Beacon Trust

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When Disruption is a Positive

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There is no denying that the word “disruption” comes with a negative connotation, “an unwelcome or unexpected break in a process of activity,” even, “a state of disorder.” For companies experiencing a disrupted environment, it might mean more time and money to retain customers and more money needed to expand facilities, which might detract from profitability if poorly spent. But if a company disturbs the environment in its favor, the outcomes can be surprisingly positive and profitable.

Microeconomic theory suggests that for a company to survive in the long term, it must have a sustainable competitive advantage. If an industry is extremely profitable for a year, chances are that more and more companies will attempt to access that profitability by entering the business. As the number of companies occupying the space increases, the supply of products increases, resulting in a lower price per product in order to compete, which eventually destroys the profitability that was there to begin with. Therefore, the only way to sustain a competitive advantage is through continuous innovation – also known as disrupting the long-run equilibrium. Here are a few areas in which companies are enjoying the disruption:

Biotechnology - The Living Science

Figure 1 **BIOTECH BREAKING OUT**

Source: Strategas Research Partners, LLC

In recent decades, the profitability of traditional pharmaceuticals suffered with the increase of generic drugs, or chemical copies of once-unique drugs. An alternative to chemical-based drugs, called Biotechnology, is defined as the study and use of living organisms to bolster human health. Companies that have been able to develop drugs derived from human proteins, which are differentiated from traditional drug development, have been able to establish wider economic moats that have protected their profitability.

The focus for many Biotech companies is on high-profile diseases with inelastic demand for the treatment, meaning that the price for treatment is largely irrelevant as people will pay whatever they can to receive the drug. For example, Celgene’s (CELG) pipeline has a focus on Mutiple Myeloma, Leukemia, and Lymphoma, while Alexion Pharmaceuticals (ALXN) focuses on ultra-rare disorders such as ones characterized by anemia induced by the destruction of red blood cells.

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Market of Relevance: Equities

Sectors Mentioned

1) Healthcare

2) Energy

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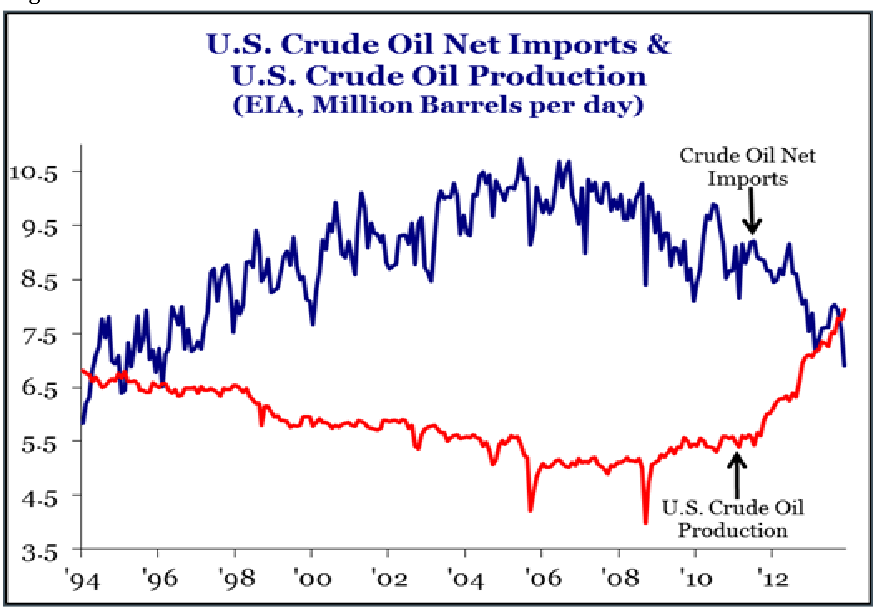
Recently there has been more discussion about "biosimilars," the biotechnology equivalent of generic drugs, but the road to getting FDA approval for a biosimilar is relatively uncharted and unclear. Amgen (AMGN) has recently announced that it intends to form a portfolio of biosimilars, basically targeting successful drugs developed by competitors and designing its own versions (Figure 1). This development could usher in a new disruptive theme in the future.

Energy - The North American Supply Glut

New oil and gas discoveries and sophisticated technologies to unearth these opportunities have ushered in the possibility of North American energy independence (Figure 2). This is a development in stark contrast to what was once a continent built around energy infrastructure designed to import oil to one that exports oil. As the landlocked oil and gas supply continues to increase in geographic regions with infrastructures designed to export oil, the price of North American oil has become decoupled with the international price of oil. This disruption creates two major opportunities worth noting.

First, energy infrastructure companies like Chicago Bridge & Iron (CBI) that build storage tanks, liquid natural gas (LNG) liquefaction terminals, and other energy-related products have seen increased need for their services because of the growth of exports and the need to improve transportation infra-structure in landlocked energy sources in different parts of the U.S. This need for building out infrastructure will continue as long as comparable barrels of oil trade for different prices in different parts of the country.

Figure 2



Source: Strategas Research Partners, LLC

Second, the US refinery market is experiencing a burst of profitability due to the improved spread between the price of crude oil inputs based on local market dynamics and product prices set in international markets. Refiners like HollyFrontier (HFC), Valero (VLO), Tesoro (TSO), and Phillips 66 (PSX) can achieve a sizeable margin because they sell their refined product at prices driven by the international crude price while their cost structures are advantaged by local lower-priced oil feedstocks depressed by the oversupply of raw crude. This situation exists because the U.S. does not allow the export of raw crude but it does allow the export of refined products such as gasoline and jet fuel.

For the companies mentioned above, disruption is creating opportunities for increased profitability. As the competitive landscape continues to shift, we watch for the birth of new disruptive trends and the stocks that capitalize on them.

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