Perspectives

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Sector Outlook: Healthcare-Related Sectors

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Since the election, we have continued to analyze the investment implications of the new Trump Administration's proposed policies. Corporate tax reform and "repeal and replace" of the Affordable Care Act were both cornerstones of the President's platform, and both could have major implications for corporate and municipal borrowers. Due to the wide range of potential impacts and the relatively poor pricing of risk in the market, we are cautious on the sector. Read below for additional details.

Regulatory Changes Abound

Historically the Healthcare and Pharmaceutical sectors traded at tighter spreads than the Bloomberg Barclays Corporate Index and displayed less volatility. This made sense given the inelastic nature of the products and services combined with the relatively solid balance sheets of many of the largest companies. The two main Trump platforms that will impact these sectors are: 1) Tax reform, specifically a reduction in the corporate tax rate, a cash repatriation tax, and some form of territorial tax system thereafter and 2) Affordable Care Act "repeal and replace" which can also have impacts on state finances as well as companies directly serving patients. In addition, Pharmaceuticals are likely to see continued scrutiny of pricing practices.

Health Insurers

In general, health insurers have struggled under the Affordable Care Act and have disclosed losses by participating in the exchanges. On the surface, removing a loss-making business would be positive for the sector. The final makeup of the new legislation will drive the ultimate outcome, but some are pointing to market-based solutions and Medicare Advantage in particular as a model for the new system. A market-based plan that would allow insurers to profitably add lives covered would be a positive, so we lean toward a positive impact for this sector from the Trump agenda but the details will matter.

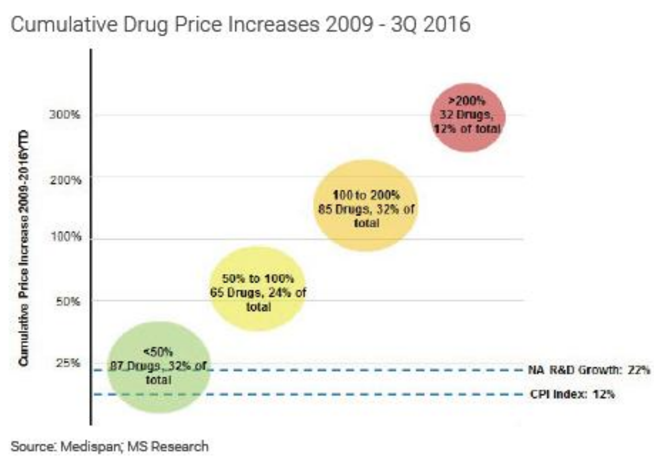
Pharmaceuticals

Both positive and negative factors affect Pharma which in aggregate lead to a negative fundamental outlook for the sector, somewhat offset by a positive supply backdrop with valuations that reflect some, but not all of these risks.

The Healthcare and Pharma sectors have a combined $225+bn in cash held outside the US. Our expectation is that any repatriation will continue to be used for more shareholder-friendly actions, such as share buybacks and dividends, but perhaps 25% less debt issuance should ensue due to the cash funding which provides a positive technical backdrop.

Pharmaceutical pricing has been a major controversy affecting market spreads since September 2015 when Hillary Clinton tweeted about pricing practices in the industry and has continued with President Trump. Exhibit 1 outlines drug price increases over time, and this is the type of data that has inflamed the debate. These companies produce products that affect people's lives, and they enjoy patent protection for many years with gross margins that are among the highest of any sector. Still, the criticism is not unfounded. Our analysis suggests that a price reduction of ~5% would reduce industry free cash flow by 15-20% and increase leverage by 0.5x and would still enable the companies to innovate.

Exhibit 1: Cumulative drug pricing



We do not believe spreads adequately reflect this risk to the sector and we believe the uncertainty may present a buying opportunity in the future: patience may be rewarded.

Healthcare

This sector consists largely of device manufacturers and lab companies. Some have overseas cash that may be repatriated, and most have reasonably favorable fundamentals. The ACA has increased coverage but has not seemed to have caused a material change in volumes of procedures. Initial estimates of the current proposed AHCA suggest large reductions in the number of insured. We believe the AHCA will be modified and there will be additional measures taken to get the number of covered individuals to be similar to current levels or better in-line with campaign promises.

For-Profit Hospitals

For-profit hospitals were hit particularly hard as a sector immediately following the election. The basic premise is that hospitals materially benefitted from the expansion of coverage under the ACA and could suffer from the repeal. This is made worse by the fact that this space is made up of highly levered, below investment grade issuers that are looking for asset sales to reduce leverage. The estimated benefit to EBITDA (earnings before interest, taxes, depreciation and amortization) from the ACA was 4-8%. The current draft of the ACHA keeps coverage levels largely unchanged through 2019 with changes taking effect in 2020. The final form of those changes will determine the financial impact.

Not-For-Profit Hospitals and States

The impact to not-for-profit hospitals will vary depending on the quality of the institution. We tend to invest in very high quality core regional hospitals with significant research funding. While there will be a financial impact should bad debt expenses pick up, we expect these high quality hospitals to be able to weather that storm.

Another idea being circulated is block funding for the states for Medicaid. The Medicaid program is jointly funded by the federal government and the states. The federal government currently pays states for a specified percentage of program expenditures, called the Federal Medical Assistance Percentage (FMAP). FMAP varies by state based on criteria such as per capita income. The average state FMAP is 59%, but ranges from 50% in wealthier states up to 75% in states with lower per capita incomes. The basic idea of a Medicaid block grant is to give states maximum flexibility in exchange for their accepting a fixed dollar amount of funding from the federal government. Trump’s proposal to convert Medicaid into a block grant would eliminate shared funding which we view as credit negative for states given the expectation that total funding would be reduced. Once the block grant is used up, states would be forced to either curtail services or pick up a higher percentage of the costs themselves.

Conclusion

Across the Healthcare landscape there are various positives and negatives. Our analysis of the available information suggests caution is warranted as there are likely to be fundamental headwinds and increased volatility in many parts of the sector and patience is likely to be rewarded.

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