Headed for Redemption? GSK and its Strategic Turnaround

Introduction

Facing rising scrutiny from American activist investors, GlaxoSmithKline (GSK), Britain's second-largest pharmaceutical company, is undertaking a major strategic shift. By spinning off its consumer healthcare division, and recently acquiring Sierra Oncology for $1.9bn, which is about to introduce a new blood cancer treatment to the market, GSK is hoping to fend off pressure from activist investors and build up a new drug pipeline which it can showcase.

About GSK and Sierra Oncology

GlaxoSmithKline is divided into three divisions: pharmaceuticals, vaccines, and consumer healthcare. The pharmaceutical business itself has a large portfolio of respiratory, HIV, immuno-inflammation, and oncology drugs. Their R&D heavily focuses on immunology, human genetics, and advanced technologies. GSK also is the world's largest vaccine company by revenue and an indispensable healthcare provider as the number one over-the-counter respiratory medicine company. GSK's market capitalisation is currently around $110bn, with $40bn in revenues and $6bn in net income in 2021.

Sierra Oncology, California-based, is a late-stage biopharmaceutical company aiming to deliver targeted blood cancer therapies. Sierra has a highly experienced management team with a proven track record of success in oncology drug development. Their lead product candidate, momelotinib, is a drug being tested on anaemic patients with a type of bone marrow cancer called myelofibrosis. The company is in process of bringing momelotinib to market after strong Phase 3 test results. Sierra Oncology is listed on the NASDAQ at a $1.3bn market capitalisation and reported a net loss of $95mn in 2021.

Deal rationale and structure

GlaxoSmithKline's acquisition of Sierra Oncology for $1.9bn comes as GSK tries to fend off pressure from activist shareholders. In fact, GSK's chief executive, Emma Walmsley, has been facing mounting calls to shore up its drug pipeline – with more short/mid-range specialized drugs - since the institutional investor Elliott built up its stake in GSK last year. The pressure to introduce new specialised drugs, which GSK can monetise rapidly, has been steadily increasing in the past years.

The deal will give GSK access to Sierra Oncology's momelotinib, which GSK believes to have "significant growth potential" and it expects sales to start next year, with one analyst predicting it could generate peak annual sales of about $1.7bn. In fact, momelotinib offers a differentiated treatment option that would address the unmet needs of anaemic patients, the major reason patients discontinue treatment. With the proposed acquisition, GSK can potentially bring meaningful benefits to patients and further strengthen its portfolio of speciality medicines, proving that it is taking investors' concerns, especially that of its specialised drugs portfolio weakness, into account.

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Sierra Oncology will be acquired by GSK for $55 per share. GSK is paying a 39% premium in cash to the company's closing price on the day of the announcement, April 13th. GSK expects Sierra's sales contribution to start in 2023 with significant growth potential thereafter.

Strategic shift to specialised drugs

As mentioned, GSK has been dealing with profound pressure from activist investors, most notably from Elliott, the American hedge fund. Back in 2021, Elliott had questioned whether CEO Emma Walmsley, previously of L'Oreal, was the best fit to lead GSK. Since taking its multi-billion-dollar position it argued, among others, for slashing R&D expenditure. Since then, GSK has been focused on spinning off the consumer healthcare division and devising plans for a new drug pipeline.

In the healthcare industry, the value and commercial viability of a drug is measured by the net present value (NPV). Total revenue depends on price premium, market share, population size, and length of patent protection. Oncological drugs currently are the highest NPV projects in the pharmaceutical industry, which partly explains GSK's move to acquire Sierra Oncology. Further, the UK company will be able to quickly monetise the drug, as the momelotinib drug will likely enter the market in 2023. It is hoping the move can release at least some of the investor pressure the company is dealing with.

Oncology also benefits from increased regulatory support, with a projected total clinical development spend of $82bn, over triple that of any other area (respiratory, dermatology, etc.). Investments in oncology are set to yield high returns, with an expected $188bn in net present value (NPV), representing 34.8% of the value of the US clinical pipeline.

According to EvaluatePharma's latest report, oncology will amount to 20% of the total pharmaceutical sales in 2026, with immuno-oncology sales increasing to $94.7bn by 2026 at a CAGR of 20%. GSK will therefore operate in a growing market segment, with many new opportunities for mergers and acquisitions with more experienced players like Bristol Myers Squibb.

The acquisition of Sierra Oncology epitomizes how seriously activist investors' concerns were taken by GSK, and Elliott has particularly been pleased by the board's decisions. The hedge fund's apprehension of Emma Walmsley has subsided at least for now. That said, GSK's CEO certainly does not operate in calm waters and will have to deliver on her promises or face further pressure to step down.

Haleon spin-off

In late February 2022, GlaxoSmithKline announced its decision to spin off its consumer healthcare division, to be named Haleon. The British pharmaceutical company plans to complete the spin-off as planned in mid-2022 after rejecting offers from Unilever, the British consumer goods behemoth. The complete plan was disclosed after GSK had rejected Unilever's $59bn offer late last year on the grounds that it undervalued the company. The move to spin off the consumer health division is the first of many steps to alleviate activist investors' issues concerning GSK's performance and management.

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One of the grounds for the spinoff is the prospect of transferring a significant amount of debt to the new entity, Haleon. This approach will enable the slimmed-down GSK to cut its debt ratio and open the door to future M&A activity, similar to the deal for Sierra Oncology. GSK will pursue a progressive dividend strategy with a target payout ratio of 40%-60%, beginning with ￡45 in 2023.

Following the split, Haleon is scheduled to be listed on the London Stock Exchange (LSE), with an American Depository Receipt (ADR) listing in the United States. If approved, the deal will be completed by demerging at least 80% of GSK's investment in the consumer healthcare division to its shareholders. The slimmed-down GSK will retain 20% of Haleon as a short-term investment, which it will monetize when the financial sheet is improved, and pension obligations are met.

The move to spin off the consumer health division can be partially explained by the recent activist investor pressure on GSK to address its contracting margins and sub-par stock performance. Elliot, the US hedge fund known for its activist strategies, purchased a significant position in GSK in April 2021. Since then it has pressured GSK's Chief Executive Officer, Emma Walmsley, to speed up the company's strategic refocusing in order to improve its overall performance. Elliott has a history of pressing for reforms in ailing healthcare firms. The hedge fund had previously advocated for reforms at Alkermes Plc, Allergan, and Bayer AG and the sale of Alexion Pharmaceuticals Inc. before AstraZeneca purchased the company.

Arguably, GSK has stagnated in recent years, with profit margins shrinking and no new medications in the pipeline. Simultaneously, a number of other companies moved aggressively into specialized niches which yield higher profits than generic drugs. Despite its high dividend distribution policy, this is one of the reasons behind GSK's dismal stock performance. Consumer healthcare generated ￡9.6bn of revenues, a 4% decrease from 2020. GSK's annual earnings before tax decreased to￡5.1bn in 2020, down from￡6.4bn the year before. After years of "disappointing performance" the New York hedge fund made a number of suggestions to GSK's chairman Sir Jonathan Symonds and the company's board of directors in a 17-page public letter. It demanded that GSK appoint new board directors with deep pharma and consumer health expert knowledge to introduce a process to select "the best executive leadership".

GSK's consumer healthcare business increased organically by 4% between 2019 and 2021, but the firm believes it is "well-positioned" as part of the ￡150bn consumer healthcare industry. According to GSK, the demerger process has the backing of a sizable majority of the company's shareholders, who anticipate benefiting from the unit's good prospects for sales and profit development and significant cash output.

Haleon expects "modest, sustained growth" in adjusted operating margins in the medium term, after increasing margins in the previous two years despite the pandemic's negative effect. The corporation plans to expand revenues by 4 to 6% in the longer term, up from ￡10bn last year. Brian McNamara, the future Haleon CEO, who heads the business as part of GSK, said the firm would have an edge in a ￡150bn industry that is currently expanding at a 3 to 4% annual rate. Arguably, the move will allow both GSK and Haleon to specialise in specialised drug development and consumer health, respectively. Slimmed-dow GSK hopes the spin-off will reinvigorate its business and allow it to regain the arguably lost strategic focus. Many investors will be asking themselves if spinning off the consumer healthcare division is a possible path to redemption.

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GSK's financial outlook

At constant currency rates, slimmed-down GSK expects revenue growth of more than 5% and adjusted operating profit growth of 10% over the next five years. Profit growth will be supported by a mix of robust revenue growth from new vaccines and speciality drugs, improved operational performance, and advantages from recent transformation. The business plans to increase adjusted operating margins from the mid-20s to over 30 per cent by 2026. Improved revenue growth, sales mix advantages, and the realisation of previously stated cost reductions are all anticipated to contribute to improvements in operating margins. GSK has discovered an additional £200mn in yearly savings from the Separation Preparation (Future-Ready Supply Chain with Predictive and Prescriptive Maintenance) initiative, raising its cost-savings objective from £800mn to £1bn with no additional delivery expenses. All restructuring programs will be completed by 2022, with no other significant restructuring programs anticipated.

GSK intends to generate more than £33bn in revenues by 2031. The commercial execution of GSK's existing late-stage pipeline will fuel the achievement of this goal. On a non-risk adjusted basis, the business forecasts that some assets in late-stage development have the potential to generate peak year revenues of more than £20bn. Slimmed-down of significant debt, GSK is likely to prioritize R&D and commercial investment in vaccines and speciality medicines, which are estimated to account for about three-quarters of total company revenues by 2026. Vaccines are predicted to expand at a high single-digit CAGR in 2021-26, while specialty medicines are expected to increase at a double-digit CAGR.

The growth prospects in illness prevention and treatment present substantial scientific and economic opportunities for the company. At its core lies the company's research and development emphasis on immune system science, human genetics, innovative technologies, and world-leading vaccine and pharmaceutical development skills. Currently, the firm has a pipeline of 20 vaccines and 42 medications, many of which are best-in-class or first-in-class candidates.

In terms of Haleon, its net debt to earnings before interest, tax, depreciation, and amortization ratio will be up to four times. It said that it will pay down the debt to reduce the debt-to-equity ratio to up to three times by 2024. The firm claimed it had saved an extra £100mn in annual cost savings from the integration of Pfizer's consumer business, bringing the total to £600mn, which would substantially cover the spun-off company's higher annual costs in 2022.

Haleon expects to pay a dividend at the lower end of the 30 to 50% payout ratio range, pending approval by the new board, led by former Tesco CEO Dave Lewis. Transformed GSK is planned to have a net debt/adjusted EBITDA leverage ratio of less than two times after the separation of the consumer healthcare division. This, together with predicted higher cash flow generation, will provide the company with more flexibility to fund future growth projects. GSK is estimated to earn more than £10bn in cash from operations by 2026. Starting at 45p per share in 2023, the company's first full year of operation, The slimmed-down company would pursue a progressive dividend policy aiming for a 40-60% dividend payout ratio.

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Pharma competition will likely remain high as many companies sit on cash piles from vaccine production - most notably Pfizer and a newcomer, Moderna, who will rival GSK in the vaccine field with the nascent mRNA technology. GSK has an uphill battle to earn institutional investors' faith in the current competitive climate. However, attributable to synergies with Sierra and effective leadership, the firm has a solid opportunity to maintain its leading position and continue to pursue innovative healthcare solutions.

TAGS: GSK, Sierra, Pfizer, Novartis, Moderna, pharma, drug, pipeline, Elliot, oncology

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