Our Outlook for Health-Care Stocks

The health-care sector is in the waiting room.

By Alex Morozov, Associate Director of Equity Research

After an event-filled few quarters, the second quarter of 2009 was relatively calm for the health-care sector. Certainly there were a number of developments on the health-care reform front, as many proposed system changes have started to take shape, but we now don't anticipate an actual firm proposal on the president's desk until the latter part of this year.

The credit markets appeared to have stabilized, and while recovery is far from imminent, the worries about destocking and the freeze in capital purchases have subsided. There were also no significant mergers in the quarter, a stark contrast to the first three months of 2009, which saw the largest flurry of activity since 2000, with three giant pharmaceutical firms gobbled up in a few-month span.

The health-care industry as a whole appears to be in waiting mode, with a giant unknown—reform—damping investors' enthusiasm for what appears to be very attractive valuations in this recession-resistant sector. In fact, the overall sector saw only a modest recovery in the second quarter, with the 13-week return of under 9% as of June 19 (as calculated by the Morningstar health-care index) dwarfed by the massive 17% rally of the overall market. That said, the market-cap bias of the index (and a flat performance by the giant drugmakers, hides the exceptional performance of several segments within health care.

We discussed in detail what is currently on the table and the potential implications of the broad overhaul on the entire industry in our May issue of Morningstar Healthcare Observer, with managed-care and pharmaceutical sectors in the cross-hairs of the efforts to rein in spending. While still too early to tell, managed-care companies are likely breathing a sigh of relief, as the administration's proposal to establish a government payer to directly compete with private insurance is still lacking broad support. The trepidations of government involvement in private insurance that caused managed-care stocks to nose-dive in the early months of 2009 have partly abated, with several stocks rallying mightily since late-March (our top pick Wellpoint WLP is up close to 40% since March 30). Time will tell whether the exuberant run is premature, but judging solely by the recent performance, Mr. Market appears to have priced a less dire scenario for managed-care into its valuations.

On the other hand, the drug industry, particularly large pharmaceutical firms, by and large didn't participate in the rally. Investors remain concerned, in our opinion, with the drugmakers' ability to withstand government-exerted pricing pressure. Some concerns, such as drug reimportation, can be largely discarded, in our view, but the notion of a powerful government payer (even if only through the Medicare and Medicaid programs) squeezing seemingly robust pharmaceutical manufacturers' profits continues to send shivers down investors' spines. To be fair, though, only a third of drugmakers' revenue is derived directly from the government programs, and up to 46 million uninsured people could eventually gain access to drugs, which could be a boon to the pharmaceuticals. Also, these firms haven't been sitting idly by waiting for the government to come in and squash their profits; merger activity and cost-improvement initiatives all appear to be focused on sustaining future earnings power, even if the government cuts drug reimbursement within its programs.

Valuations by Industry

As discussed above, managed care was the sector's top performer in the second quarter. We would caution once again that if the government payer plan gains steam, this sector could see its bottom fall out. That is precisely the reason many managed-care companies we cover carry a high uncertainty rating (even though we don't think this "nuclear" option will materialize). We would also caution not to put too much stock in hospitals' rally. We still don't see many positive catalysts for this beleaguered industry, and while bankruptcy concerns have abated as credit markets opened up, hospitals remain very susceptible to the ailing economy. We would, however, point investors toward the medical device and instruments industry, even though this sector has fared pretty well over the past three months. Many device makers still trade at very attractive discounts to our fair value estimates and are less susceptible to the current recessionary environment given the essential nature of their businesses.

Health-Care Industry Valuations

Segment	Average Star Rating	Price/Fair Value*	P/FV Three Months Prior	Change (%)	Uncertainty** (%)
Biotechnology	3.52	0.82	0.83	-1	55.7
Diagnostics & Research Services	3.69	0.77	0.64	20	36.4
Drugs	4.34	0.7	0.58	21	10.2
Hospitals	3	1.01	0.6	68	95.5
Managed Care	3.63	0.91	0.41	122	89.8
Medical Appliances & Equipment	4.49	0.74	0.55	35	5.7
Medical Instruments & Supplies	4.04	0.75	0.57	32	8.0
Generic Drugs	3.24	0.86	0.7	23	39.8
Health Care Services	3.63	0.6	0.52	15	80.7

Data as of 06-12-09.
*Market-Weighted Harmonic Mean
**Ranks the industry's fair value uncertainty (most uncertain =100) based on the aggregate market-weighted uncertainty ratings of all industries under coverage.

Our Top Health-Care Picks

Top Health-Care Sector Picks

Company	Star Rating	Fair Value Estimate (USD)	Economic Moat™	Fair Value Uncertainty	Price/ Fair Value
Becton, Dickinson	★★★★★	93.00	Narrow	Low	0.74
Genzyme	★★★★★	89.00	Wide	Medium	0.62
Intuitive Surgical	★★★★★	228.00	Wide	Medium	0.7
McKesson	★★★★★	66.00	Narrow	Medium	0.67

Data as of 06-17-09.

Becton, Dickinson BDX

We view the bulk of Becton's products as recession-resistant, primarily due to the essential nature of their use. Sharps, even slightly costlier safety-engineered products, would be the last resort for any hospital cuts, as the risk of being unable to perform basic surgical procedures outweighs any financial considerations. While we saw some very modest indications of destocking in the past few quarters, the slight bleeding down of inventory has already ceased, and the next few quarters should see a more normalized demand for surgical instruments. Further, despite significant foreign currency weaknesses, the company continues to advance its safety-engineered products overseas—sales grew at a robust 20% clip over the past few quarters—underscoring strong unfulfilled demand for safety products. Despite Becton's relative resistance to the economic turbulence, its stock has still been affected by the overall decline in equity markets. While its valuation may not be as attractive as that of several peers in the medical device industry, the firm has only limited exposure to capital spending cycles, which helps set a floor for more risk-averse investors. Also, the Becton's balance sheet is stellar; at the end of the last quarter, it was sitting on $730 million in cash and equivalents, a very comfortable position given its total debt of under $1.2 billion and annual free cash flow in excess of $1 billion.

Genzyme GENZ

Despite holding up well against economic pressures, Genzyme hasn't been able to avoid drug approval delays and manufacturing issues, which have pressed its shares well into 5-star territory. However, we view these hurdles as short-term in nature, and we think Genzyme's diverse collection of profitable drugs and diagnostics will allow it to reach its goal of 20% five-year non-GAAP earnings per share growth through 2011. We also think it has an impressive collection of novel drug candidates that will boost growth in the years beyond, both from internal discovery efforts as well as partnerships with promising firms in cutting-edge fields, like Isis ISIS in RNA-based drugs and Osiris OSIR in stem cell therapies. With $1 billion in cash and no debt as of the end of the first quarter, Genzyme is still in a strong position to in-license promising drug targets in areas like oncology and kidney disease.

Intuitive Surgical ISRG

While Intuitive has rebounded substantially off its March lows when concerns about the economy were reaching a fever pitch, we still think this wide-moat firm is trading well below its intrinsic worth. The firm is targeting a very large market opportunity—converting open procedures to minimally invasive surgeries—with its robotic technology, and we think it has just scratched the surface of its potential. The last two quarters revealed some cyclicality in Intuitive's business, as some hospitals chose to delay purchases of new daVinci systems, but we were encouraged by the continued expansion of instrument sales and services, which are driven by increased utilization of the firm's installed system base and should become increasingly important sources of revenue as it matures. Surgeons appear to be increasingly incorporating daVinci-enabled procedures into their practices, and we expect that trend to continue for the long run. Also, despite the uncertainty hanging over all health-care firms that operate in the U.S., we think Intuitive actually looks well positioned to withstand an overhaul of the U.S. health-care system due to its focus on minimally invasive surgeries, which can be much less costly to the overall system than alternatives.

McKesson MCK

Distributors of pharmaceuticals and medical-surgical supplies are among the best-positioned firms to weather both the recession and policy reform. That is because distributors operate with slim margins that are only maintained by achieving economies of scale, creating high barriers to entry and limiting the ability of regulators to extract value by pressuring margins. Plus, while the volume growth of health-care goods has slackened somewhat as a result of the recession, this sector is much less exposed than other areas of the economy due to the non-discretionary and non-deferrable nature of most health-care demand. Volumes could get an additional boost from reform efforts that decrease the number of uninsured Americans, which will further bolster distributors' scale. McKesson is a leader in pharmaceutical and medical-surgical supply distribution, and it also has a health-care IT segment, which could get a boost from government incentives to increase the adoption of electronic medical records and other health-care IT. We think McKesson is attractively priced, trading at a greater than 30% discount to our fair value estimate.

Alex Morozov, CFA, has a position in the following securities mentioned above: WLP