The Drug Industry performed well during the first half of 2017, highlighted by double-digit price increases from several of the sector's top players (*Novartis, GlaxoSmithKline, Eli Lilly*). A recent rebound from beleaguered drugmaker *Valeant Pharmaceuticals* (+90% since early May) also contributed to the group's upward trajectory. While political scrutiny related to drug pricing intensified in late 2016 and early 2017, it appears that the new administration is softening its stance, somewhat. This, coupled with solid operating results and an improved macroeconomic backdrop have been key catalysts.

The XLV ETF, which tracks the performance of the broader healthcare industry has advanced more than 15% in value year to date. In comparison, both the Dow and S&P 500 have gained 8% since January 1st.

In the following report, we touch on the changing political landscape, patent losses on the international side, and *Valeant's* recent rebound.

Political Landscape

It appeared that drugmakers would be facing significant challenges in 2017 as both presidential candidates were highly critical of certain industry practices, specifically price gouging, and each vowed to take swift action if elected. Canada-based *Valeant* was at the forefront of this scrutiny after the company acquired two drugs and aggressively hiked their respective prices by hundreds of percent. The highly-publicized case of Martin Shkreli, former CEO of Turing Pharmaceuticals, brought more negative attention to the matter when his company acquired decades-old drug, Daraprim, then increased its price by 5000%. When President Trump eventually took office, the criticism continued and increased regulation seemed imminent.

In late June, the new administration's stance appeared to soften somewhat when reports surfaced that drafts of an executive order, which outlined policies to curb drug costs, were not as harsh as some had originally feared. Some key initiatives put forth in the draft include ways to accelerate drug approval times, which could potentially lower R&D costs, and changes in trade agreements to strengthen patent protection in international markets, which could increase overseas revenue. At this juncture, it is uncertain which aspects of the draft will make it into the final order or if they will ultimately be effective in lowering drug prices in the United States. However, judging by the biotech rally in late June, investors are clearly more optimistic than earlier in the year.

Patent Losses Overseas

London-based *AstraZeneca* continues to face significant generic competition on its *Crestor* franchise. The drug's sales plummeted 45% in the first quarter and further erosion is likely in the back half of the year. Given that *Crestor* is currently the company's #2 revenue generator, the impact will be substantial. Increased pressure on *Seroquel XR* is another overhang facing the company, though less significant to the top line. The drug's sales declined 67% last quarter due to the launch of two generic versions.

INDUSTRY TIMELINESS: 89 (of 97)

Another overseas drugmaker, *Novartis*, is not targeting much in terms of growth this year due to the patent loss on its blood cancer franchise, *Gleevec*. While the company has several exciting new assets and a well-stocked pipeline, further development will likely be needed to offset *Gleevec* losses. Management indicated that it doesn't anticipate to enter its next growth phase until 2018.

Valeant's Rebound Sustainable?

Valeant's stock has been on a tear in recent months, roughly doubling in price since mid-April. While the company's first-quarter results were a bit soft relative to consensus expectations, investors seemed pleased with management's full-year guidance and progress made on reducing the hefty debt load. Sentiment also got a boost from the aforementioned reports concerning the new administration's softening stance on drug pricing.

In our view, the future of *Valeant* comes down to the debt. Although slight progress has been made (lowered from $29.8 billion, to $28.2 billion in Q1), investors will probably want to see something more substantial over the balance of 2017. Management is currently leaning on its divestiture strategy for further reductions, but doing this without sacrificing some of its core assets could prove challenging.

Dividends

The Drug Industry boasts a number of high-yielding equities with relatively low-risk profiles. Investors seeking an income play should take a look at *GlaxoSmithKline* (4.5%), *Pfizer* (3.8%), and *Novartis* (3.2%).

Conclusion

In terms of Timeliness, the Drug Industry has plummeted in recent months, losing 64 spots since our April report. The group currently ranks 89th out of the 97 industries under *Value Line's* coverage. While investors will likely find more-attractive year-ahead growth options elsewhere, the sector still offers a strong base of safe, well-established equities with above-average income components.

Michael Ratty