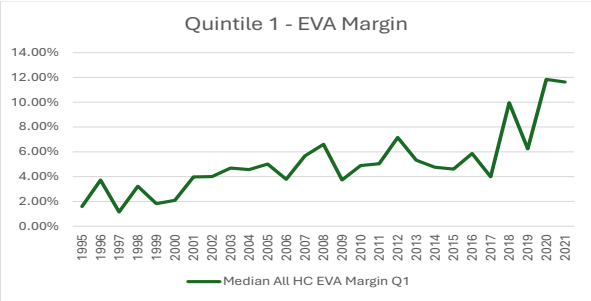
Chart 1: Health Care FGR Breakdown



Source: ISS EVA Investor Express

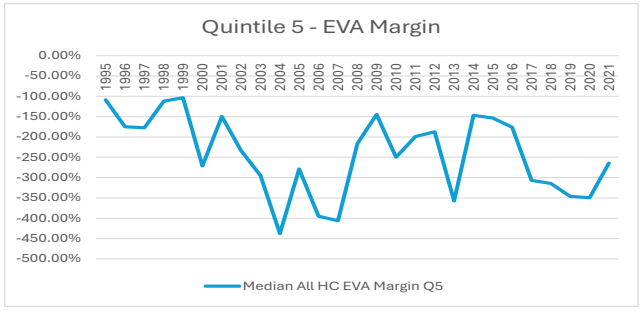
Readers will recall our long-held philosophical affinity to the Economic Value Added (EVA) principle, with positive EVA Margins (EVA/Sales) implying a company's Return on Invested Capital is above its Weighted Average Cost of Capital. So how do these Quintiles compare in the creation of Economic Value? Charts 2 and 3 below demonstrate the details. Namely, as one might suspect, the 1st Quintile (again, by FGR) materially outperforms the 5th Quintile with respect to EVA Margins. This fits the idea that many Biopharma companies not only lose money and destroy economic value but also trade at valuations that require a massive improvement in results in the future to justify their stock prices.

Chart 2: Quintile 1 - EVA Margin



Source: ISS EVA Investor Express

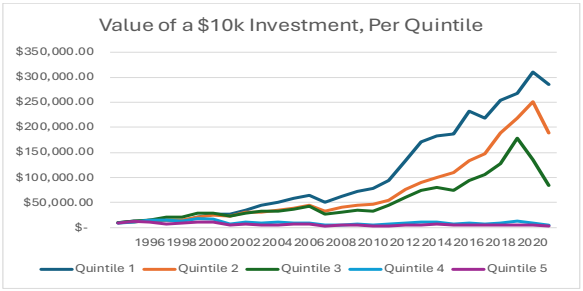
Chart 3: Quintile 5 - EVA Margin



Source: ISS EVA Investor Express

As investors, we want to bring the narrative back to share price performance and what we can learn from this data. Looking at the value of $10,000 invested into each Quintile back in 1995 demonstrates this in an easy-to-understand way.

Chart 4: Value of a $10k Investment, Per Quintile



Source: ISS EVA Investor Express

You will see that using the **median** return for each group from each period, the first Quintile is the best performing stratum, with Quintile 2 and 3 not far behind with smaller but positive returns. Investments in Quintiles 4 and 5 have lost value over the timeframe[2]. Examining the data further, we would note that on average Quintiles 1, 2, and 3 generate Economic Value, while Quintiles 4 and 5 do not. Is this a coincidence that the three EVA creating Quintiles generate the best median returns (and in descending order) while the two value destroying Quintiles return losses? Perhaps not.

Closing Thoughts

Within the Health Care sector, we believe Future Growth Reliance is meaningfully related to investor expectations. We believe that the data supporting that high FGR firms tend to have stock prices that underperform is tantamount to a well-documented investor belief that firms with high expectations tend to underperform. The magnitude of performance differential between Quintile 1 and Quintile 5 is striking, as is the amount of the economic value creation/destruction differential between the two quintiles (see Chart 2 vs. Chart 3 above), supportive of the notion that economic profitability matters. Powerful industry outliers can certainly influence the Health Care sector's performance outcome, yet analyzing performance from a median perspective highlights the linear relationship between FGR (expectations) and forward-looking returns. It is for this reason that we have begun utilizing FGR in our backtesting process for Health Care and believe the metric appears to offer one of the most fertile hunting grounds for finding excess return opportunities in the sector.

[2]We should note these are median returns for the companies in each Quintile. When using average returns Quintile 5 actually performs very well with an annualized return nearly 300 basis points above Quintile 1. After digging into this, the average returns are skewed by some very high returns generated by a small number of firms in Quintile 5 that pull the calculation higher. Perhaps this is not surprising as the Biopharma area is well known for binary outcomes where a select few companies generate outsized returns while many more may end up worthless. We believe that analyzing the lens through the use of medians is more appropriate.