

Health Innovation Q3 investment update

October 2023

Investment manager Marina Record and investment specialist Richie Vernon give an update on the Health Innovation Strategy covering Q3 2023.

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Richie Vernon (RV): Hello, and welcome to the Q3 2023 update for the Baillie Gifford Health Innovation strategy. My name is Richie Vernon. I'm one of the investment specialists on the Health Innovation team, and today I'm joined by Marina Record, investment manager and one of three decision-makers on the strategy. Welcome, Marina.

Marina Record (MR): Thank you, Richie.

RV: So, the Baillie Gifford Health Innovation strategy invests in companies that are driving a revolution in human health. It's a concentrated strategy of 25 to 50 companies that we believe are the most transformative in healthcare, enabling early diagnosis, better treatment of disease and more effective and accessible models of healthcare. This is not your typical healthcare strategy. And similarly, we are not in the business of trying to make bets on the binary outcomes of single drugs. We invest in platform technologies and companies with competitive advantages that can tip the odds of success in their favour.

So for the next ten minutes, Marina and I are going to discuss the performance of the strategy, any changes we've seen and some of the themes that the team are most excited about across healthcare more broadly. Marina, I think it's best if we start with performance. I know over the last quarter we saw another difficult performance period. I wondered if you could explain some of the factors behind that.

MR: That's right, Richie. To put it in context, the past two years have seen some of the most challenging performance in relative terms for healthcare in nearly 20 years. And this has continued in the last quarter. There are multiple reasons for that. Macroeconomic headwinds, budget pressures, regulatory changes to drug prices, the adjustments that companies are making post-Covid and geopolitical tensions. All of these factors have raised the levels of uncertainty within the

markets. And in this environment, the companies that have fared best are those that have near-term momentum and visibility.

Now, we invest in companies that we think can deliver a transformational change within the next ten years. And very often it requires trade-offs between short-term profitability and long-term growth prospects, and the markets are particularly sensitive to such trade-offs at the moment.

For example, in the recent quarter, one of the biggest detractors from performance was ShockWave Medical. This is a medical device company that is making cardiovascular procedures accessible to more patients by making them safer, and easier to use for doctors. Now, ShockWave Medical has had a very strong period of performance as it brought multiple products to market, obtained reimbursement and has seen the use of its technology accelerate.

In the past quarter, revenue growth was 40 per cent, but profit growth disappointed. And it disappointed because the company is investing to expand its market opportunities threefold or more. We're very excited to see the company doing that because we think by investing in that way, they have a very real chance of making that 40 per cent growth sustainable for years to come.

But the markets don't see it that way and therefore the share price has stumbled and ShockWave has been one of the biggest detractors this quarter.

RV: I think ShockWave's a great example of that short-termism we're seeing in the broader markets, and I know the broader environment is challenging out there. One thing for the team [that] is giving us a lot of faith, is the financial resilience of the portfolio as a whole. I know for the most part, most of the companies in the portfolio are free cash flow-positive, they have enough cash to be able to fund their own growth.

And for others that aren't, they tend to have very long cash runways. Considering the broader financial resilience of the portfolio, are there any specific companies that we might have any concerns around?

MR: More generally, we think that there will be a growing divide between companies that are now making the investments to strengthen their competitive positions and accelerate and expand their growth opportunities, and those that cannot do so whilst maintaining a sound balance sheet. So there is a small subset of companies within the portfolio that were forced to restructure, and we're now evaluating where the changes that they're making will have a long-term impact on their competitive positions and on their growth opportunities.

RV: And changing tack a little bit from there, have we made any changes to the portfolio over the last quarter?

MR: We have added to Wuxi Biologics and we have funded that addition by a complete sale of Oscar Health and also by trimming our position in ShockWave on the back of a very strong run of performance prior to the recent share price tumble.

To explain the rationale a little bit. Wuxi Biologics is an outsourcing business. It offers services for the life sciences industries ranging from early-stage drug discovery, where it takes a very lucrative royalty stake in drugs that will potentially succeed. Wuxi Biologics offers services all the way from drug discovery to commercial manufacturing and has been gaining share very, very rapidly. In these early-stage drug discovery projects, it takes a royalty stake, which, if they start to succeed, will provide a very lucrative royalty stream, which would come at 100 per cent margins further down the line, maybe 5 to 10 years from now. And the commercial manufacturing streams, that's a very sticky revenue stream because making any changes at such a late stage in the drug development process is very risky for companies. And the fact that Wuxi has been winning a higher share there speaks a lot about its reputation and the services that it offers. So those revenues tend to be very sticky.

Now, the market has been very concerned about geopolitical tensions. This is a Chinese-owned business, that is listed in Hong Kong. But it has been expanding very rapidly, building facilities outside of China. And it's also been taking a global market share of the biologics outsourcing market. It currently accounts for 12 per cent of all globally outsourced biologics projects, but it's been taking share of over 40 per cent when it comes to new projects. We spoke to customers to understand how they perceive the geopolitical risks, and we were quite surprised by the strength of their response.

They are very encouraged by the pace at which Wuxi is expanding its facilities internationally. They are not very concerned about geopolitical risks and they praise it very highly on key metrics such as quality, the speed of its services, the technical difficulty of the projects that it is able to take on. And so, our conviction rate has increased in that business, that it is very strongly differentiated offering that Wuxi can bring to markets and that the current financial market's perception of geopolitical risk seems to be at odds with what clients think. So, our conviction in Wuxi has increased.

Now, we have fully sold Oscar Health. Oscar Health is an insurance business operating in the very complicated space of US health insurance. This is an area where scale is very important, and Oscar has not been able to grow at the rates that we expected it to grow, to strengthen its competitive position and gain market share and have lucrative economics further down the line. So, we feel that the investment case has broken, our conviction has declined, and so we sold out of that company.

And with ShockWave I already mentioned we took the decision to trim because we saw the opportunity within Wuxi Biologics and ShockWave had a very strong run. And so, we decided to reallocate some of the holdings to Wuxi.

RV: It's good to hear that we've been able to take advantage of some of the volatility in the market to make adjustments within the portfolio. I wondered, are there examples in the portfolio we could share of companies that we think are executing really well and showing clear signs of operational progress?

MR: One of the top holdings in the portfolio is Argenx, and that is a European, a Belgian biotech business that is very rapidly emerging as a leader in autoimmune diseases. Argenx recently brought its first drug to market, and it's been one of the most successful drug launches in history. And that drug is also being developed in 12 other indications. And recently this past quarter on the back of some very positive late-stage clinical data, Argenx has been able to raise more than \$1bn, which it will now invest in accelerating its pipeline, building it out, but also this puts it in a very strong position to maintain the economics of the drugs that it develops. So our conviction [in] that company has been increasing, it's very strong.

RV: Great to hear. Last question from me. So, looking maybe beyond the portfolio now into the wider market, I know the team are seeing some really exciting opportunities and there's lots of innovation in broader healthcare. Are there any particular themes or areas that you'd draw our attention to as areas that are particularly interesting to our investment team?

MR: Well, thinking back to why we started Health Innovation, we have this hypothesis that the convergence of rapidly advancing technologies combined with new business models could transform healthcare. And I think what's really exciting for us is that we're seeing that thesis maturing. But we're also seeing the opportunities deepening.

For example, in the last five or so years, gene sequencing has become ubiquitous amongst researchers. Gene sequencing is the technology that allows us to read the instructions for cells that are contained within our DNA. And we are now on the cusp of a transition from research into the clinic, which is a much larger market opportunity. Liquid biopsy, [and] personalised cancer vaccines would not have been possible without gene sequencing.

The next frontier is to move beyond reading the instructions for our cells to actually what is happening within our cells right now. And there are technologies. Recently, technologies have been put on the market that can do just that. 10x Genomics is a holding, which has an instrument for these applications.

But also, there's a lot of progress in an area that's called proteomics. And so we're currently studying that area to understand, what would it take for those tools to transition from research into the clinic? Because when they can make those transitions, the market opportunities will be very, very large. It would mean that we could use these technologies not just for cancer and rare diseases, but increasingly for complex diseases. We know that there are a lot more processes and a lot more changes happening after those DNA instructions within our cells. So that's in life science tools.

But also in biotech, for example, we have seen that medicines can be programmed. So Moderna and Alnylam do just that with their RNA therapies. And we've seen that that translates to much faster development timelines and much higher chances of success. The next frontier is to deliver these genetic medicines to more areas within the body, and both Moderna and Alnylam are trying to do just that.

But there are also other companies that have unlocked these vistas within the human body, and the diseases that they can now target. We're finding new opportunities, for example, with a company that has been able to deliver to the lung, therefore, unlocking the opportunity within diseases of the lung.

But beyond that, we are seeing opportunities across many different subsectors of healthcare. We're currently looking at organ transplants, we're looking at synthetic biology. And really, our conviction in the opportunity set has been increasing. We're finding opportunities across this wide range of subsectors within human health. And we can see that the growth opportunity remains very large and progress continues to accelerate.

RV: Marina, I think that optimistic view is the perfect place to finish. Thank you very much for your insights on the portfolio and across healthcare, more broadly. For those watching, thank you very much for joining us. We hope to see you again next quarter. Goodbye.

Health Innovation

Annual past performance to 30 September each year (net%)

	2019*	2020	2021	2022	2023
Health Innovation Composite*	N/A	66.8	30.7	-45.5	-12.1
MSCI ACWI	N/A	11.0	28.0	-20.3	21.4

Annualised returns to 30 September 2023 (net%)

	1 year	5 years	Since inception*
Health Innovation Composite*	-12.1	N/A	2.9
MSCI ACWI	21.4	N/A	8.8

*Inception date: 31 October 2018

Source: Baillie Gifford & Co and MSCI. USD. Returns have been calculated by reducing the gross return by the highest annual management fee for the composite.

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