PGIM FIXED INCOME

All the Credit®, Ep. 47

Transcript

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Female Voice: You're listening to *All the Credit*®, a monthly podcast series brought to you by PGIM Fixed Income, an active global fixed income investment manager.

Brian Barnhurst, CFA, Co-Head of Credit Research: Hello and welcome to *All the Credit*®. I'm Brian Barnhurst, Co-Head of Global Credit Research. Amidst an abundance of 2024 outlooks, we present some lighter fare and explore the investment implications of GLP-1s across fixed income markets and industries. More commonly known by their many brand names, GLP-1s have actually been around for many years but were thrust into the spotlight earlier in 2023 with a flurry of media attention, social media presence, and perhaps most impactfully, Walmart's October public comments regarding the drug's impact on purchasing behavior. I'm fortunate to be joined by three of my senior research colleagues. Scott Swanson covers food and beverage and consumer goods. Rich Kus is one of our packaging analysts. And Liz Halpin covers healthcare. Scott, Rich, Liz, welcome to the podcast.

Scott Swanson, CFA, U.S. Leveraged Finance Credit Research Analyst: Thanks for having us.

Elizabeth Halpin, CFA, Co-Head of U.S. Leveraged Finance Credit Research: Thanks, Brian.

Richard Kus, CFA, U.S. Leveraged Finance Credit Research Analyst: Thanks for having us.

Brian: I want to start with a level set on the background of GLP-1s, so I'm going to go to the healthcare analyst, Liz Halpin. Liz, help us understand, what are GLP-1s?

Elizabeth: Thanks, Brian. Before I dive in, I just note that as a credit analyst, the details that I'm sharing and what my colleagues will also share are based on an investment focus and are not intended to be a substitute for professional medical or health advice, diagnosis, or treatment. So, for the avoidance of doubt, what we're about to discuss does not constitute medical or other professional advice in any form. Okay, so back to your question, GLP-1, that stands for glucagon-like peptide-1 agonist. They mimic the GLP-1 hormone that your small intestine makes. The GLP-1 hormone does several things in our bodies. GLP-1 triggers insulin release. That allows your body to use food for energy and lowers blood sugar levels. GLP-1 also decreases glucagon secretion. That prevents more glucose or sugar from going into your bloodstream. GLP-1 also slows stomach emptying. That means your body releases less glucose or sugar from the food you eat into your bloodstream. GLP-1s also affect areas of your brain that process hunger and your feeling of fullness. In general, GLP-1 medications were developed to help lower or control blood sugar levels and they are now being touted and studied for promoting other potential health benefits such as weight loss, lower cardiovascular vents, slower chronic kidney disease progression, amongst other potential therapeutic applications. For individuals with type 2 diabetes, these medications may help manage blood sugar levels. The fullness effect from GLP-1 sometimes results in a reduction of food intake, appetite, and hunger, which may then result in weight loss.

Brian: And then, Liz, where are we in the drug development and consumer uptake timeline?

Elizabeth: The FDA actually approved the first GLP-1 in 2005, so we're further along in the development timeline than you might expect. I would say we're in middle innings if we're going to use a baseball analogy.

Early GLP drugs were used to successfully manage blood sugar levels and on average, were then found to have weight loss benefits ranging from 3% to 11% of one's body weight, according to a variety of sources. Based on the information available now, some newer GLP-1 drugs have been found to have a bigger impact on weight loss. Some can result in 15% to 20% of weight loss on average and some versions have been launched with FDA approval specifically for weight loss use. The greater weight loss impact and potential knock-on effects on society, healthcare, and other industries is what has garnered heightened market and investor focus recently. That said, I would characterize uptake for weight loss use specifically as being in very early innings. Based on prescription data and estimated off-label use, experts believe and studies suggest that 1% to 3% of the potential use group—if we're defining that by body mass index as obese or overweight individuals—is taking GLP-1s for weight loss. Multiple third-party and independent experts expect it to take about a decade, though, for GLP-1s to potentially have a measurable health impact on their patients.

Brian: A recurrent theme as we think through the investment implications of GLP-1s is going to be the cadence and quantum of uptake, so I want to probe a bit on that. First, help us think about some of the regulatory and reimbursement considerations that may impact that rate and scale of drug uptake.

Elizabeth: Yes, there are a number of considerations that will definitely govern the rate and scale of GLP-1 uptake, and we, like the market, believe that reimbursement and therefore payer coverage of the drugs is one of the critical gating factors for broad-scale adoption. Out-of-pocket costs are relatively high, depending on the treatment condition, and payer coverage is relatively low, again, depending on the treatment condition and health plan. Without broader payer coverage, current pricing for GLP-1s is too prohibitive, we think, for broad adoption in the short term. Medicare does not currently cover weight loss drugs. An act of Congress would be required to change that, and there are Congressional Budget Office scoring considerations that would come into play in that process. A change in Medicare coverage could change over time as additional health benefits are better understood. On the commercial side, to date, commercial coverage for anti-obesity drugs has been limited as well due to high price points and an uncertain return on investment. The question remains: will consumers remain compliant, and will employers realize cost savings over time in order to garner broader commercial coverage?

Brian: And then away from regulatory and reimbursement gating factors, as you put it, touch on some of the behavioral implications of actually being on a GLP-1 drug regimen that may govern uptake further.

Elizabeth: Sure, there are a lot of factors that may go into a patient's decision or a doctor's decision to prescribe or stay on this therapy. One is convenience. These are primarily injectable medications right now, although there are oral versions on the market and others that are being developed that could increase utilization longer term. Generally, dosing can vary from daily to one times per week, which, if you're doing an injectable, may be a deterrent for some folks. Another factor is compliance. Will a patient stay on the drugs? GLP-1 drugs are non-invasive but are maintenance drugs. So, if a patient stops taking the drug, then there's the possibility that their body weight could come right back. Obesity is obviously a very complex condition. Patients will have to work with their doctors to determine the right path forward for them, but effective management may require several therapies like dietary change, exercise, behavior modification programs, as well as potentially medications or surgical interventions. Also impacting potential patient compliance and the duration of drug use are potential side effects. According to the drug manufacturers, there are a number of potential negative side effects, including loss of appetite, nausea, vomiting, diarrhea, and there can also be a severe low blood sugar risk for patients. These are a few of the milder potential negative side effects that the manufacturers have warned about and there are potential, more severe side effects as well. We talked about access from the perspective of cost and payer coverage previously. Manufacturing supply constraints are playing into that equation presently as well.

Brian: Switching gears, let's bring in Scott. There's been growing media attention around GLP-1s throughout the year, really thrust into the spotlight, and it hit a fever pitch in October with some very public comments by the country's largest food retailer, which also has data on the behavior of consumers taking some of these

drugs. And they pointed to "a pullback in overall basket size, just less units, slightly less calories." And that created quite a reaction across food, beverage, restaurants, consumer goods. That's what I want to probe. Setting aside the wisdom of the market making some attempts to price in what we expect will be very long-run delayed impacts, at least at scale, I want to ask you, Scott, to put some context around this notion that if you're wagering on a material impact to consumer goods or food products from GLP-1 behavioral changes, I want to get a rough sense of what the underlying assumptions would be, because I think they're quite massive. So, I want to put some perspective around that.

Scott: Here's a rough way to frame potential long-run impacts. Right now, the adult population is about 260 million people. About two-thirds of this population is considered either overweight or obese. That equates to about 170 million people. Looking at long-term penetration rates of drugs such as statins, it's about 15% of the population that are on these type of drugs. Applying that same penetration level to the target population for GLP-1 drugs gets you to roughly 25 million people. So, assuming the average calorie reduction for a GLP user is about 25% of caloric intake or about 500 calories, that translates roughly to six million fewer people eating, which is about 2% of the overall population. Again, this is clearly illustrative only but helps to frame the long-run potential impacts.

Brian: Appreciating that's clearly a lot of assumptions upon assumptions, I do think it can be instructive to help frame the magnitude of GLP-1 uptake and sustained drug uptake required to produce a material impact on consumer packaged goods. It's particularly relevant when considering that these are long-run treatments, and when users come off the treatments, there's quite a bit of evidence of behavioral reversion. I think that's why some of the moves in the market earlier this year, particularly equity markets, seem premature and overdone given the likely cadence and sustained uptake required to produce material impacts. Okay. Let's get into some of our thought process around sectors and go around the horn. Moving to Rich, we've talked about the healthcare backdrop and a framework for thinking about potential uptake of GLP-1s in the future. Rich, how are you thinking about investment implications for the packaging sector?

Richard: Yeah, thanks, Brian. As you heard Scott just mention, he sees the overall impact being sized around 2% of food consumption, basically. And it's our perspective that this is something that's very, very manageable for packaging companies. By the way, as I think you had just pointed out, this doesn't exactly account for any offsetting impact of natural population growth over time, right? Because the population grows at a low single-digit percent rate over time. But to put it into context, if you look at the packaging companies overall, this year, companies have had to manage historically high volume declines from anywhere in the mid-single digits lower to upwards of 20% in some cases. Now, a lot of this has been driven by de-stocking among end customers, and your end market consumers are consuming a little bit less as a result of inflation, which has had an impact on the amount of packaging that's sold. But despite this, profitability has been impacted far less, and these companies still are continuing to generate solid operating cash flow. And then if you go back and you kind of look at Scott's 2% assumption here on volumes, if that was to materialize, these companies would end up taking out a whole bunch of costs to further minimize that impact on profitability. So, we think that over time, the impact on packaging companies and their ability to generate cash flow and profitability is going to end up being negligible. So, I think that truly, this ends up being a bigger problem from a valuation multiple standpoint than as a result, a bigger problem for maybe equity, as you think about slightly lower growth expectations over the long run, even at the full run rate here. But from a credit standpoint, these packaging companies are likely to continue to generate substantial free cash flow, and we would think prove pretty resilient in terms of profitability. So, it's our view that we would look at any dislocation arising from this as more of an opportunity for some long-term oriented investors.

Brian: And, Rich, I, again, go back to the notion that to get a material impact in the near term, or even in the medium term, the consumption uplift required across the consumer landscape is massive, and again, before considering any offsets. Let's go back to Scott and get your perspective, Scott, on how you were thinking about the food space, particularly around packaged food, supermarkets, and then also food away from home—food retail, restaurants, et cetera. Scott?

Scott: Yeah. You know, we go back to that 2% it, to the overall food consumption. But the one point maybe that we didn't address and you kind of brought up is that's an active prescription. You're not on these drugs for life. You're on this during your weight loss. Your calorie consumption is down about 500 calories a day while you're actively on it. And then once you get to that weight, it's up to you to be disciplined to maintain that weight loss. So that 2% is a moving average of the active user. But even when you think about what do I think it's going to do while someone is actively on it, the 500 calories is not a big number. It's a bagel with cream cheese, right? It's a Big Mac. It's seven double-stuffed Oreos. It's not a lot of volume coming off on a daily basis across this window of time while someone is actively on it. Now when they get to their weight loss, to your point, it's about actively maintaining your weight. And what Liz talked about, those GOPs about appetite suppression and emptying of the stomach, that's on you now to handle, and to maintain going back to, say, a 2,000-calorie diet, you're going back to eating these foods again, right? If you're looking to maintain. So, overall, you're going to see a minimal, minimal decrease in consumption while actively on the drug. But once you're off the drug, I see minimal effect on the overall food consumption.

Brian: And then we'll go full circle and bring Liz back into discussion and get your perspective on how you're thinking about different healthcare sub-industries and how they may be impacted not only by weight loss implications from GLP-1s, but also the potentially much more expansive application of the drug for other uses down the line. How are you thinking about the investment implications across the healthcare industry?

Elizabeth: There are a number of areas within healthcare that could be impacted, again, we think over the longer term. Some examples would be companies that are focused on diabetes. For instance, manufacturers of continuous glucose monitors or products that are focused on the insulin side of the equation. There are sub-sectors like dialysis or obesity link sub-sectors, such as those companies focused on bariatric surgery, that have come into focus. There are providers of services and product manufacturers focused on sleep apnea as well. And then looking at the broader tools category, there could be impacts given the prospect that this may have benefits from a cardiovascular disease standpoint, as well as other ongoing studies that could have broader impacts. There's been a lot of volatility in those markets and sub-sectors as a result of all these ongoing trials and future data readouts regarding the potential broader application of the therapies. But we think this has provided short-term investment opportunities. From a societal standpoint, these could be very positive. Again, it's a game of what will be covered by payers and when because there are studies coming out over the next four to five years that could address over 20% of healthcare spending. By some estimates, that's $750 billion of spending out of $3.5 trillion. So, there could be a major positive impact from that standpoint as well.

Brian: Just massive numbers, 20% of overall healthcare spend is potentially a huge impact to a really large industry. It's clearly early days in the life cycle of GLP-1s, both as a weight loss drug and, as you heard Liz talk about, a number of other potential future applications, some of which could have sizable impacts on the healthcare industry and over the long run, potentially consumer behavior. To date, we have not altered our investment approach. Our working view is that in the shorter run, dislocations in fixed income markets or industries rooted in fears of GLP-related disruptions are opportunities to exploit. Over the longer run, it's going to be important to stay open-minded and diligent as the market evolves and more data becomes available, particularly longer cycle data. Liz, Scott, Rich, this has been a great discussion. Thank you so much for your perspectives.

Scott: Thank you.

Richard: Thanks, Brian.

Elizabeth: Thank you.

Brian: For all of our listeners, you can find more of our thought leadership, latest research, and The Bond Blog on our website at PGIMFixedIncome.com. Thanks again for listening to *All the Credit*®.

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