Back to school, repeating the same class

After rebounding strongly in July from the prior month lows, markets took a breather in August, held back by the FED's repeated warnings of rising interest rates. The fact that Jerome Powell's Jackson Hole speech hinted at a possible recession, although not unexpected, only added to market nervousness. Healthcare equities shed 6.0% in August and global equities lost 4.2%. The sector's year-to-date outperformance now stands at 4.8%.

In August, Q2 earnings season proved an important driver of performance (more on page 2).

Providers & Services were the best monthly performing sub-sector (-1.6%), helped by US Distributors (emergence of an activist investor at Cardinal Health and solid earnings for the other companies), as well as strong quarterly reports by the large US Services names, CVS and Cigna. Managed Care and Facilities were a drag to performance.

Biotechnology (-3.3%) was volatile. While continued M&A activity (Pfizer is to buy Global Blood Therapeutics for USD 5.4bn, Amgen to acquire Chemocentryx for USD 3.7bn and Gilead to take over MioBio for USD 405m) and positive trial readouts (e.g. for Alnylam's Phase 3 APOLLO-B trial of Onpattro (patisiran) in ATTR-CM) helped performance, uncertainty with regards to drug pricing legislation (see page 2) and the still pending and much-anticipated Merck-Seagen deal were drags.

Equipment & Supplies (-6.1%) were hampered by the hearing aid and dental groups, both flagging softer consumer trends. Vision Care, following a mixed set of results, also had a detrimental effect.

Pharma (-7.7%) dropped on news flow regarding the new drug pricing legislation and the Zantac lawsuits (see page 2).

Tools & Services, despite a strong Q2 reporting season, shed 9.4%. Stocks lost ground on fears of a potential impact on revenues from drug development, due to the drug pricing reform. Illumina's comments on customer inventory reductions might also have weighed on some names.

Healthcare Technology stocks fell 9.9%, after Jerome Powell's Jackson Hole comments put pressure on growth stocks at large.

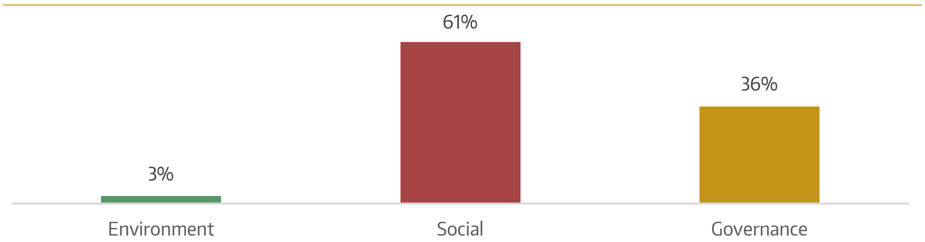
In the spotlight

Earnings season: August nearly concluded the Q2 2022 reporting season. The trends discussed in our July commentary held true. Overall, the main Q2 features were the continued resilience of the Tools & Services subsector (thanks to healthy end markets, efficient management of the Chinese lockdowns, strong pricing power, increasing recurring sales, lesser industrial and greater biopharma exposure), as well as the solid performance of Providers & Services, driven by Managed Care firms benefitting from more muted utilisation trends (implying lesser expenses), on top of reduced COVID-19 costs. At the other end of the spectrum – and less surprisingly – Equipment & Supplies continued to face many headwinds in the quarter, such as the Chinese lockdowns, staffing issues, component shortages and reduced/delayed pricing power.

Zantac litigation: Launched in the 1980s by GSK, Zantac was used to relieve heartburn and later transitioned to over-the-counter medication. In 2019, it was taken off the market, after the FDA reported that NMDA-levels (a carcinogenic) could increase to unacceptable levels over time. Thereafter, GSK, Sanofi, Pfizer and other generic producers were accused of failing to adequately warn patients about the health risks. Prior to the first trial in one of these lawsuits in August, analysts released a series of reports, highlighting the potential company exposures. Based on similar past litigation settlements, the damages from Zantac litigation could theoretically – but not realistically – reach tens of billions. These analysts reports triggered a combined market cap wipe-out of USD 44bn in the above-named firms, and casted a longer-lasting shadow on them.

Drug pricing reform: In August, the Senate passed the Inflation Reduction Act (IRA) of 2022, which includes reforms to Medicare drug pricing policy:
1) Drug price negotiation: starting in 2023, the IRA will authorise the Secretary of Health & Human Services (HHS) to begin negotiating the prices of ten high-cost prescription drugs. Negotiated prices for the first ten will be effective in 2026 for Medicare Part D and in 2028 for Medicare Part B drugs. By 2029, a total of 60 drugs will be subject to negotiated prices;
2) Inflationary rebates: Starting this coming October, if the price of a Part D drug is hiked by more than the general inflation rate, the drug producer must reimburse Medicare for the amount exceeding inflation. Rebates for Part B medications will begin in 2023;
3) Part D redesign: amongst the most important changes is the fact that, starting in 2025, patient out-of-pocket costs for Part D prescription drugs will be capped at USD 2,000 per annum. Further, Part D premium increases are to be capped at 6% per annum through 2029.
The implications on market dynamics are not yet fully clear. Thus far, however, the market has taken a rather rational – not overreacting – approach to the reform. Shares of affected pharma companies posted mid-single digit percentage drops over a few days. Which is exactly in line with the first computations of the impact on their NPVs.

Chart of the Month: Breakdown of significant controversies in the healthcare sector



Source: MSCI ESG, Kieger

With the continuously growing amount of ESG data, it is extremely important to focus on what is material for a company. In the healthcare sector, some 60% of ESG controversies pertain to social issues. Governance issues are also material, at 36%. The number of environmental controversies is low, however, with manufacturing in the sector being highly regulated and management of environmental issues generally good. Intuitively, it makes sense for social controversies to be so important, as healthcare products have a significant impact on society. Unfortunately, there are many historical examples of major product recalls due to serious side effects. Such recalls will undoubtedly continue to occur in the future, as all medication has potential side effects. In our view, this means that one should focus on companies that have responsible strategies in place to monitor the safety and quality of their products. And we also analyse how managements proceed in the event of a product recall.
https://kieger.com/news/kieger-healthcare-chart-of-the-month-10/

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