Our Outlook for Health-Care Stocks

Mergers and acquisitions replace reform as a key health-care topic.

By Alex Morozov, Associate Director of Stock Analysis

- The passage of the health-care reform completion didn't result in a sector rally despite its overall benign attributes.

- Big Pharma performance was particularly weak in the quarter, primarily as a result of near-term noise. Industrywide trends and fundamentals are attractive, and stocks remain undervalued.

- Mergers and acquisitions dominate the industry landscape. More consolidation is expected.

We have written in great detail previously what the passage of health-care reform would mean for all industry participants, and the final bill's language largely fell in line with our long-held expectations of fairly benign changes to the industry landscape. We were correct when we forecast only marginal changes to the health-care delivery system in the United States, which allowed us to stick with our contrarian buy recommendations, particularly in the maligned managed-care sector (see our May 2009 issue of *Healthcare Observer*).

We were, however, incorrect so far in our prediction that a lack of cataclysmic provisions in the reform would quell investors' uncertainty fears, resulting in a widespread rally across the sector. On the contrary, health care's performance in the second quarter was the worst among all industries when measured on a market-cap-weighted basis despite a number of positive macroeconomic developments. The surprising performance is even more jarring when considering that health-care stocks have only limited exposure to Europe's credit woes, though we note that the Euro's rapid decline will be a notable drag on the performance of health-care multinationals, particularly Big Pharma.

Big Pharma stocks were hit hard in the quarter as direct costs associated with the reform made their way onto financial statements and annual forecasts. For a number of firms, particularly Eli Lilly LLY, the charges were slightly higher than our expectations, but consistent with our view that health-care reform will weigh on the industry's earnings per share by as much as 5% annually in the first few years of reform implementation. A weak euro isn't helping matters as European operations account for as much as a third of total sales for this group, but only a fraction of this headwind will flow through to the earnings line considering that pharmaceutical firms are naturally hedged fairly well.

Gauging by the investor reaction during the past quarter, they are not seeing the forest for the trees; Big Pharma stocks have fallen as much as 15%-18% during the past three months, hardly representative of the firms' long-term fundamentals and opportunities. Reform, while a detriment to near-term earnings, has positive long-term implications on the group. We estimate that the volume created by the increased number of insured patients will mitigate the cost pressures by as early as 2014 and eventually lead to a net positive impact for Big Pharma.

The industry has also been aggressively taking costs out of the system, the fact largely obscured by a reform-related earnings hit. Restructuring programs implemented during the past few years are already providing a boost to the group's margins, and should position the industry on the solid earnings growth trajectory once it makes it past the impending patent cliff.

Finally, a shifting strategic focus toward niche diseases and emerging markets is transforming Big Pharma; the industry is moving away from a developed world/primary-care model to niche drugs and emerging markets, which should yield stronger pricing power, longer shelf lives for drugs, and a lower-cost basis for the industry. Valuations for large pharmaceutical stocks currently don't reflect these developments.

Although the reform passage didn't trigger a stock rally, the reduced uncertainty for health-care firms manifested itself in the heavy volume of mergers and acquisitions in the quarter. Astellas Pharma acquired OSI Pharmaceuticals for $4 billion in the quarter giving the Japanese pharma firm a promising cancer treatment and a robust pipeline. Abbott ABT expanded its emerging-markets presence by acquiring an India-based generics firm for $3.7 billion. Covidien COV made the largest acquisition in its history as an independent company by agreeing to purchase ev3 EVVV for $2.6 billion. Universal Health UHS consolidated its presence in behavioral-treatment centers by buying Psychiatric Solutions PSYS for $2 billion. Charles River CRL made inroads into China with a pending $1.6 billion acquisition of WuXi WX. Finally, Biovail BVF and Valeant Pharmaceuticals VRX have announced their intent to merge, creating a strong diversified pharmaceutical firm.

Robust pipelines in niche therapeutic areas and emerging-markets exposure are two themes that increasingly appear in analyzing prior and identifying likely future acquisition targets. These two go hand-in-hand with the rhetoric coming from the acquirers' camp—niche diseases provide pharmaceutical firms with drugs more resistant to competition, pricing pressure, and patent exposure, while emerging markets offer virtually untapped growth opportunities in a variety of sectors ranging from medical instruments to drugs. We have identified a number of firms that could be acquired for their technology, pipelines, or geographic presence in our February M&A Outlook in *Healthcare Observer*. Vertex VRTX and Human Genome Sciences HGSI top our biotech list, while Mettler-Toledo MTD and PerkinElmer PKI are lead acquisition candidates in the medical-device market. Considering depressed valuations across the health-care industry, we think the hectic pace of acquisition activity is likely to persist throughout 2010.

Industry-Level Insights

With reform-related hits in the rearview mirror, pharmaceutical companies hope to shift investor focus to the underlying strength of their product portfolios and cost-cutting efforts in the upcoming quarter. We anticipate strong second-quarter results despite what could be a stiff currency headwind. The industry has annualized most of significant patent losses while only starting to see benefits from massive restructuring programs undertaken during the past 12 months. On the new drug front, data for J&J's JNJ rivaroxaban and Merck's MRK TRA is expected during the next few months; both drugs have a blockbuster potential if approved.

Hospital inventory levels and a flow of government stimulus funds should be in focus for medical-device and -instrument makers as the reform-related earnings hit will not show up on the firms' financial statements until 2013. We anticipate a rather strong second quarter from this sector as favorable comparables should mute the negative impact of a strong dollar. Hospital inventory levels have been on the rise during the prior two quarters, and purchasing activity should be particularly strong this quarter as inventory destocking peaked in the second quarter of 2009.

Makers of hospital equipment, such as Stryker SYK and Becton Dickinson BDX, should see strong demand for their products; coupled with tight cost-control measures implemented during the past 12 months, earnings growth should accelerate in the quarter. Stimulus-related spending on life-science instrumentation is another likely catalyst for the industry.

Our Top Health-Care Picks

Our health-care top recommendations cover most of the industry's sectors, ranging from pharmaceuticals to managed care. We maintain that many of these firms remain undervalued even as the appetite for health-care stocks has already improved and the share prices of many of them rallied in the past few months.

Top Health-Care Sector Picks

Company	Star Rating	Fair Value Estimate (USD)	Economic Moat™	Fair Value Uncertainty	Price/ Fair Value
Baxter	★★★★★	67.00	Narrow	Medium	0.63
Abbott Laboratories	★★★★★	68.00	Wide	Low	0.71
Covidien	★★★★★	67.00	Narrow	Medium	0.65
Genzyme	★★★★★	78.00	Wide	Medium	0.68
UnitedHealth Group	★★★★★	50.00	Narrow	Medium	0.62

Data as of 6-21-10.

Baxter BAX

We remain impressed by the firm's new products and pipeline prospects. In medication delivery, new nutritional products are starting to boost the segment's growth. In renal, the company's focus on home dialysis could pay off in 2011 and beyond with the expansion of peritoneal dialysis to more eligible patients and a new product launch in home hemodialysis. Both options would greatly improve convenience for end-stage renal patients eligible to receive treatment outside clinics, and expanded use of peritoneal dialysis could actually reduce costs for the overall health-care system, making it a potential winner in a reforming health-care system. Beyond 2014, we think Baxter's BioScience segment looks highly promising, and the firm's long-term pipeline may include game-changers in Alzheimer's disease and Type I diabetes. While lower short-term market growth and share losses are plaguing Baxter's plasma protein and antibody therapy products, the market is overestimating their impact on Baxter's long-term growth potential.

Abbott ABT
Unlike many of its industry peers, Abbott faces only a few patent losses during the next five years and is well positioned to ride a strong tailwind of demand for its products. Taking advantage of many drug firms' decisions to leave primary-care indications like cardiovascular disease, Abbott is becoming a leader with several new drugs to treat heart disease. We believe the less competitive environment should bode well for Abbott. Most important, we expect continued strong demand for the company's leading drug, Humira. With drug penetration in rheumatoid arthritis reaching only 20% and even less in psoriasis and Crohn's disease, Humira could grow at double-digit rates for the next four years. Abbott's strong competitive position in nutritionals and diagnostics reduces the volatility of its earnings and creates additional avenues of growth.

Covidien COV
Covidien's investment in medical devices is yielding a number of promising product launches and technological advancements. The company's research-and-development prowess that had wilted under the Tyco roof is starting to flourish again, and Covidien is re-establishing itself as a powerhouse in surgical instruments. The company's segments outside devices face a challenging near-term environment, but Covidien is taking steps to return these businesses to value accretion in the near future. With sales momentum ramping up, bottom-line-oriented investors should be amply rewarded as favorable product mix and operational leverage should result in strong double-digit earnings growth during the next few years.

Genzyme GENZ
Severe shortages of Cerezyme and Fabrazyme in the second half of 2009 resulted in only a slight decline in Genzyme's total revenue in 2009 (to $4.5 billion from $4.6 billion in 2008), a tribute to the firm's wide economic moat and otherwise high-growth portfolio. Both products are now shipping from the overhauled Allston, Mass., facility, and we think Genzyme should be at full speed by the end of 2010. While Shire's Vpriv now competes with Cerezyme in the U.S., and Protalix (partnered with Pfizer) will probably compete in 2010, patient loyalty to Genzyme's products remains high. We think Lumizyme will receive Food and Drug Administration approval in 2010, and sales should increase quickly as patients on free drugs become paying customers. We're also bullish on Genzyme's late-stage pipeline. Several products are poised to enter the market in 2011-12, including cholesterol drug mipomersen and Campath in multiple sclerosis.

UnitedHealth's UNH
UnitedHealth's stock has doubled from its lows, but we still see significant value in this industry-leading managed-care organization. UnitedHealth's best-in-class auxiliary businesses and unmatched scale should enable it to grow faster than its industry, which already benefits from the tailwind of health-care spending growth. The threat of comprehensive health-care reform has kept investors wary of the managed-care sector, but this risk should now dissipate as reform in its current form should have only a modest impact on UnitedHealth's future

earnings. Reform aside, underwriting results appear to be stabilizing, administrative costs seem to be under control, and UnitedHealth continues to throw off massive free cash flows.

Alex Morozov, CFA, does not own shares in any of the securities mentioned above.