Industry Top Trends 2018:

Health Care

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Overview

– **Ratings outlook slightly negative:** Although 78% of our outlooks are stable, there is a significant negative bias to our non-stable outlooks, even following a year where rating downgrades outnumbered upgrades by an almost 5:1 margin, including downgrades on high-profile companies such as Teva Pharmaceutical Industries Ltd., Abbott Laboratories, and Community Health Systems Inc. Our outlook bias primarily reflects operating weakness among low-rated service providers and generic pharma companies, as well as some companies with stretched balance sheets following mergers and acquisitions (M&A). We see pharma and health care equipment industry fundamentals as healthy, with big pharma having capacity for moderate-sized acquisitions.

– **2018 forecasts call for stable growth and flat margins, but pockets of weakness exist:** On a consolidated basis, we expect the health care companies we rate to grow revenues about 4%-5% in 2018, which includes the impact of M&A. While operating trends for health care equipment and big pharma companies remain very stable, health care service companies face slowing organic growth next year given likely soft patient volume, and we expect generic drug manufacturers to face another year of significant price deflation. Margins are broadly stable across the portfolio, with some deterioration among service providers (especially hospitals), as well as generic and some specialty pharma companies.

– **Regulatory risk is lower following failed attempts to repeal the ACA:** We expect governments in developed countries and private payors in the U.S. to continue exerting pressure on health care spending. While we see a repeal of the Affordable Care Act (ACA) in the U.S. as unlikely following several failed attempts, we expect some declines in insurance coverage levels as a result of Trump administration policies, and that scrutiny of pricing will limit companies' ability to raise prices on older drugs in competitive classes.

– **Slowing health care utilization and shifts in financial policies are key risks:** For more highly leveraged companies, especially providers, we're focused on the risk that patient growth slows more than expected, given very stretched sector credit metrics. We also see risks that investment-grade companies will temporarily shift toward more aggressive financial policies if we see meaningful U.S. tax reform, given cash overseas for many companies and our policy of netting some cash in leverage calculations. While we don't factor in this level of "event risk" into outlooks, at least two of our prominent investment-grade rating actions of 2017 (our downgrade of Abbott and our negative CreditWatch listing on Becton Dickinson & Co.) were a consequence of sudden shifts in financial policy.

– **Payors remain in the driver's seat:** Powerful commercial payors continue to exert pressure on providers through plan design (including narrow networks as well as the use of co-pays and deductibles to encourage use of lower-cost providers). Meanwhile, payors and pharma purchasing groups are using competition to push down prices on older, substitutable drugs. Across the board, health care companies will need to effectively innovate to preserve their competitive positioning and profitability.

S&P Global Ratings

Ratings trends and outlook

Global Health Care

Chart 1 – Ratings distribution

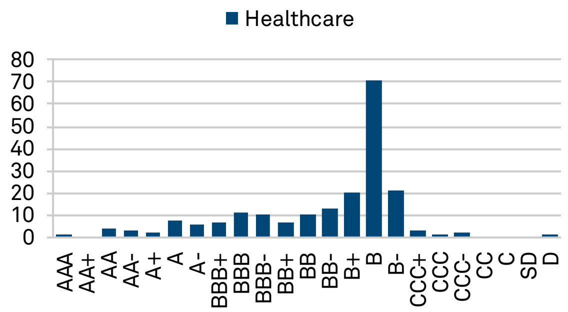
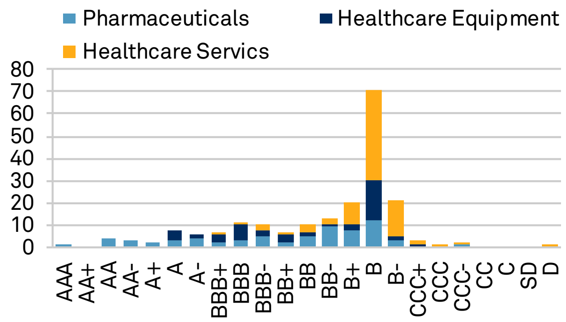


Chart 2 – Ratings distribution by subsector



The corporate health care sector ratings distribution is skewed toward the 'B' category, reflecting the presence of many small, private equity owned companies, especially in the health care services subsector. Our investment-grade rating distribution continues to drift lower, with continued shift from the 'A' category to 'BBB' category.

Chart 3 – Ratings outlooks

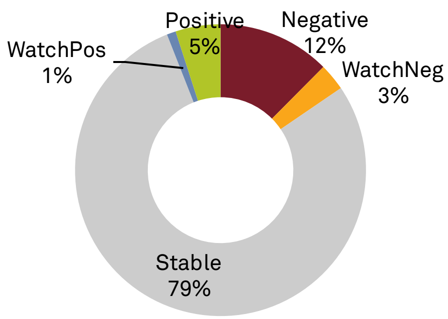
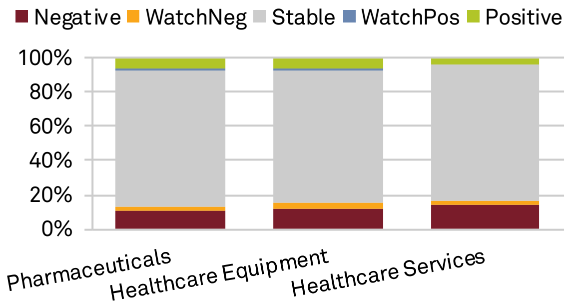


Chart 4 – Ratings outlooks by subsector



Though ratings are predominantly stable, the net negative outlook bias primarily reflects operating pressures (including weak volumes for service providers and pricing challenges for generic and specialty pharma companies), with less impact to ratings from debt-financed M&A activity.

The weakest ratio of negative to positive outlooks in the health services sector primarily reflects operational challenges in this sector, as payors seek to restrain health care utilization growth.

Chart 5 – Ratings outlook net bias

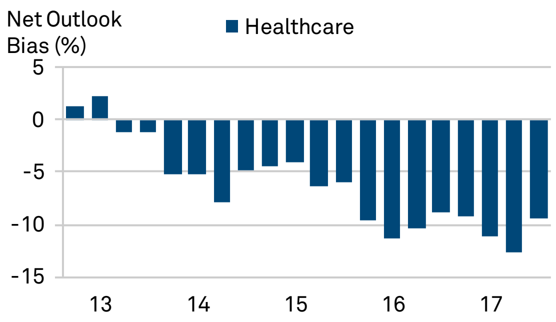
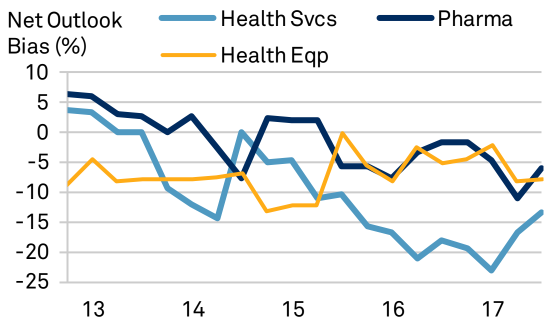


Chart 6 – Ratings net outlook bias by subsector



Our net negative bias, which intensified in 2016, persists in 2017, reflecting operating challenges and, to a lesser extent, stretched balance sheets following recent M&A in pharma and equipment.

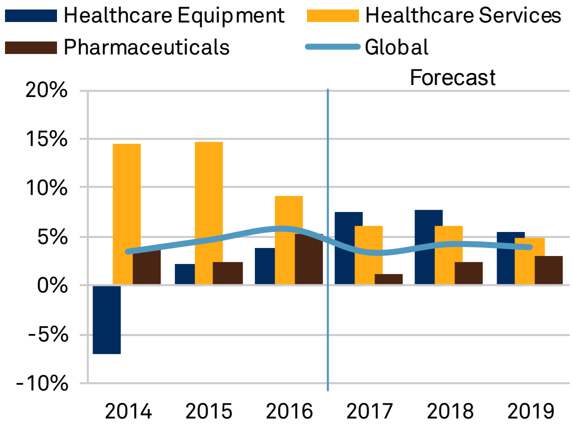
Our net negative bias remains strongest for health care service providers, and recent improvement to the trend reflects, in part, several downgrades among companies that were previously on negative outlook. The bias remains modestly negative on pharma and equipment companies.

Source: S&P Global Ratings. Ratings data measured quarterly with last shown quarter ended Sept. 30, 2017.

Industry forecasts

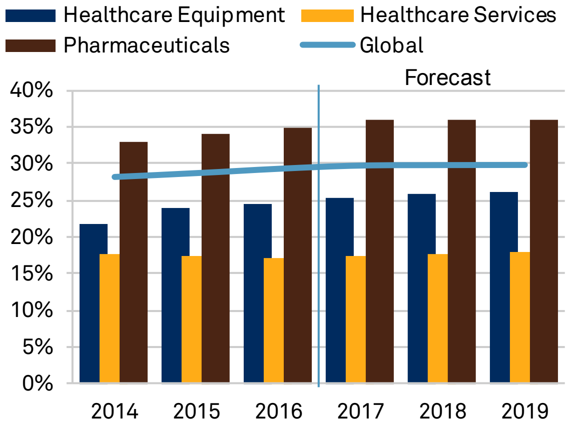
Health Care

Chart 7 – Revenue growth (local currency)



Industry revenue growth slowed somewhat in 2017, reflecting lower levels of M&A in pharma and services and some Big Pharma patent expirations. We expect about 4% industry growth in 2018–slightly higher in services and devices (reflecting low-single-digit organic growth and the impact of M&A) and slightly lower for pharma, given our expectations for Big Pharma patent losses in 2018 and pricing pressure for generic and some specialty players.

Chart 8 – EBITDA margin (adjusted)



We expect broadly stable EBITDA margins in 2018 across all three subsectors. We expect pockets of margin deterioration among hospital operators (who face a challenging volume environment) and among generic and specialty pharma companies, who face pricing challenges.

Chart 9 – Debt/EBITDA (median, adjusted)

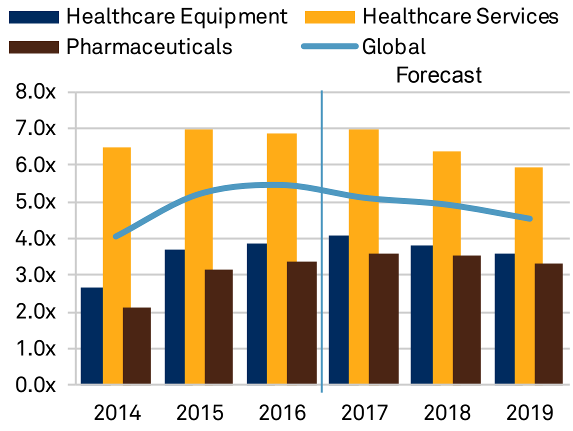
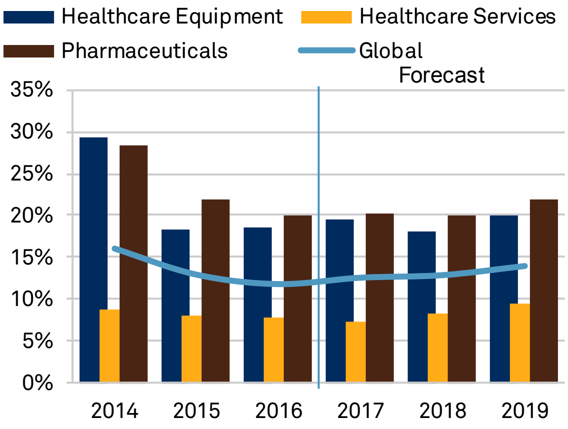


Chart 10 – FFO/debt (median, adjusted)



Source: S&P Global Ratings. Revenue growth shows local currency growth weighted by prior-year common-currency revenue-share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate.

Pharmaceutical industry forecast

We expect global pharmaceutical sales to grow in the low-single-digit range, about 3%, slower than recent years due to patent expirations and a continued negative pricing environment for generic and some specialty products. We expect public scrutiny around pharma pricing to continue into 2018, and think that this pressure will result in another year of more moderate price increases. Patent expirations abound in 2018, and several large companies, including Merck & Co. Inc., Novartis AG, Eli Lilly & Co., and Valeant Pharmaceuticals International Inc., face headwinds from drugs going off-patent.

We expect the generic pharma industry to remain challenged in 2018, as high-single-digit price declines on older generics will not be offset by new product launches. This sector has already experienced downgrades in 2017 after we lowered ratings on Teva Pharmaceuticals (BBB-/Negative/--) and Endo International PLC (B/Stable/--) by one notch each, reflecting operating weakness tied to generic price deflation. Following our Teva downgrade, we revised our rating outlook to negative just month later following weak third-quarter operating results. Very difficult conditions in generic end markets are also driving consolidation in this space, with Amneal Pharmaceuticals LLC and Impax Laboratories Inc. recently announcing their intent to merge, creating the fifth-largest global generic manufacturer.

With the notable exception of the generic players, we expect margins to be flat in 2018, and for credit metrics to remain stable. While M&A has slowed somewhat (likely reflecting uncertainty around prospects for U.S. tax reform), we think that the industry trend toward slower organic growth (especially among big pharma companies), decreasing profitability, higher volatility of revenues, increasing development and marketing costs, and longer and uncertain returns on investments will force increased M&A to drive revenue growth. Still, most large players in pharma have healthy balance sheets and debt capacity within their existing ratings profiles, supporting our expectation for ratings stability. This is despite our acknowledgement that our ratings do not reflect the risk of transformational M&A, and the fact that more than a few large companies have been willing to sacrifice ratings over the past few years to fund game-changing acquisitions.

Health care services forecast

For health care service companies, we expect low-single-digit organic growth in 2018, with significant variation across subsectors. We expect hospitals to see very low single-digit organic growth (consisting of near-zero volume growth and low-single-digit blended reimbursement rate increases), while companies providing outsourced services to hospitals and outpatient providers should grow slightly faster. We expect industry participants to see modestly higher bad debt expense in 2018 (reflecting slightly lower insurance coverage levels and the increasing prevalence of high-deductible health plans, given difficulty in collecting amounts owed by consumers). Given a strengthening U.S. economy, we could see incremental upward pressure on wages, which, combined with lower growth, would lead to further margin pressure for facilities-based providers (especially hospitals). We see leverage as broadly stable, with some potential for large issuers like Tenet Healthcare Corp., Community Health Systems, and Quorum Health Corp. to reduce leverage through asset sales.

In Europe we expect reimbursement to for-profit health care service providers to remain under pressure as governments continue to curb expenses. We therefore expect continuing pressure on profitability, especially for hospitals, nursing home operators, and social care services as fixed costs such as wages continue to increase and further cost savings will be harder and harder to generate.

We expect M&A activity to remain high but transactions to stay mostly small as the industry continues to consolidate. Given private equity interest in rolling up smaller providers (especially those with asset-light business models, like staffing providers and some physician practices), we expect a continued high level of first-time issuers in this sector in 2018. In Europe, we expect to see more acquisitions in the sector, especially in the labs and hospital services areas as these markets remain fragmented.

Health care equipment forecast

For equipment companies we see mid-single-digit top-line growth, with mid-single-digit revenue growth supported by favorable demographic trends, increasing penetration in emerging markets, and steady technological innovation stemming from regulatory requirements and extensive intellectual property. This incorporates our view that companies will face low-single-digit pricing headwinds stemming from margin pressure at hospital customers, a continued shift from volume to value, and initiatives to accelerate the pace of regulatory approvals, which incrementally increases competition. We expect incremental deleveraging in 2018 among larger rated players in the sector, as several companies that participated in large-scale M&A over the past few years reduce debt to meet their stated financial policy targets.

We expect health care equipment M&A to moderate in 2018 following three years of large-scale consolidation. Given that many of the larger industry players are currently digesting large acquisitions and working to restore leverage to historical levels, we think acquisition activity will be largely limited to tuck-ins in 2018, with minimal impact to credit metrics.

Key assumptions

Health Care

1	**2018 should see greater stability on the U.S. regulatory front** Following several failed attempts at “repeal and replace,” we think it’s unlikely that the ACA will be repealed in the U.S. Although pharma pricing remains front-page news, we see federal drug pricing legislation in the U.S. as unlikely in 2018.
2	**Payors remain focused on cost containment** Despite the presence of many large players, even the largest health care companies we rate, including behemoths like drug maker Pfizer Inc. or hospital operator HCA Healthcare Inc., have very small market share, especially when compared to a very consolidated group of payors (including governments and very large U.S. commercial insurance companies). With payors focused on limiting growth in health care spending, we expect further pressure on U.S. patient volumes and on global pharmaceutical pricing.
3	**Industry consolidation continues, but we see limited ratings risk** While we expect the health care industry to continue to consolidate, we think this consolidation poses limited risk to ratings in the near term, as we think many industry participants will likely be on the sidelines for large-scale transactions pending the outcome of corporate tax reform proposals in the U.S.

2018 should be a year of greater stability on the U.S. regulatory front

While we think it's unlikely that the ACA will be repealed in the U.S., we believe that federal health care policies are likely to be a small incremental credit negative for health care providers because we expect the administration to prioritize cost containment over coverage expansion. We expect U.S. insurance coverage levels to be incrementally lower in 2018 versus 2017 as fewer individuals sign up for ACA exchange plans given marketplace uncertainty and lower advertising, and we see further risk to provider bad debt levels as a result. With the notable exception of labs, which face sizable cuts, the preliminary 2018 Medicare rates are mostly benign for providers. While we believe that any efforts to weaken Medicaid coverage are unlikely to affect providers in 2018, we see risks that a longer-term shift from Medicaid as an entitlement to block grants could exert further pressure on service company revenues and margins.

Meanwhile, we expect pharmaceutical pricing pressure to continue, even without regulatory intervention. This is because we expect public scrutiny around pharma pricing to continue into 2018, and think that this pressure will result in another year of more moderate price increases. In addition, with opioid addiction an ongoing public health crisis, we see some product liability risk to companies that manufacture or distribute these drugs, though we do not expect the exposure to lead to rating changes.

We see health care equipment companies as facing only limited exposure to regulatory risk. Notwithstanding the recent Trump administration move to curtail recent bundled payment initiatives for hip and knee replacements, we think the shift toward value-based payments is likely to continue over time, which could affect equipment company margins. In addition, following several years of high product liability expense for several large companies, we expect this exposure to wane in 2018, though we acknowledge product liability to be an ever-present risk for equipment manufacturers.

Payors remain focused on cost containment

While health care equipment providers have often cited persistent low-single-digit annual price deflation, health care providers and branded pharma companies have long enjoyed mid-single-digit (or higher) annual price increases from commercial payors. While we expect provider reimbursement rates from government and commercial payors to grow at a low-single-digit rate in 2018, payors are becoming more aggressive in using plan design (including co-pays, deductibles, and narrow networks) to direct patients to lower-cost settings. This trend is a substantial headwind for hospital operators, who face growing competition from ambulatory surgery centers, outpatient imaging, urgent care facilities, and freestanding emergency rooms. With the notable exception of labs, which face sizable cuts, the preliminary 2018 Medicare rates are mostly benign for providers.

Generic drug price deflation stole the headlines in 2017, and we expect the pain to continue into 2018. We expect mid- to high-single-digit pricing deflation on older generics in 2018 as payors (including pharmacy benefit managers) continue to push down prices on drugs in competitive categories through the use of preferred positioning on formulary tiers (and in some cases, formulary exclusion) to drive greater discounts. However, innovative, highly effective drugs will be able to continue to command premium pricing.

Industry consolidation continues, but we see limited ratings risk

For health care service providers, 2017 was a year of consolidation among smaller providers (reflected, in part, in the large number of first-time debt issuers we rated this year). We expect this trend to continue in 2018, as smaller players seek to gain scale to effectively negotiate with very large, concentrated payors (both government and commercial). We don't expect M&A to have a meaningful impact on credit quality across the subsector because we think more leverage-neutral transactions are likely given that leverage in this space is already high. Notably, we've also seen a few large hospital companies selling assets to refocus their portfolios, with Tenet Healthcare, Community Health Systems, and Quorum Health likely to remain net sellers and HCA Healthcare Inc. a net buyer. In Europe, we see rapid consolidation in the laboratory industry, primarily in response to ongoing reimbursement cuts. The majority of these transactions are predominantly debt funded, which could put current ratings under pressure.

Following several blockbuster deals in 2014 and 2015, M&A activity in the pharma sector has been relatively muted with only a few notable transactions with a price tag over $25 billion, including Shire PLC's takeover of Baxalta in 2016, Johnson & Johnson's takeover of Actalion in 2017, and Abbott Laboratories' purchase of St. Jude Medical in 2017. While Shire was previously unrated and J&J had sufficient debt capacity at its rating, Abbott's buying spree prompted a four-notch downgrade, to 'BBB', from 'A+'. That said, with many European companies in the middle of strategic portfolio reviews and U.S.-based companies most likely waiting to see the results of potential tax reform promised by the Trump administration, we think the M&A focus will be on tuck in acquisitions, for now. At the same time, some pharma companies are rationalizing their portfolios: Pfizer Inc. and Merck KGaA are considering selling their consumer health care segments, and Sanofi announced that it could sell its generics division, with European pharma companies GlaxoSmithKline, Bayer, and Sanofi (who have expressed interest in this space) among the possible suitors.

Health care equipment companies are coming off of a period of large-scale consolidation, and we think large companies will likely focus on tuck-in acquisitions and reducing leverage in 2018.

Key risks and opportunities

Health care

1	**U.S. tax reform: good news in the long term, but short-term risks** While U.S.-based health care companies stand to benefit from potential corporate tax reform in the U.S. over the long term, given the potential for lower rates and higher free cash flow over time, we see some risk that some large companies with historically conservative balance sheets and large cash balances may view the ability to repatriate cash at attractive rates as an opportunity to finance large one-time share repurchases, or spur very large-scale M&A not currently incorporated into our ratings or outlooks.
2	**Value-based pricing poses risks and opportunities over time** We expect health care industry pricing dynamics to slowly transition pricing models to value-based models where pricing is determined by quality and outcomes from a fee-for-service approach. For industry participants that can demonstrate superior performance (in the form of safer medical devices, better drug treatment outcomes, or higher quality care), this shift poses opportunities, but there will be winners and losers over time.
3	**The regulatory "wild card" remains in play** While our base-case expectation is that we see no major impact from U.S. health care legislation in 2018, we cannot discount the risk that further attempts to dismantle the ACA, convert Medicaid to block grants, or regulate drug pricing at the federal level are possible.

U.S. tax reform: good news in the long term, but short-term risks

While U.S.-based health care companies would benefit over the longer term from tax reform that reduced corporate tax rates and allowed for lower-cost repatriation of overseas cash, we think any policy change could lead to short-term financial policy shifts for some companies that might be tempted to use repatriated cash for large share repurchases. Because we net a portion of many companies' cash against debt in our leverage calculations, we'd view a decrease in these cash balances as a credit negative.

We also think that more clarity on future tax policy could spur an increase in very large-scale M&A, especially in the pharma sector, where large deal flow has slowed somewhat over the past few years. We view this risk as slightly less pronounced for health care equipment companies given the recent wave of large-scale consolidation, and see limited ratings risk to health care service providers, most of which are U.S.-centric (with little to no overseas cash) and generate substantially lower federal income tax bills relative to higher-rated pharma and health care equipment peers.

Value-based pricing poses risks and opportunities over time

While the shift to value-based pricing is a slow moving trend, the industry continues to move toward new pricing models that reward quality and outcome over quantity of treatment. Notwithstanding the recent Trump administration move to curtail recent bundled payment initiatives around hip and knee replacements, we think the shift toward value-based payments is likely to continue over time, and note that recent studies have shown that about 40% of large employers are now incorporating value-based initiatives into health care plan design. This poses both risks and opportunities for health care companies because those that can show the highest quality outcomes at competitive costs may be able to take market share at the expense of competitors.

In pharma, the launch of new classes of very promising oncology treatments with expected very high price tags and very targeted patient populations is driving a shift toward new value-based pricing models, where payors receive refunds or rebates if a drug doesn't perform as expected in a particular patient. This approach is not novel, as value-based pricing models have already been used for some diabetes treatments and for expensive PCSK9 inhibitor cholesterol drugs.

The regulatory "wild card" remains in play

Though our forecasts currently don't contemplate any major changes in U.S. health care or drug pricing legislation, we think the current U.S. administration will remain focused on cost containment at the expense of insurance coverage levels, and we see some risk of further attempts to restructure the federal-state Medicaid program, including trying to convert the program from an open-ended entitlement to a block grant program, which would likely result in both lower reimbursement to providers and fewer individuals covered (and higher bad debt expense to providers, especially hospitals).

While we still think U.S. federal drug pricing legislation is unlikely, we believe there is a risk that pricing pressures will intensify, most likely as a result of the industry reacting to greater public scrutiny. While we think U.S. federal drug pricing legislation is unlikely in 2018, several states have passed or are considering bills that could negatively affect pharma pricing or profitability, including a pending California bill that would limit the ability of manufacturers to offer coupons or rebates on drugs for which a cheaper generic is available and a Nevada law passed in June that requires greater disclosure around pricing and pharma and pharmacy benefit manager (PBM) profits from diabetes drugs.

Key takeaway: Innovation is key in a changing landscape

Across health care subsectors, the industry is consolidating as companies react to increasingly aggressive attempts by payors (both government and private) to control health care spending growth. In addition, we're seeing competitive threats emerge from new corners, including payors buying providers (UnitedHealthcare, through its Optum subsidiary), as well as e-commerce giant Amazon considering an entry into the pharma space, possibly competing with pharma supply chain participants, including distributors and PBMs. While we think the short-term risk is low given high regulatory barriers to entry, we see Amazon as posing a competitive threat to all pharmaceutical industry participants-including pharma companies, PBMs, distributors, and pharmacies–given the potential to dramatically improve price transparency.

For pharma companies, the ability to innovate remains key to success. Many pharma players face patent cliffs on their best-selling drugs, including Merck (Invanz, Vytorin), Novartis (Gleevec), Bristol–Myers Squibb Co. (Reyataz), Roche Holding AG (Herceptin), Sanofi (Lantus), Eli Lilly (Strattera), and Glaxo SmithKline PLC (Advair). At the same time, payors (including PBMs) are becoming increasingly aggressive in holding down spending on expensive "me too" drugs, using tools like higher co-pays and even formulary exclusion to limit spending on pricy drugs that don't offer better outcomes. As usual, oncology remains at the forefront of innovation, with upcoming immunotherapies that have been heralded as the most important developments in cancer treatment in generations. While the space has seen a few big failures, Merck's Keytruda has achieved great clinical success and we expect more oncology blockbusters to emerge in the near future.

For service providers, legacy operators will need to rethink how they deliver services to compete with new business models offering consumers access to care at convenient and less expensive sites of care. Many large hospital operators have shifted in this direction, but with leverage across the sector very high, it will be difficult for many to invest in building out their care networks. In the meantime, we expect health care companies to face persistent competition from new business models.

Related Research

- Recent Performance In The U.S. Health Care Sector Is Increasingly Volatile, Sept. 21, 2017
- Pricing Pressure Continues To Weigh On Generic Drug Makers, Sept. 5, 2017
- Making The Rounds: Health Care Service Providers Have the Summertime Blues, Aug. 31, 2017
- The S&P Pharma Dose Newsletter: The Pharma Industry Outlook Is Revised To Stable From Negative As M&A Momentum Slows, April 7, 2017
- Despite A Three-Year Downgrade Streak for Investment-Grade Medical Device Companies, The Industry Outlook Remains Stable, Feb. 10, 2017

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Cash, debt, and returns

Global Health Care

Chart 11 – Cash flow and primary uses

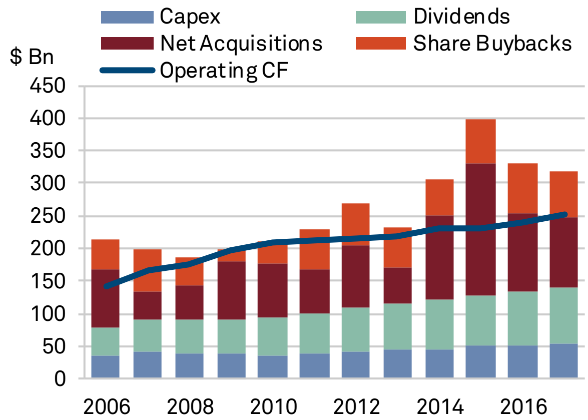


Chart 12 – Return on capital employed

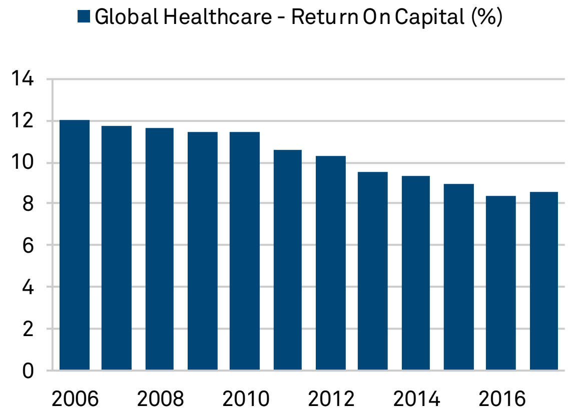


Chart 13 – Cash and equivalents/total assets

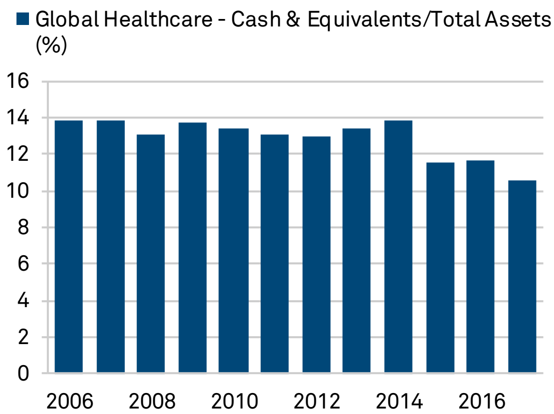


Chart 14 – Total debt/total assets

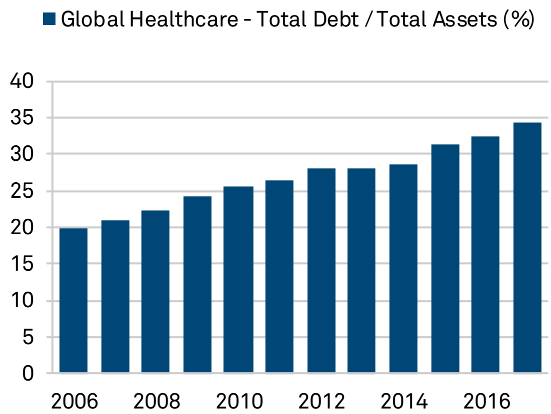


Chart 15 – Fixed versus variable rate exposure

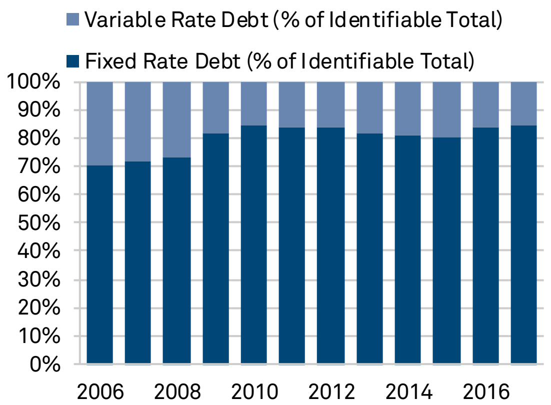
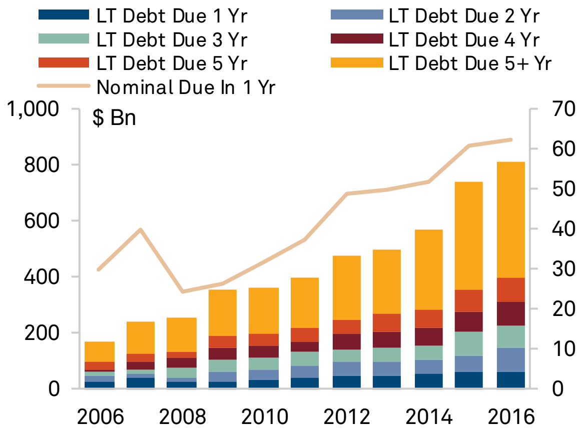


Chart 16 – Long term debt term structure



Sources: S&P Global Market Intelligence, S&P Global Ratings calculations.

spglobal.com/ratings