

Kieger – Thoughts from the Street

JPM HC Conference 2018

Zurich, January 16, 2018

Back to *business as usual* in a normalizing (US) healthcare market environment

We attended the 36th annual J.P. Morgan Healthcare Conference 2018 from January 8th to 11th in San Francisco.

Over the years the conference has developed into the single most important event for healthcare investors and sets the tone for the investment year.

A common theme across the presentations and management conversations was the potential dynamics around the US tax system reform in an otherwise normalizing healthcare market environment.

The JPM conference itself is a phenomena. Over 500 companies (USD +500tn market cap) and over 10'000 registered attendees (and more unregistered) use the conference as communication platform. The side effects of such a landmark event are highly elevated hotel room rates (by factors), elevated restaurant prices and elevated Uber fares.

Company presentations and conversations with managements were encouraging and signalled expectations of a more normalized US healthcare market environment post

the cancellation of the Obamacare repeal and replace attempts. The US tax reform was the common theme across the different presentations.

It's the tax system, stupid!

Since the election of Donald Trump as president of the USA two topics dominated the conversations among healthcare investors: A potential repeal and replace of Obamacare and a potential US tax reform. While the first lost steam (see our Thoughts from the Street from the Jefferies Conference 2017) and eventually was cancelled, the latter passed through Congress and was signed into law before Christmas 2017.

The tax reform is complex and evaluating the exact impact will take months, however for investors it comes down to two main changes. Firstly, a reduction in the corporate tax rate from 35% to 21% and secondly, the change to a territorial tax system combined with a forced repatriation of prior year outside US (OUS) profits. The main questions across most company presentations and our conversations at the conference were on who will benefit from the reform to what extent and on how the companies are going to use the cash from repatriation.

- **Tax rate reduction:** In general a reduction in the US corporate tax rate is favourable for all companies doing business in the US and in relative terms will matter more for companies with a high US share of profits and a high pre reform effective tax rate. From a company size point view this means that small and midcap companies should profit more than large multinationals and from a subindustry point of view domestic focussed groups like providers and health insurance companies should benefit more than big Biopharma, big Medtech and big Tools companies. The second leg of the conversation was on durability of the positive impact, which primarily seems to depend on the degree of competition. For highly competitive markets like - for example - commercial health insurance it seems that the positive impact will be competed away fairly quickly. For companies where the competition is more benign due to product and service differentiation or where the competition is mainly tax exempt (providers) the positive impact should last longer. We also had the impression that in markets where the state is the biggest payor (dialysis, Medicaid and Medicare) over time part of the tax reduction will be claimed back even in the cases where the reimbursement rate setting does not include an after tax margin component.
- **Repatriation:** Given the already efficient tax structure of big multinationals they will only benefit little from the reduction in the tax rate and therefore the repatriation or access to OUS cash is more relevant. This increased access is acquired by a onetime tax (8% on illiquid assets and 15.5% on cash) payable over 8 years. From an investors point of view the use of cash will determine the potential value creation. At the conference most companies assured that they will use the cash prudently according to their existing capital allocation strategies including debt pay down, share buy backs, internal investments and M&A. Looking back in history, in 2004 the American Jobs Creation Act reduced the repatriation rate to 5.25% from 35% and 9'700 companies took advantage and repatriated USD 312bn. However, a 2011 Congressional Research Services study concluded that companies tended to use the money dominantly to buy back own shares.

Bottom line: Positive tone in a normalizing market environment

Healthcare executives at the conference signalled confidence in their business prospects in a more stable and more normalised environment post the cancellation of the repeal and replace attempts. The degree of upside for healthcare investors from tax reform is determined mainly by company specifics.

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