TEVA PHARMACEUTICALS

Pharmaceutical innovation has been tremendously beneficial to humanity, but the pharmaceutical business has not always been beneficial to investors. Shareholders have often been treated to a "boom-bust" experience as some drugs become blockbusters, while others fail before ever getting to market. A focus on generic drugs, however, has made Israel-based Teva Pharmaceuticals (TEVA) a more consistent top-20 global pharmaceutical company and the world's largest producer of generic drugs—much to the benefit of its shareholders.

With its December 2008 purchase of Barr Labs, Teva now operates in over 60 countries worldwide, generating nearly $14 billion in revenues. This is quite a transformation from its beginnings in 1901 as a tiny drug wholesaler with a single storefront in Jerusalem. A long history of successful acquisitions, combined with a shift to providing generics to the U.S. market during the mid-1980's, were especially well timed.

We like businesses that stand to benefit from dominant, long-term macroeconomic trends, and the generic pharmaceutical business is especially attractive from a long-term economic standpoint. Global demographics suggest an aging population, particularly in the prosperous economies of the developed world, and generics offer the benefit of lower cost without compromising the quality of care. Additionally, less developed countries often lack even the most basic medical care, and low cost generic drugs are helping to change that. In short, the entire world demands increased, but affordable, healthcare, and it seems generic drugs must be a part of any solution. These factors, along with the list of blockbuster drugs due to come off patent over the next several years, help explain why the generic industry is expected to grow around 10% per year through 2012—nearly twice that of the proprietary drug business.

Teva's operating performance clearly demonstrates the benefits of the generic business: superb revenue growth (27% per year since 2000), great net profit margins (averaging around 20% over the same period) and excellent cash earnings. Of course, these kinds of opportunities attract intense competition, and that's one key risk. However, being the largest producer leads to lower costs, and having a global distribution system makes it difficult for others to compete. Teva also develops its own proprietary drugs and has a few blockbusters of its own, including Copaxone, a leading treatment for multiple sclerosis. Combined, proprietary products make up 19% of Teva's sales.

Teva is also among the most aggressive generic producers in challenging patents and pursuing "first-to-file" status. Patent challenges are a legal strategy whereby generic makers seek to reduce or eliminate the period of exclusivity afforded to new drugs. Generally speaking, these challenges have held up fairly well and helped increase the momentum of generic drug sales. The coveted first-to-file status provides a six-month period of exclusivity to the first viable generic substitute.

Given how far it has come from its humble beginnings, it's not surprising that Teva isn't satisfied with the growth rate projected for the generic drug market. Early in 2008, CEO Shlomo Yanai announced a goal of doubling sales to $20 billion by 2012. Acquisitions will certainly play a major role in achieving this goal, but so will the greater penetration of generics into emerging markets and developed countries such as Japan, where government policies have limited generic sales to date.

While we don't know the specific details of how insurers, healthcare providers, employers and governments will respond to the problem of satisfying the increased need for affordable healthcare, we remain convinced that the ability of generic drugs to reduce costs without compromising care will be part of any solution. And we believe that Teva will remain a leader in that business. It's an excellent example of one sort of investment that we pursue—a best-in-class operator with clear operational advantages and a proven business model that is well positioned relative to powerful economic trends.

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