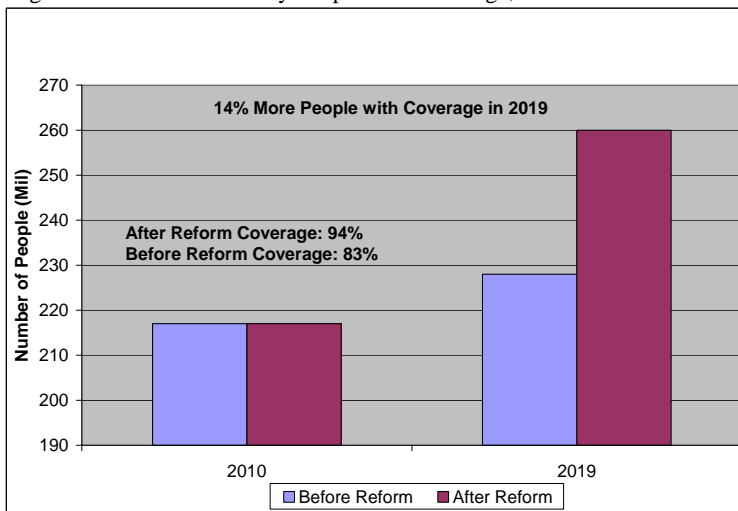


Navigating Healthcare Reform: Bottom Up Opportunities From Top Down Changes

By Alexandra Lee, MD, Research Principal

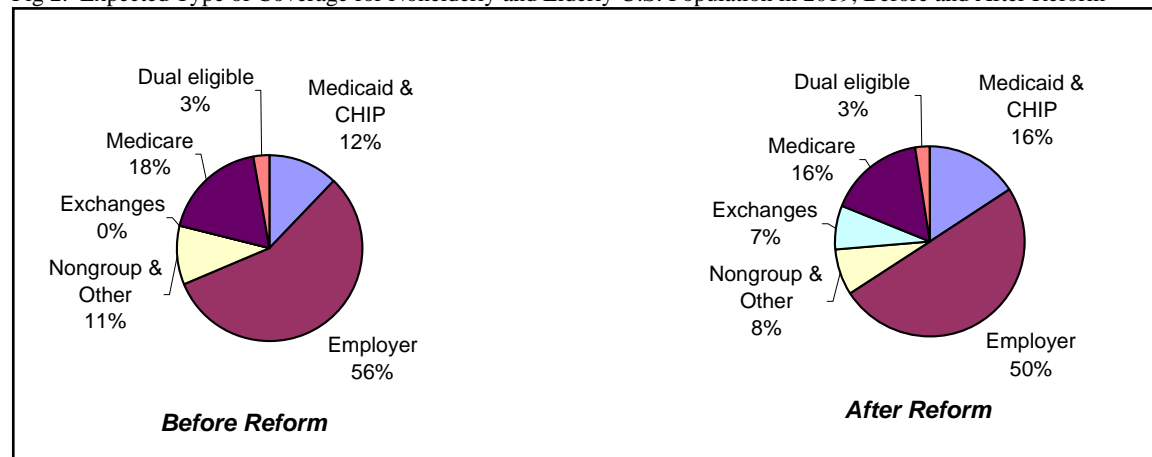
After a year of wrangling, the U.S. Congress finally approved health reform legislation. The nature of health reform changed along the way. It started out as a true reform effort to lower costs, improve quality, and expand coverage, but eventually ended up as a **health insurance reform bill with expanded coverage**. From an investment perspective, health insurers seem to be the most negatively impacted. Although their customer base will expand, they face increased regulation and must undergo structural changes to adapt to new rules such as guaranteed coverage for those with preexisting conditions, mandated use of community rating for premiums (insurers can vary premiums only by tobacco use, age, and family composition), and mandatory medical loss ratios. However, for the other participants such as hospitals, pharmaceutical firms, and medical device companies, the legislation does not entail an overhaul of current industry practices, and leaves intact the existing structure for reimbursement and payment systems. Thus, other than fines/fees, the most important aspect of reform in the near to intermediate term appears to be an **increase in the population with insurance coverage, i.e. access to health care** (Figure 1). This will be accomplished by expanding Medicaid and through new insurance exchanges, though employers will remain the main source of coverage (Figure 2).

Fig 1. Number of Nonelderly People with Coverage, Before and After Reform



Source: CBO Estimates

Fig 2. Expected Type of Coverage for Nonelderly and Elderly U.S. Population in 2019, Before and After Reform



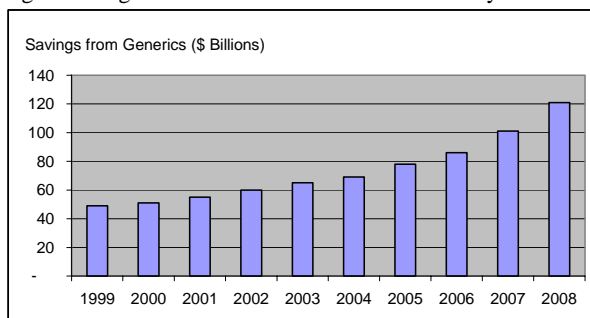
Source: CBO, 2009 Medicare Trustees Report, SGA Estimates

As it stands today, the **legislation appears to lack the mechanisms necessary to rein in costs**, as some of the most significant cost-cutting measures (such as a public healthcare plan, and a powerful Independent Medicare Advisory Commission) were weakened or removed. As a result, utilization and expenditures on healthcare will likely balloon over time, despite an estimate from the Congressional Budget Office (CBO) that reform will reduce the federal budget deficit. In the state of Massachusetts, where a health reform bill achieving 97% coverage was passed in 2006, spending on healthcare increased from \$1.4 billion in 2006, to an expected \$2 billion in 2009, an annual growth rate of 12%. This does beg the question of whether more government regulation to cut costs is inevitable over the long term, changing the landscape further. In fact, there are a number of pilot projects embedded within the health reform bill that we will keep a close eye on. While challenges are significant currently, pilot projects in bundling physician and hospital payments and comparative effectiveness studies, for example, could provide ways for the government to cut costs over time.

In our view, the potential for increased pressure from the government to cut costs in healthcare has always been there. And we expect it will continue to be a factor driving stock performance in the industry, together with the other powerful secular drivers of healthcare: increased demand from **greater access; innovation** from advances in science, genomics, and technology; a shift in **demographics** that drives higher consumption levels; and a growing appetite for more and better care in **developing economies** with rising purchasing power. With these factors in mind, we have assembled a portfolio of companies that we think are very well positioned. While we conduct bottom-up analysis to pick our portfolio companies on an individual basis, our companies fall into two investment themes as it relates to health reform: (1) those **structurally positioned to benefit from health reform as part of the solution**, and (2) those that have **strong market positions enabling them to withstand the risks of reform and take advantage of the opportunities from increased access**.

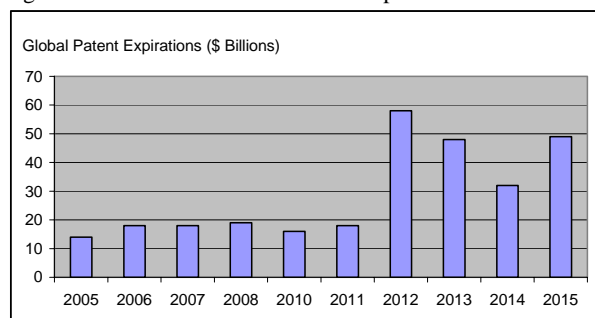
Because higher healthcare costs are a growing problem for governments around the world, we believe that **companies that are able to lower healthcare costs on a system-wide basis (i.e. not just moving dollars around from one participant to another) and in a sustainable way will benefit over the long term**. An example is our longstanding investment in **Teva Pharmaceuticals**, the worldwide leader in generic pharmaceuticals. The generic industry is estimated to have saved the U.S. healthcare system \$734 billion over the past decade (Figure 3). Because of this tremendous value proposition, the industry continued to post healthy prescription volume growth of 5.9% in 2009, versus -7.6% for branded pharmaceuticals (source: IMS). Looking ahead, the **opportunity for the industry appears to be even greater**, as the value of patent expirations on branded pharmaceuticals remain high (Figure 4). In addition, Teva has a very strong position within the industry, characterized by its broad portfolio, low-cost position, aggressive pipeline, geographic footprint, financial strength, and superb execution. With or without health reform, Teva Pharmaceuticals should enjoy secular tailwinds, but health reform should accelerate Teva's growth as the company becomes part of the solution by delivering drugs at a lower cost to more people.

Fig 3. Savings from Generics to U.S. Healthcare System



Source: IMS, GPhA

Fig 4. Global Pharmaceutical Patent Expirations



Source: McKinsey & Company

We also believe that **deployment of information technology will reduce waste and error in the health system, enabling higher quality care at lower costs.** By automating processes, facilitating better coordination of care, increasing transparency, and promoting evidence based medicine, HIT (healthcare information technology) could deliver \$500 billion in annual savings, according to an industry estimate (Table 1). A study from non-profit think-tank RAND Health that was published in the New England Journal of Medicine ranked HIT as one of top reform ideas to reduce growth in cumulative national healthcare expenditures. The authors estimated that HIT could contribute almost 25% of the 6.2% reduction required to bring the growth in national healthcare spending in line with GDP growth over the next decade. Cost savings potential should be even greater over the long term, as **IT serves as the foundation** for other more effective cost cutting measures, such as improvements in delivery or payment systems. Consequently, we believe that the industry is a **structural long-term winner**, which was the thought process behind adding **Cerner**, a leading HIT provider, to the portfolio last year. We like Cerner's wide footprint within U.S. hospitals, as well as its pipeline of innovative products and forward-looking management. Even before health reform was enacted, Cerner was positioned to benefit from the government's drive to modernize hospitals' IT infrastructure, which was funded by the Health Information Technology for Economic and Clinical Health (HITECH) Act in 2009. We think that **health reform only accelerates the growth trajectory for Cerner** as hospitals look ahead to an environment where government reimbursement becomes increasingly tied to quality measurements, forcing hospitals to adopt information technology to not only raise quality of care and reduce costs, but to receive proper reimbursements.

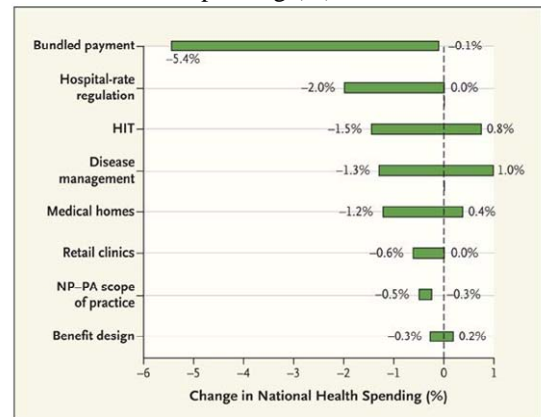
Table 1. Potential Savings from HIT

Savings	Strategies
\$77-\$100B	Automate the current healthcare delivery system by implementing workflow and EMR systems
\$100B	Base treatment decisions on evidence, not memory
\$82-\$100B	Coordinate care across the fragmented elements of our current healthcare system
\$230B	Disrupt the current payment methods with a modern, all-electronic method of healthcare commerce

\$500 billion in annual savings to the U.S. Healthcare System

Source: Cerner

Fig 5. Impact of HIT and Other Reforms on National Health Spending (%)



Source: New England Journal of Medicine, 2009

In the category of companies that we think will benefit from increased access to healthcare while withstanding the risks of reform, we own **Johnson & Johnson**, a long-time SGA universe company. With leading franchises across **diversified platforms in pharmaceuticals, medical devices, and consumer products**, Johnson & Johnson stands to gain from growing demand for its products stemming from increased access. In addition, as a research-driven company with a **rich pipeline of innovative products** and a series of industry-leading franchises, the company should be able to withstand regulatory and/or pricing pressures that may arise from the healthcare legislation. Importantly, we think Johnson & Johnson is also at an inflection point as it **should start reaping the benefit of some of its pipeline investments** from the last decade, leaving behind a difficult period during which it suffered generic competition to key pharmaceutical franchises. Combined with the cost-cutting measures the company executed in recent years, Johnson & Johnson is well positioned to demonstrate **strong and improving fundamentals**.

Increased potential regulation from health reform benefits larger companies such as Johnson & Johnson because they have the scale, know-how, and financial prowess to navigate through increased scrutiny and rules. Ultimately, they will benefit more from the increased demand versus their smaller competitors. **Zimmer Holdings** and **Medtronic** (Table 2) are two other companies in our portfolio that also enjoy **strong market positions** within their industries and should benefit from expanded healthcare coverage. Zimmer principally makes hip and knee implants, while Medtronic makes implantable devices across wide categories of chronic and debilitating diseases. **Ageing demographics and rise in chronic diseases should drive volume growth** for both companies for many years to come (Figure 6), and we think both companies are also well positioned to capture market share. We also do not see health reform interrupting the continued adoption of **Intuitive Surgical’s** robotic technology, which enhances **surgical outcomes—a valuable proposition to all constituents in healthcare**, whether receiving care or paying for it. We recently added Intuitive Surgical to the portfolio because of its unique capability to improve a surgeon’s technique, which in turn increases the quality of care and reduces hospital stay. Its technology is gaining fast adoption across the globe.

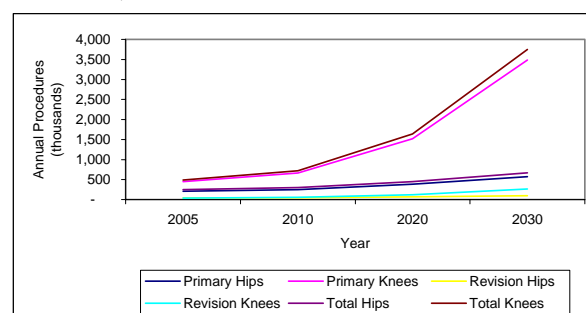
Table 2. Medtronic’s Leading Market Position

Franchises	Position	Share
Cardiac Rhythm Disease Management	#1	46%
Spine	#1	41%
Neuromodulation	#1	66%
Diabetes	#1	66%
Cardiovascular	#2	21%
Surgical Technologies	#1	32%

Medtronic Holds Leading Market Position in Key Franchises

Source: Medtronic, Barclays Capital

Figure 6. Projected Number of Joint Replacement Procedures, 2005 to 2030



Source: Journal of Bone & Joint Surgery, 2007

Looking ahead, we expect numerous **adjustments to be made to health reform**. For example, we wonder if the penalties imposed on individuals are enough to compel the young and healthy to buy insurance, a critical element to expanding the risk pool. We also expect **implementation challenges at many levels**, from Congress to the Centers for Medicare and Medicaid Services (CMS). The extreme partisan nature of the health reform debate, and the more than 3 years vacancy for the CMS Administrator are just some of the factors complicating implementation. Longer term, either rising costs will have to be addressed, or taxes will have to be raised, or both. In terms of potential structural changes, we think that some of the pilot projects in the bill, if successful over time, could become tools for greater government involvement to cut costs. We will be monitoring developments on that front carefully.

Healthcare **remains very much a dynamic environment**, but we have **positioned our portfolio in anticipation of reform**, in companies that can deliver **predictable earnings and cash flow growth**. We expect our healthcare holdings to deliver an average of 15% in earnings growth the next three years. In our view, Johnson & Johnson, Medtronic, Zimmer, and Intuitive Surgical are market leaders that can withstand potential pressures and will ultimately benefit from increased access. Companies like Teva and Cerner are part of the solution to rising healthcare costs, and health reform should only accelerate their growth trajectory. Lastly, the political drama and uncertainty have provided an **exceptional valuation opportunity**: our healthcare portfolio is averaging a 5% free cash flow yield, trading at a discount to our portfolio and the market. So we remain enthusiastic about the potential for these companies to positively impact performance in the future.

The opinions expressed herein reflect the opinions of Sustainable Growth Advisers, LP and are subject to change without notice. Past performance is no guarantee for future results.