THE LONG VIEW

Cipla: Beyond the Pursuit of Profit

Can you do well by doing good?

'As always, Cipla will follow a compassionate and humanitarian approach to healthcare that goes beyond the pursuit of profit. Access to medicines at affordable prices has been the main objective that has seen the growth of Cipla over the past 86 years.'

Dr Y.K. Hamied, Chairman, Cipla (2021)[1]

A CASE STUDY SHOWING HOW WE ASSESS BUSINESSES

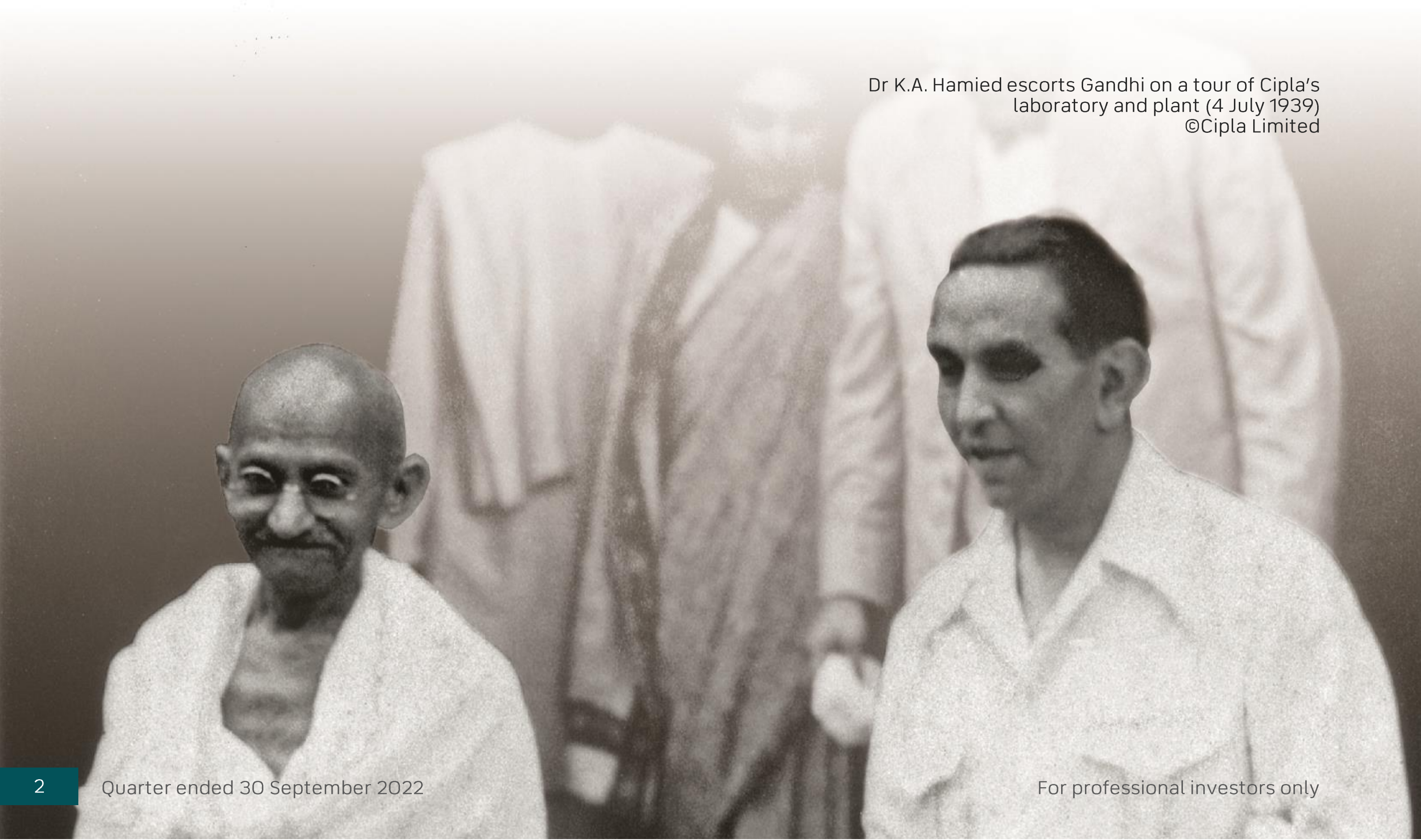
We have always believed that finding companies that are both far-sighted and fair-minded should make it possible to deliver good returns over the long term. It's worth emphasising several parts of this statement. Any company that prioritises longer-term success over short-term gain will favour decisions that might be painful at first but are the right ones for the long-term health of the business. A fair-minded company is one that recognises its many different stakeholders and treats these people in a way that enhances rather than diminishes its reputation. Benjamin Franklin pointed out in *Poor Richard's Almanack* that 'glass, china and reputation are easily crack'd, and never well mended'[2].

Over the years we have found this approach to be a successful and repeatable way of identifying companies that not only do what they have to do, perhaps what is required by local laws, but also go beyond and position themselves for the future in a way that they are achieving or sometimes setting global standards. To illustrate this we thought it would be helpful to look at Cipla, a business that we have owned since the strategy's inception.

HOW WE FOUND CIPLA

What led us to Cipla originally was an interesting report from the Changing Markets Foundation, titled *Bad Medicine*[3]. This report, which originally came out in 2015, looked at how EU and US pharma companies were engaging in environmental arbitrage by outsourcing their manufacturing to India and China, where environmental compliance and auditing were much weaker. The pollution from these companies was in turn leading to poor outcomes for local communities by contributing to the growth in antimicrobial resistance (AMR) and the rise of so-called 'superbugs'.

We were surprised and a little disappointed to see some well-respected companies named and shamed in the report but one company that stood out by its absence was Cipla. As we dug deeper, we discovered that not only was Cipla not being called out, but it was also taking a global lead in the fight against AMR. Cipla was the first generics[4] manufacturer to avoid paying its salespeople by volume sold. This matters because linking pay to sales volume encourages over-selling and over-prescribing of drugs, which in turn increases the problem with resistance in populations. Cipla still maintains this separation between pay and volume for more than 99% of its sales[5]. It was clearly a company that merited further investigation.



Dr K.A. Hamied escorts Gandhi on a tour of Cipla's laboratory and plant (4 July 1939)
©Cipla Limited

CIPLA'S HISTORY

Chemical Industrial and Pharmaceutical Laboratories (CIPLA) was founded in 1935 with the aim of bringing self-sufficiency to India in pharmaceutical medicines. Its founder was Dr K.A. Hamied, who studied pharmacy in Germany at the urging of Mahatma Gandhi. The business moved quickly from its inauspicious beginnings in a rented bungalow in Mumbai and grew well. A significant turning point for the company came in 1972 when the Patent Law of 1911 that had resulted in multinationals holding an 80% control of sales in the country was rewritten after lobbying by Dr Hamied. This allowed Indian companies to reverse engineer existing medicines for sale in India. From 1970 to 1995 the number of domestic pharma companies in India rose from 2,000 to 24,000 and India is now the third-largest manufacturer of pharmaceuticals by volume in the world. It is, however, 14th by sales[6], which is a function of much of the industry developing from the manufacture of commodity drugs.

Cipla rose through this crowded space and registered its first drugs with the US Food and Drug Administration in 1985 and in 2000 released CFC-free inhalers 10 years before the Montreal Protocol banned these harmful greenhouse gases[7]. What really helped us understand the character of this business, however, was the involvement of the founder's son, Yusuf Hamied, in bringing affordable HIV/AIDS medicines to Africa.

In the late 1990s it was discovered that a combination of anti-retroviral drugs would dramatically reduce the death rate from AIDS[8] but the drugs were patented and sold for US $10–15,000 per annum around the world, in both developed and developing nations. These were beyond the means of the people who existed on less than $6,000 a year in relatively well-off South Africa, where an epidemic raged. In 2000 more people died in a single year from AIDS than in all the wars on the continent (2.4 million[9]) and of the 36 million people infected, 23 million lived in sub-Saharan Africa[10]. On 6 February 2001, Cipla offered to supply a three-drug regimen for $1 a day[11], which was below their cost of production[12].

The low cost of Cipla's offer created the shock required to force action and helped lead to the establishment of a programme to help treat HIV/AIDS in Africa.

In 2002 the World Health Organization, in a setback to the lobbying efforts of Western pharmaceutical companies, included Cipla on its list of approved providers. Dr Hamied was quoted as saying, 'This proves that we adhere to good manufacturing practices on a par with other companies. It says Cipla is kosher, so now the multinationals can't throw at us what they have said: "They're Indian, they're Third World, the quality might be iffy."' The path from the offer to the wide availability of treatment was not a short one but the incidence of deaths in South Africa from AIDS per 1,000 people has dropped from around six in 2007 to less than one in 2021[13].

OUR ANALYSIS

We assess four key areas of quality when considering a business – sustainability, people, franchise and financials.

In considering **sustainability**, apart from studying the company's history we look at whether what they produce or provide is essential both now and into the future. It was clear from studying Cipla that this was the case. Our research also implied a strong sense of ethics in the company that might protect us from possible governance failures and a culture that thought about everyone who's affected by the business, not just shareholders. Whereas some large pharmaceutical companies' decision to hold their ground on pricing in Africa may have led to higher profits in the short term, we believe the damage it did to their reputation in the longer term was significant.

The sustainability of the company was therefore not in doubt but this on its own is not sufficient to demonstrate quality; every holding in our portfolios must also demonstrate the integrity and talent of the people who run it, the strength of the franchise and the financials that support it.

On **people**, the company is transitioning to the third generation with Dr Hamied's niece, Samina, taking the reins for the family. Samina decided to work for Cipla after returning to India in 2011 following an early career in global finance. This has coincided with a shift to professional management, a difficult transition for any family-owned business, and the current CEO Umang Vohra has made his mark in expanding the profitability of the company over the past six years. We have met Samina on several occasions and believe that with her in the role of executive chair the family remains a steward of the strong culture and thoughtful oversight in the long-term allocation of capital.

As far as the **franchise** goes, the life of a manufacturer of generic drugs is not an easy one. As drugs from major pharmaceutical companies come off patent, generic manufacturers can reverse engineer them to provide lower-cost alternatives, helping to broaden the affordability of treatments. The challenge is that there are many generic manufacturers competing with the same drugs, which rapidly become commodities. There are, however, several successful strategies that the industry has pursued to enable it still to generate acceptable returns.

In Cipla's case, they have focused on niches where competition is not so intense, using their long history of working with methods of delivering medication through inhalation. As this requires some specialist knowledge Cipla stays away from the worst commoditisation in the industry. The second, and more subtle, advantage comes from the careful development of their reputation over many years as a high-quality producer, something we observed when comparing the history of negative incidents such as product recalls at Cipla with its peers[14]. This has helped Cipla to form partnerships with several of the major pharmaceutical companies to in-license their branded drugs into India, a relationship based on trust in Cipla's continued care for its reputation.

We also like the fact that Cipla is not as dependent as its peers on the United States: 40% of Cipla's revenues come from its domestic business. Although the United States spends more on healthcare than any other nation, competition there is fierce. Meanwhile, the long-term demand from the more than 1.3 billion Indian people who are underserved should help the company become a lot larger than it is today. The provision of medicines to those in developing markets has always been a core part of the company's purpose and puts it in a strong position to fund careful expansion overseas.

The fourth area we consider in assessing quality is the company's **financials**, which include the transparency of the accounts, decisions around capital allocation and the company's attitude towards risk. The last of these is most simply demonstrated by the fact Cipla has brought down its outstanding debt since Umang took over as CEO[15] and is now holding more than one year's profit in net cash. The business also paused acquisitions to digest the companies bought under his predecessor, something that shows a sensible attitude towards risk.

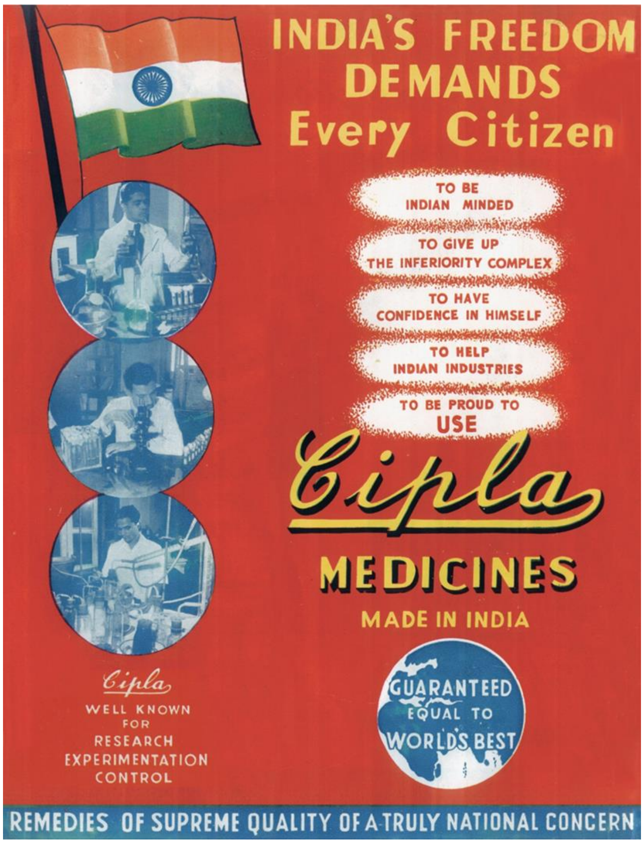
The acquisitions Cipla has made play a long-term strategic purpose, primarily establishing a full presence in the United States to give direct access to buyers and control of this channel to the company. Not all acquisitions in this industry are so sensible. For example, one of Cipla's peers that we have looked at bought a manufacturer of opiates in the United States despite the US opiate-related pandemic. This decision led to the write-off of several hundred million dollars – a poor outcome for shareholders. We regularly speak to companies about how we consider acquisitive activity to be reflective of the culture of a company and how it is perceived by suppliers, competitors, customers and future employees.

The final part of our decision to hold Cipla shares was based on valuation but, simply, if the company fails on any of the four key areas of quality – sustainability, people, franchise or financials – price is not a deciding factor and we move on.

LOOKING TO CIPLA'S FUTURE

In this case, we believe, Cipla has a long road ahead of it to grow both in wealthy markets such as the United States and Europe and in emerging markets across Africa and of course in India. The combination of the change in generations in the family and top management also leads us to believe that returns in the business could continue improving as it delivers on a clearly articulated strategy. As in any investment there are many risks, and we could be wrong in our assessment of the business, so we must remain open to information that could contradict what we believe, which is not always easy to do.

Core to our philosophy is the belief that behaving sustainably is a necessary condition for investment but not the only one. The company must also cross other quality hurdles and be available at what we consider to be a reasonable price. These are rare beasts, which helps explain low turnover within the strategy. What allows us to sleep at night in an industry where trust and quality are paramount to the continued existence of the business is the family's obvious care for and protection of its reputation. This is evident not only in what the company delivers for us as shareholders but in the why and how it is achieved.



1 Dr Y.K. Hamied, Chairman, Cipla Annual Report 2021-2022.

2 Benjamin Franklin, *Poor Richard's Almanack*, 1750.

3 https://changingmarkets.org/portfolio/bad-medicine

4 Generics or generic drugs are pharmaceuticals that have come off patent and can be legally copied by other manufacturers. These are still subject to regulatory approval before they can be sold in a given market.

5 https://accesstomedicinefoundation.org/amr-benchmark/report-cards/cipla-ltd#performance

6 Cipla Annual Meeting 2022: www.youtube.com/watch?time_continue=635&v=ESx4o9nlGGo&feature=emb_logo

7 www.britannica.com/event/Montreal-Protocol

8 www.niaid.nih.gov/diseases-conditions/antiretroviral-drug-development

9 https://data.unaids.org/publications/irc-pub05/aidsepidemicreport2000_en.pdf

10 Kofi Annan as quoted in *The Guardian*: www.theguardian.com/world/2000/mar/14/unitednations

11 'Indian Company Offers to Supply AIDS Drugs at Low Cost in Africa', *New York Times*, 7 April 2001.

12 The movie *Fire in the Blood* tells the story of the battle to bring affordable AIDS treatment to Africa and extensively features Cipla and Dr Hamied.

13 AIDSinfo: https://aidsinfo.unaids.org

14 Source: RepRisk.

15 Source: CapitalIQ.

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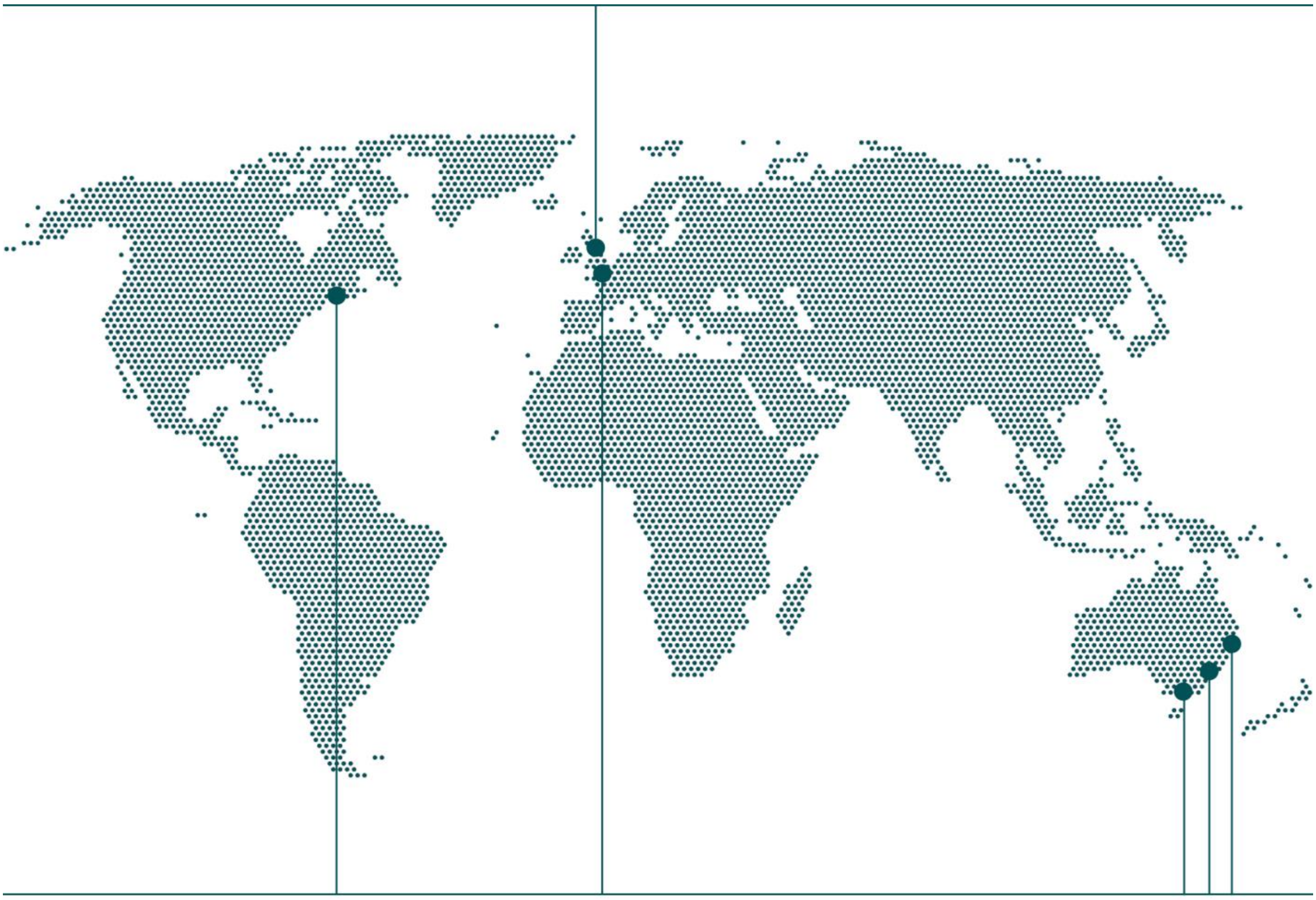

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