Industry Top Trends 2016
Healthcare

U.S. HEALTHCARE REFORM IS DRIVING A CHANGING LANDSCAPE

- **Ratings Outlook.** The ratings outlook for health care services and equipment is broadly stable. The ratings outlook for pharmaceuticals is negative as a result of M&A exerting downward pressure due to high valuations and integration risks.

- **Forecasts.** We expect health service and equipment companies to experience low- to mid-single-digit organic growth rates and margin pressure. We expect the pharma sector to grow 4% to 5% with significant variance by region but to generally be within the low-single-digit to high-single-digit range.

- **Assumptions.** Business prospects in this industry are not highly correlated to GDP growth rates. We don’t expect the outcome of the presidential election to result in a repeal of the Affordable Care Act (ACA).

- **Risks.** Key risks for health care service companies include reimbursement pressure, the growing influence of alternative payment methodologies, narrow networks, and consumerism. Equipment companies face significant pricing pressure, and competition. Pharma companies are subject to risks associated with patent expirations, product pipelines, and pricing power.

- **Industry Trends.** The impact of health reform, including the Affordable Care Act, is pressuring payments to providers and contributing to record levels of mergers and acquisitions. The pharmaceutical industry is also reshaping itself with significant merger and acquisition activity.

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We expect the ratings distribution to remain relatively intact with a large concentration in the ‘B’ category. The ratings of the pharmaceutical companies will remain the highest rated health care subsector but may experience some deterioration in its rating profile if mergers and acquisitions (M&A) continue to result in ratings downgrades. We expect the outlook net bias to remain relatively close to the current level.
This revenue trend line is not representative of our underlying growth estimates as it includes numerous factors skewing the results including the impact of M&A activity as well as divestitures and currency fluctuations.

Source: S&P Ratings. All figures are converted into U.S. Dollars using historic exchange rates. Forecasts are converted at the last financial year end spot rate.
ASSUMPTIONS

We expect growth rates to be low, generally in the low- to mid-single-digit area and margins to remain constrained.

We do not expect the Affordable Care Act to be repealed despite the outcome of the upcoming presidential election.

Pharma industry will continue to benefit from demographics, pricing power, and generally strong cash flow.

1. Health care services and equipment company growth rates will remain low, pressuring margins

Although health care spending increased over 5% in the U.S. last year, we expect that momentum to slow. This reflects the influence of health reform and cost containment efforts which are driving the formation of new kinds of vertically aligned health care delivery systems. Over the long term, we do not expect spending to accelerate as health care service companies will contend with an increased focus on population health management.

2. ACA will not be repealed

Despite all the election rhetoric and Republican view that the ACA should be repealed, we do not believe it a realistic option no matter the outcome of the upcoming presidential election. Given the complexity of the ACA and the extent to which it is embedded into our health care system, we believe a repeal is unrealistic. We think it would be very disruptive to unwind it. Instead, we view more modest revisions of the act as more likely.

3. Pharmaceutical industry growth trends vary considerably, but sector fundamentals will remain solid

With the backdrop of mixed macroeconomic growth trends globally, we believe revenue drivers are independent of global GDP, and are more reflective of disease patterns, population, and life style-related trends. This contributes to our positive outlook on the industry, which is in contrast to our negative rating outlook. We expect specialty drugs prices will continue to have more upside pricing opportunity than generics. Improved pipelines and pricing gains help offset declining sales of products from expiring patents and from currency swings.
RISKS AND OPPORTUNITIES

1 | Reimbursement Risk For Service Companies

Reimbursement risk has always been a key risk, but becomes even more so as health reform expands and the impact of the ACA becomes more of a factor.

2 | Innovation Opportunity For Equipment Companies

Equipment companies that can offer new, innovative products that help reduce the cost of care could help mitigate the risk of margin erosion.

3 | M&A: A Risk And Opportunity

We expect M&A activity to remain high for the entire sector and exert downside pressure on ratings due to the high valuations and integration risks.

1. **Reimbursement risk remains the most important risk**

   Reimbursement risk has always been a key risk, but becomes even more so as health reform expands and the impact of the ACA becomes more of a factor. Growing emphasis on outcomes, payment methodologies slowly moving away from fee for service, and the increasing impact of consumerism is prompting companies to look for new strategies to protect their revenue stream and margins. These developments are key factors driving significant M&A activity.

2. **Innovation for equipment companies is necessary to offset weak pricing**

   Equipment companies are experiencing pricing pressure as their customers deal with their own reimbursement pressures. This emphasis on pricing is leading to lower margins. The strain is felt particularly by companies that provide capital equipment whose replacement cycle can be extended. However, companies that can offer new, innovative products that help reduce the cost of care could help mitigate this risk.

3. **Mergers and acquisitions are both a risk and opportunity**

   We expect M&A activity to remain at high levels for the entire industry. For health service companies, M&A is a critical strategy as they adapt to the evolving challenges of health care reform. As many companies head to uncharted waters, their M&A decisions will have a large impact on their future. Not all these decisions will be successful, particularly as the high valuations leave less room for error. Moreover, acquisition-driven growth is also a way to create shareholder value through cost and revenue synergies as a substitute for organic growth, particularly when revenue growth is low.

   M&A in the pharmaceutical subsector will remain robust as companies look to increase scale and product diversity, enhance pipelines, and in certain cases seek tax inversions. We expect M&A activity to remain high for the entire sector and exert downside pressure on ratings due to the high valuations and integration risks.
GLOBAL HEALTHCARE: CASH, DEBT AND RETURNS

CHART 11 | CASH & EQUIVALENTS / TOTAL ASSETS

Global Healthcare - Cash & Equivalents/Total Assets (%)

CHART 12 | TOTAL DEBT / TOTAL ASSETS

Global Healthcare - Total Debt / Total Assets (%)

CHART 13 | FIXED VS VARIABLE RATE EXPOSURE

Variable Rate Debt (% of Identifiable Total)
Fixed Rate Debt (% of Identifiable Total)

CHART 14 | LONG TERM DEBT TERM-STRUCTURE

LT Debt Due 1 Yr
LT Debt Due 2 Yr
LT Debt Due 3 Yr
LT Debt Due 4 Yr
LT Debt Due 5 Yr
Nominal Due in 1 Yr

CHART 15 | CASH FLOW AND PRIMARY USES

Capex
Net Acquisitions
Dividends
Share Buybacks
Operating CF

CHART 16 | RETURN ON CAPITAL EMPLOYED

Global Healthcare - Return On Capital (%)

Source: S&P Capital IQ, S&P Ratings calculations
RELATED RESEARCH

- The U.S. For-Profit Health Care Outlook Remains Broadly Stable, July 15, 2015

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