

# MONONGAHELA CAPITAL MANAGEMENT

## PERCEPTIONS

<b>2<sup>nd</sup> Quarter, June 30, 2015</b>			
	<b>06/30/2015</b>	<b>% Change 2<sup>nd</sup> Quarter</b>	<b>% Change Year to date</b>
Dow Jones Industrials	17,619.51	- 0.29 % *	0.03 % *
S & P 500	2,063.11	0.28 % *	1.23 % *
Russell 2000	1,253.95	0.42 % *	4.75 % *
BC Aggregate BD Index		- 1.68 % *	- 0.10 %
10 YR Treasury Yield	2.335 %		
30 YR Treasury Yield	3.110 %		

\* *Includes reinvested dividends*

### **Spin-Offs and Redwoods**

In the quarter just ended, the equity markets were essentially flat, buffeted by headlines of the collapse of Greece, the manipulation of the Chinese markets, and the imminent rise in interest rates. Bond markets also felt the pressure of rising interest rates with the BC Aggregate Bond Index down 1.68% for the quarter. Even in a seemingly stagnant investing environment there is a constant shifting and change below the market surface. A recent lecture on the growth patterns of coastal redwoods presented a number of parallels between the redwoods and the current markets.

The coastal redwood is a magnificent conifer that can reach heights of three hundred and seventy feet, span twenty-five to thirty feet in diameter, and can live for two thousand years. The bark of the coastal redwood can be twelve inches thick with a bright red-brown color that gradually darkens over the years. These unique trees occupy a very narrow swath of land approximately four hundred and seventy miles along the Pacific Coast stretching from Big Sur to Southwestern Oregon. The width of the band is approximately five to thirty-five miles, a relatively small area characterized by moderate to heavy winter rains and summer fog. The summer fog is crucial in reducing water evaporation and keeping the soil moist.

The coastal redwoods are unique in the conifer family in their ability to reiterate or sprout new trees. While both the giant sequoia and the coastal redwood can grow from seed, only the redwood can reproduce from stumps, roots, branches and burls. This allows redwoods to quickly re-sprout after fires, while the redwood reiteration allows the trees to gather nutrients more efficiently than other conifers. The redwoods extend and connect in canopies allowing greater support for all associated trees. At times the dominant sprouts will form a ring of trees around the parent root called a "fairy ring."

In the corporate world, a similar phenomenon occurs with corporate spin-offs. These occur when shareholders of a parent company receive equity stakes in a newly spun-off subsidiary. One only needs to travel to North Chicago to see the “fairy rings” of Abbott Labs. Abbott Labs was founded in 1888 and, like the coastal redwoods, has grown and prospered. In 2004, Abbott Labs spun off (sprouted) Hospira to its shareholders and in 2013 followed up with a spin-off of Abbvie Inc. The parent Abbott and sprouts of Hospira and Abbvie now have a combined market capitalization in excess of \$200 billion.

Our interest was recently piqued by a neighbor of Abbott Labs, Baxter International. Baxter is another healthcare company, founded in 1931. On July 1<sup>st</sup>, 2015, Baxter completed the spinoff of their biopharmaceutical division, Baxalta.

Baxter International (Baxter) is an American healthcare company headquartered in Deerfield, Illinois. Over time, Baxter developed expertise in both the creation and production of life-saving medical products and the development and marketing of innovative biopharmaceuticals. Baxter’s products range from market-leading intravenous solutions and nutritional therapies, drug delivery and administration systems, inhalation anesthetics and bio-surgery products, products related to the treatment of renal disease and for the treatment of hemophilia and other bleeding disorders, products for immune deficiencies and products for treatment of burns and shock, to name a few. As the company developed solutions to health care challenges, their portfolio of healthcare products expanded in diversity. In 2015, in order to take advantage of the unique strengths of each division, Baxter announced a separation into two stand-alone companies: Baxter International and Baxalta Inc.

In considering the division of the company, management believed that the split would allow for the management of each individual company to focus on their distinct product lines more effectively. While each retained world-class product portfolios, strong pipelines and a comprehensive customer base, the management of Baxter International believed that the restructuring represented by the split would unlock the inherent value in each company.

Baxalta, the biopharmaceutical sprout of Baxter, should generate greater organic growth than the parent Baxter and will eventually be rewarded a higher market multiple. With a strong presence in hematology, immunology and a robust pipeline in oncology, Baxalta should generate revenue and earnings growth to boost earnings per share towards \$2 in 2017. Having been nurtured under the strong canopy of parent Baxter, Baxalta should provide a high quality growth opportunity in the biopharmaceutical industry.