

After a strong multi-year run, the Drug Industry had somewhat of a rough go in 2016. While most of large pharma performed well from February through early August, in tandem with the major U.S. indexes, the group significantly underperformed in the back half of the year due to weak third-quarter operating results, high-profile clinical failures and concerns related to U.S. drug pricing.

The "XLV" ETF, which tracks the broader health-care industry has declined 9% in value since August 1st, compared to an 8% gain in the Dow and a 4% advance in the S&P 500. For full-year 2016, XLV was down about 4% as fourth-quarter losses more than offset mid-year gains.

In the following report, we touch on the political landscape, Alzheimer's disease, Allergan's capital allocation strategy, notable patent losses and the world's top-selling drug, *Humira*.

Political Landscape

The Drug Industry came under intense political scrutiny in 2016, with much of the criticism stemming from drug pricing and to a lesser extent tax inversion. As we begin the new year, the former is clearly the biggest concern for investors as an increasing amount of politicians have voiced their distaste for aggressive drug price increases. While Donald Trump's victory in the recent U.S. Presidential election was initially thought to be a positive for the industry, as his opponent took a strong stance in favor of increased regulation, even he has expressed concern in recent commentary.

Alzheimer's Treatment Remains Elusive

The clinical history for Alzheimer's treatments has been dismal, with numerous candidates failing to meet endpoints in late-stage trials. The most recent blow came from *Eli Lilly's* highly-touted solanezumab, which released disappointing results in November. Despite the long list of failures, we expect Alzheimer's will remain a hot area for investment in 2017. The incidence rates of the disease continue to grow, fueled by an aging global population and the commercial opportunity for the first to bring a product to market could be huge. Some analysts suggest the market could balloon to \$10 billion by 2020 and potentially \$30 billion by 2030.

Allergan Returning Value To Shareholders

Allergan was sitting on roughly \$30 billion in cash following the sale of its U.S. generics business to *Teva Pharmaceutical* (completed August 2nd). On the company's third-quarter conference call, management announced a \$15 billion share-repurchase program and the initiation of a common stock dividend.

Drugmakers Dealing With Big-Name Losses

Swiss drugmaker *Novartis* lost a big chunk of its *Gleevec* sales in the third quarter due to the emergence of generic competition. The blood cancer drug accounts for a substantial portion of the company's top line and with further erosion expected in the coming quarters, *Novartis* will be leaning heavily on its new product cycle to mitigate losses.

INDUSTRY TIMELINESS: 20 (of 97)

London-based *AstraZeneca* is another big name facing significant generic competition. Two of its top-3 selling drugs (*Crestor* and *Nexium*) have been in free fall since losing exclusivity in most major markets and this trajectory is expected to continue in 2017. The two drugs combine for nearly a quarter of Astra's total sales.

Top Drug Facing Pressure?

AbbVie's anti-inflammatory treatment *Humira* is currently the highest-grossing drug in the world. After generating north of \$14 billion in 2015, its sales were up 15% through the first nine months of 2016. While management is guiding for a strong finish to the year, some analysts believe biosimilar competition could threaten its dominance sooner rather than later. At this juncture, several patents are being challenged in court, but *AbbVie* remains hopeful it can maintain market exclusivity until at least 2020.

Strong Appeal For Income Investors

The Drug Industry currently offers a wide base of equities with 4%+ dividend yields including, *AstraZeneca* (5.1%), *GlaxoSmithKline* (4.8%) and *AbbVie* (4.1%). Meanwhile, U.S. drug giant *Pfizer* comes in just a hair below at 3.9%.

Conclusion

In terms of Timeliness, the Drug Industry has risen significantly in recent months, gaining 29 spots since our October report. The group currently ranks 20 out of the 97 industries under *Value Line's* coverage. For near-term accounts, *GlaxoSmithKline*, *Valeant Pharmaceuticals* and *Endo International* hold our top recommendation (1) as we enter 2017, however, investors should note that the latter two come with an elevated degree of volatility. *AstraZeneca*, *Novartis* and *Pfizer* also receive market outperform ranks (2) in the coming six to 12 months. The sector also provides a strong base of safe, well-established options with above-average income components.

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