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AstraZeneca is beginning to look a lot like Tesco

Both companies use similar accounting practices

ADVICE & COMMENT

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It might be tempting to view last week's fall in the AstraZeneca share price in isolation, related to the disappointing results of the "Mystic" lung cancer drug trial. However, I suspect that AstraZeneca's problems go much deeper than a setback for a single drug.

To paraphrase the title of a Christmas song which was a hit for Perry Como in 1951, AstraZeneca is beginning to look a lot like Tesco.

In FT Money nearly two years ago I wrote a column about AstraZeneca's accounting (Why bother cooking the books at all?) in which I highlighted that AstraZeneca's move to "core" earnings in 2007 had allowed its reported results and most of the investment community to exclude three major costs from its reported profits, namely:

- Restructuring charges
- "Exceptional" legal costs
- Intangible asset amortisation

In other words, major costs were being ignored in the calculation of profits. It is this approach to accounting which is beginning to remind me of Tesco.

Historically, Tesco also managed eight changes in the definition of return on capital employed over the period 1998-2011, years when Terry Leahy was chief executive (I examined these in an FT Money column in September 2014, How investors ignored the warning signs at Tesco).

AstraZeneca moved to reporting "core" earnings in 2007. In 2012, it moved to excluding all intangible asset amortisation and impairment charges as opposed to only certain amortisation charges. In a pharmaceutical company, almost all the assets are intangible — namely the drug patents. This change led to reported "core" earnings in 2012 going up. *Quelle surprise.* While this accounting treatment would not fool a decent analyst, who in any event would be looking at cash flows rather than earnings, it certainly seems to have fooled some people.

The other way in which AstraZeneca is beginning to resemble Tesco is its vast increase in invested capital at the expense of returns. As you may know, I regard return on capital as the single best measure of financial success for a business (as does Warren Buffett for what it's worth).

In my September 2014 article, one of the planks in the argument that Tesco was headed for a fall was a chart — reproduced here — which contrasted the steady upward march of Tesco's earnings per share (EPS) which seemed to have mesmerised investors with the more or less continuous fall in its return on capital employed (ROCE).

Alongside the Tesco chart is one showing AstraZeneca's ROCE for the period 2001-16. You will see that the returns fall from a superior 28.4 per cent in 2001 and a wonderful 40.9 per cent in 2006 to a barely acceptable 11.9 per cent over the period (and have been as low as 5.1 per cent recently).

This is hardly surprising given that invested capital, the denominator in this calculation, has risen 114 per cent since returns peaked in 2006. Even "core" EPS has risen by just 10 per cent in total over the same period, and that's with the benefit of all those "core" adjustments.

It certainly looks as though all that additional capital has not been very well invested. An example may be the 2007 acquisition of US biotechnology business MedImmune for $15.6bn.

MedImmune had revenues of just $1.3bn and its main product at that time — a nasal flu spray called FluMist — had failed to live up to expectations. Yet AstraZeneca paid a premium of 53 per cent to MedImmune's share price before the company put itself up for sale — a price that one analyst (Brian Lian at CIBC World Markets) described as "extraordinary" and "difficult to rationalise".

I guess it's not that difficult to rationalise if you exclude any resulting restructuring costs and write down of the intangible assets acquired from the calculation of earnings. It is no coincidence that AstraZeneca's ROCE peaked the year before this acquisition and that it moved to reporting "core" earnings that year.

Leaving aside AstraZeneca's exploits in acquisitions and accounting, last week's Mystic drug trial problem was hardly their debut. In the past, clinical trials have also failed for drugs billed as potential blockbusters to treat heart disease, strokes, lung cancer, diabetes and blood clots.

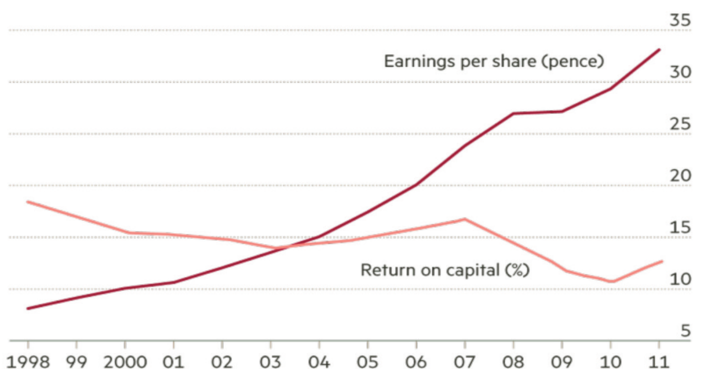
This is hardly surprising given that the odds of any one compound making it through all the stages of clinical trials and to market are about one in 10,000. Moreover, even when a drug is successful, patents have a limited life and the drug companies are running on a treadmill which requires more and bigger discoveries and product development to drive growth.

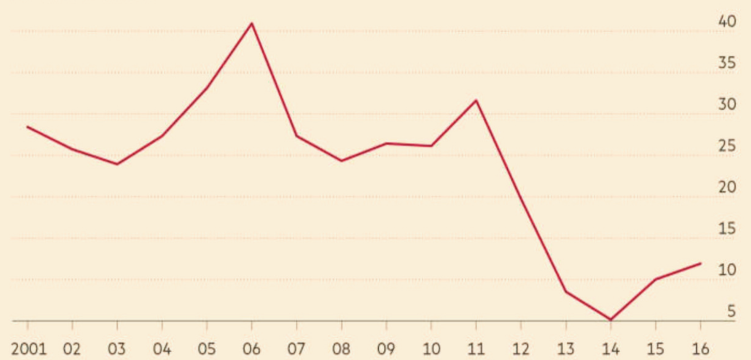
It makes me wonder what investors find so attractive about them. You might say the dividend, with AstraZeneca's shares now yielding nearly 5 per cent, but with the dividend cover at 1.1x there must be a reasonable chance that the fate of the dividend may also soon begin to remind me of Tesco.

I would guess that by now AstraZeneca shareholders are ruing the support they gave to reject the Pfizer bid at £55 a share three years ago.

Many investors' approach to these companies, with their accounting issues, remind me of the chorus of another song *Where Have All the Flowers Gone?* performed by Peter, Paul and Mary in 1962.

Terry Smith is chief executive of Fundsmith LLP; the views expressed are personal





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