JAG CAPITAL MANAGEMENT LLC

JAG Team Insights

JAG Growth Equity Thematic Insights: Q2 2024

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GLP-1 Advances: An Overview of Recent Developments

In our previous Insights piece, we highlighted the tremendous potential for GLP-1 drugs. Given the rapidly evolving nature of the discussion surrounding GLP-1s, we thought it would be helpful to summarize recent developments and potential investment implications for companies exposed to the category.

Eli Lilly (LLY) and Novo Nordisk (NVO) have been among the best-performing healthcare stocks to start 2024. Both companies reported healthy growth in Q1 due to robust demand for their diabetes and obesity products. Demand continues to outpace supply as the drug makers ramp up production.

Another topic we have touched on previously is the potential benefits these drugs possess beyond just treating diabetes and obesity. The latest evidence came in April when LLY shared positive results from two studies evaluating Tirzepatide (the molecule behind Mounjaro & Zepbound) in patients suffering from sleep apnea. The studies showed that Tirzepatide patients saw a meaningful improvement in symptoms associated with sleep apnea compared to those in the placebo group.

The success of LLY and NVO has spurred other companies to develop diabesity medicines. In recent months, Amgen (AMGN), Roche (RHHBY), and other smaller drug developers have made headlines for their efforts to bring new competitor drugs to the diabesity market. While increasing competition is always something to be mindful of, we remain optimistic that LLY is positioned to be a leader in the space for years to come. First, history has shown that early innovators tend to command a large share of the market for new medicines. LLY is also actively working on developing newer, more effective treatments. Finally, the head start that LLY and NVO have built in terms of the time and investments dedicated to their diabesity portfolios cannot be understated. Just last week, LLY announced they are investing an additional $5B into incretin medicine manufacturing facilities. LLY has now invested more than $18B in support of their GLP-1 franchise since 2020. Needless to say, any future competitors hoping to enter the market will need to commit an extensive amount of time and resources to have any chance of catching up with the current leaders.

AI's Rising Tide: Q1 Takeaways and Market Dynamics

Q1 earnings season gave us more confidence that the Artificial Intelligence (AI) theme is here to stay. All the world's largest companies (MSFT, GOOGL, AMZN, META, etc.) noted increased capex spending as they build out AI infrastructure and invest in things such as GPUs (graphics processing units). Nvidia's (NVDA) earnings provided a good example, with data center revenues up over 500% year-over-year. Arista Networks (ANET) raised its full-year revenue guidance, citing higher visibility in cloud and AI projects. Advanced Micro Devices (AMD) also said it now expects $4B in AI/data center GPU revenues in 2024, up from $3.5B in the last quarter.

While semiconductor companies will likely continue to be the most direct beneficiaries of the generative AI trend, we also see AI opportunities in other parts of the market. Our portfolio holding Axon (AXON), the public safety company providing body cameras and other equipment to law enforcement, is using generative AI to auto-generate police reports from officer body camera footage. One police department saw the time spent on writing reports decrease by as much as 82% while the quality of reports increased. Vertiv (VRT), the power and thermal management solutions provider to data centers, is another example. As data centers' power consumption grows, the need for innovative cooling solutions, including liquid cooling, becomes increasingly important. VRT is well-positioned to benefit from this trend given its integrated product offering, evidenced by a +60% year-over-year backlog growth in Q1. Recently purchased Eaton (ETN), the global leader in power management, is also benefitting from rising AI and data center demand as its products are used in key data center applications such as UPS (uninterruptible power supply) and PDUs (power distribution units).

Generative AI, however, also creates investment risks. Enterprises are heavily prioritizing AI infrastructure build-out, which can lead to tighter budgets for non-AI projects. For example, AI servers have seen rapidly rising demand, but more traditional data center capex (which includes things such as central processing units or CPUs) has lagged. While it is likely too early to judge, we could also see the first signs of AI weighing on software demand. In Q1, some of the largest software companies reported disappointing results.

For example, Salesforce (CRM) cited the return of a "measured" buying environment in the first quarter. In the long term, we believe software companies could experience slower seat growth as generative AI significantly improves worker productivity.

The Path Ahead - Adapting to Change

"Creative destruction" is a feature of capitalism and the modern global economy. The forces of innovation push society forward and ultimately result in better products and services for consumers. For investors, the rise of diabesity medications and Artificial Intelligence present opportunities as well as risks. As GLP-1 treatments become more ubiquitous, business models dependent upon "junk food" and/or other addictive products could experience dampened revenue and earnings growth. This makes us incrementally cautious on much of the fast food and consumer packaged foods industries.

The rapid development of powerful Artificial Intelligence tools could ultimately disrupt many industries, from accounting and finance, to healthcare, and even videogame and movie production.

We remain cautious on the banking industry, given our concerns that headwinds for commercial real estate could persist into 2025. A significant percentage of lending professionals and real estate development staffers have never experienced a "normal" interest rate environment. For them, the current level of interest rates represents truly uncharted territory. Higher-for-longer interest rates could continue to cause markdowns in the values of a variety of types of real estate, which could, in turn, result in significant write-downs for regional banks. All of this is far from a secret, and current bank valuations may have already discounted the unwelcome news that has yet to arrive. That said, we are reminded of the old saying, "discretion is the better part of valor," and our growth equity strategies continue to remain underweight to banks and other companies with significant commercial real estate exposure.

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Disclosures

About JAG

JAG Capital Management (JAG) actively invests for institutions and individuals in highly selective, customizable, and nimble equity and fixed income strategies. JAG is a boutique, independent, employee-owned investment management firm in St. Louis.

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