Maurer's Healthcare Insight (88)

All the News Unfit to Print

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Japan's healthcare market continues to evolve, sometimes in ways that defy a logical explanation, at least in terms of Western logic. News articles that both abuse and amuse the mind are the basis for the comments that follow.

Managements' Use of Cash

Share buybacks have come into vogue along with increased dividends. One news source reported Daiichi Sankyo will repurchase 10 million of its own shares in the current fiscal year through March 2008. The cost of this exercise is predicted to be ¥40 billion. Takeda conducted its first share buyback of ¥210 billion in fiscal 2006, while Astellas spent about 170% of net profit, or ¥220 billion to buy its own shares in the same year.

On the dividend front, the four top firms are expected to pay combined dividends of nearly ¥290 billion for the year ending March 2008. This amount is double the fiscal 2004 figure of ¥140 billion. Takeda's dividend is ¥260 a share, up from ¥128. Astellas is up ¥20 to ¥100 a share. Daiichi Sankyo up ¥10 to ¥70, and Eisai up ¥10 to ¥130 per share.

We are talking about significant payout ratios here, roughly 41% in dividends alone. In fact, Daiichi Sankyo intends to return 100% of its net profit to shareholders over the next three years through dividend payouts and stock buybacks. The reported logic for this is "... to use funds effectively in line with stockholder demands."

One such demanding shareholder is Brandes Investment Partners, a US fund with a 7% stake in Ono, who submitted a resolution calling on management to increase its annual dividend to ¥700 per share, seven times the current payout. They argued that Ono's financial assets - the total of cash and deposits, short term marketable securities and investment securities - came to ¥363.2 billion as of December 31, 2006. Even if Ono raised its dividend to ¥700 per share, Brandes said the company would still be left with more outstanding financial assets than the total of its strategic investment in the past 10 years.

Management, as you might expect, expressed its opposition to the Brandes resolution saying, "It needs the money to buy promising new medicines, among other things." The Brandes resolution was defeated at the June general shareholders meeting.

What "other things" did the Ono management have in mind for its cash hoard? In the fiscal year ending March 31, 2007 Ono and Santen spent roughly ¥1 billion buying each other's stock. Both companies argued that the cross holding relationship was based on agreements for the mutual use of active ingredients and "other" cooperation. However, a Santen official let the real reason slip out by saying "We have high hopes for shareholder stability as a side benefit."

Ono also entered cross-shareholdings with Suzuken and Toho, both pharmaceutical wholesalers, with investments of ¥200 and ¥500 million.

But Ono was not alone in its quest for shareholder stability in the face of shareholder activism. Eisai also invested in Santen and Suzuken. At the end of June Kissei announced it would buy into Wakamoto to become its leading shareholder, and Wakamoto will return the favor by this fall.

Interesting to note this rush to cross-shareholding is largely confined to mid-sized players. Takeda has remained on the sidelines.

As a private investor and the owner of several past and present small firms, I value stability and ample cash reserves for the inevitable rainy day. Yet I cannot help but wonder if these cash rich pharma companies are hoarding an excessive amount of cash because they have no idea of how to use it to grow their businesses. They are refining the art of risk aversion to a new level.

Another Dubious Use of Cash

It is bad enough that the cost of doing clinical trials in Japan is extravagant by any measure, but a recent survey by pharma firms indicated the system is flawed. From January 2004 to December 2005 657 medical institutions in the survey participated in clinical studies. Of these, 26 failed to recruit a single patient. Nevertheless they were paid a total of ¥89.2 million, or an average of ¥3.43 million each.

Must be nice to be paid for doing nothing, but the real culprits are the guys who authorized the payments. My guess is their salaries are not based on performance.

Where Have All the Children Gone?

Last year the number of children in Japan below age 15 dropped for the 26th straight year. The children's share of the population declined for the 33rd straight year. The share of children in the nation's population has been lower than that of the elderly aged 65 or above since 1997.

A slight ray of hope emerged in 2006 when the total number of marriages rose 2.4% to 748,017. This up tick in the number of marriages is due to an increase in the so-called junior baby boomers who were born between 1971 and 1974. Now in their mid-30s, this age group is sensitive to an expiring fertility window of opportunity. Not surprising that more marriages led to more births, the first increase in six years. Did you know that one in four women are already pregnant when getting married?

Generic Companies on a Roll

For the fiscal year ended March 2007 the sales of Sawai, Taiyo, Nichi-iko, and Towa increased an average of 21.8%. Net profits grew 37.6%. These big four generic companies forecast a 15% average sales growth in fiscal 2007 with net profit growth of 21.2%.

The companies are optimistic about the future as more government officials talk about raising the generic drugs' market share in volume from the current 17% to 30%, that is a doubling by 2011. If this is achieved the government's Council on Economic and Fiscal Policy estimates that annual medical costs will be slashed by roughly ¥500 billion. Some observers say that if the generic market penetration can be lifted to 50%, Japan can cut nearly ¥1 trillion off an annual drug bill that totals ¥7 trillion.

The losers in this scenario are not mentioned, e.g. companies without new products. These are typically the mid-sized companies mentioned earlier. They have plenty of cash but few new products.

Speaking of Losers

Seems as though medical examination fees of independent docs, i.e. GPs, will be cut in fiscal 2008. No doubt this group has lost its political clout. Another factor in this egalitarian society is the disparity in monthly pay between independent clinic operators who average ¥2.29 million compared with ¥970,000 for an in-house physician at a hospital. Seems unfair, but why not increase the hospital salaries?

Because the squeeze is on. When I came to Japan in 1970 national healthcare expenditures were ¥2,496 billion. Twenty years later in 1990 they were ¥20,607 billion, a 10-fold increase. Hard not to be a winner in that kind of growth environment. By 2000 expenditures went up to ¥30,142 billion, a slowdown in growth, but still comfortable. Looking ahead to 2010 growth will be anemic. Hard not to be a loser in this kind of no growth environment.

P. Reed Maurer would rather make news than write about news, but sometimes cannot resist reporting.