

# Lazard Insights

Conference Call Series

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## Summary

### U.S. Health Care Reform: Identifying Potential Winners and Losers

Featured Speaker: Rhett E. Brown, CFA, Senior Vice President, Research Analyst

#### Defining the Problem

Generally agreed upon issues regarding the health care situation in the United States include: the fact that health care costs are forecast to grow to alarming levels of GDP; tens of millions of people are uninsured, when every individual in this country should have health coverage (irrespective of pre-existing conditions or health status); and that demographic trends in the United States, driven by the aging of the baby boom generation, are exacerbating the current situation. Taking this information altogether, it is fairly clear that the current health care system is unsustainable.

#### Cost Continues to Grow

For 2007 (the most recently reported year), total health expenditures totaled just over \$2.2 trillion, representing 16.2% of GDP, as illustrated in Exhibit 1. Over the projected period from 2008 to 2018, average annual growth in health care spending is anticipated to outpace average annual growth in the overall economy by 2.1% per year, with national health care spending expected to reach \$4.4 trillion dollars, or just over 20% of GDP, in 2018.

**Exhibit 1: Historical and Forecast Data for Aggregate National Health Expenditures**



The health spending projections are based on the 2007 version of the National Health Expenditures released in January 2009

Source: Centers for Medicare & Medicaid Services, Office of the Actuary



To underscore the difficulty that the United States faces, consider the federal government entitlement programs subset of health care spend, Medicare and Medicaid: The nonpartisan Congressional Budget Office projects that the share of GDP devoted to the existing Medicare and Medicaid programs, which currently comprise an estimated 6% of GDP (\$900 billion), will approximately quintuple between 2009 and 2050, reaching just over 30% of GDP. This alone will clearly create a severe fiscal burden for the federal and state governments, even before any discussion of expansion of coverage for the uninsured.

### U.S. Health Care Coverage – Important Data Points

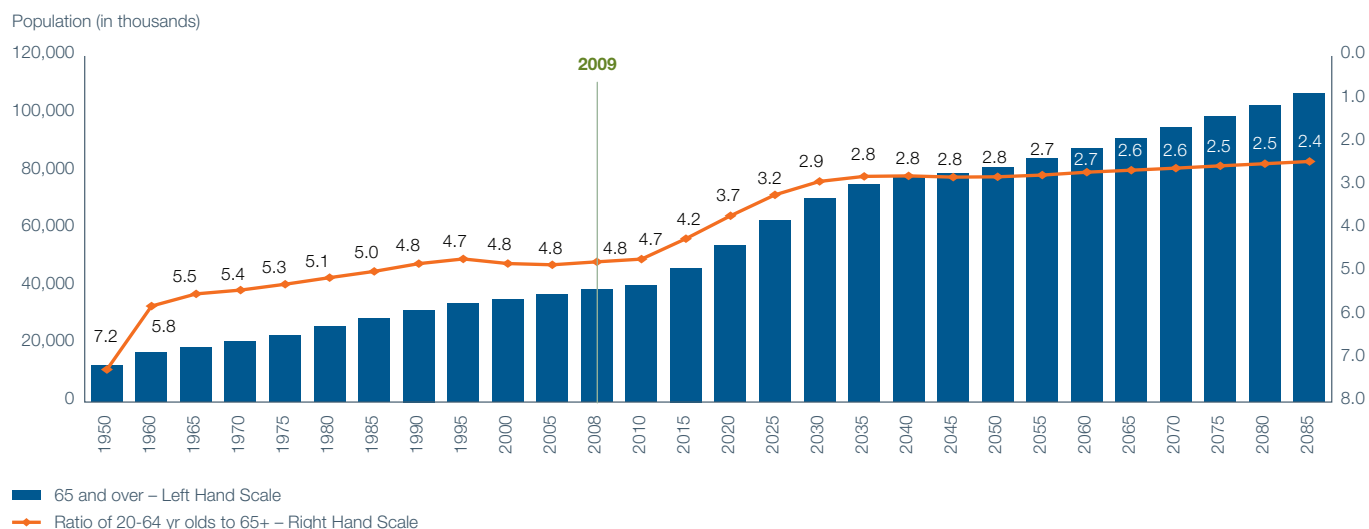
The majority of Americans (85%, or approximately 255 million people) have some form of health insurance, with 67% of the population covered by private insurance, the vast majority of which is employment based. Looking at government-funded programs, 29% of the population is covered by either Medicare, which covers people age 65 or older and some disabled persons, or Medicaid, which covers certain low-income individuals and families (note that people covered by government-funded programs may also have additional private insurance, hence there is an overlap between these two populations). That leaves approximately 46 million people living in the United States without insurance; however, 9.5 million of these people are not U.S. citizens.

Therefore, there are approximately 37 million citizens who do not have insurance across the income spectrum. We know that, from the recent census data, 10 million of these individuals could likely afford insurance. In addition, the 37 million includes students and is also likely overstated due to idiosyncrasies in the way the census data are generated. Nonetheless, the fact remains that a significant proportion of U.S. citizens do not have health insurance today.

### The Current System is Unsustainable

Emerging demographic trends, coupled with current entitlement programs, further illustrate the unsustainable nature of our current system. Exhibit 2 shows that, currently, the Medicare eligible population is 39 million and is forecast to grow to 107 million by 2085, or almost triple the current population. The red line represents changes in the dependency ratio, or the ratio of the number of people 20 to 64 years old to the number of those 65 or older. Note that, over the past 45 years, this ratio has held within a range of 5.5 to 4.7 workers-to-retirees, and it is currently standing at approximately 4.8. However, within the next 20 years, this ratio is expected to decline to a level of less than three workers per retiree, with further incremental declines expected in the ensuing decades, as the U.S. population continues to age. We believe that these forecasted movements would not only exacerbate the structural issues facing the U.S. health care system, but also strongly suggest that significant changes are needed in entitlement programs such as Medicare.

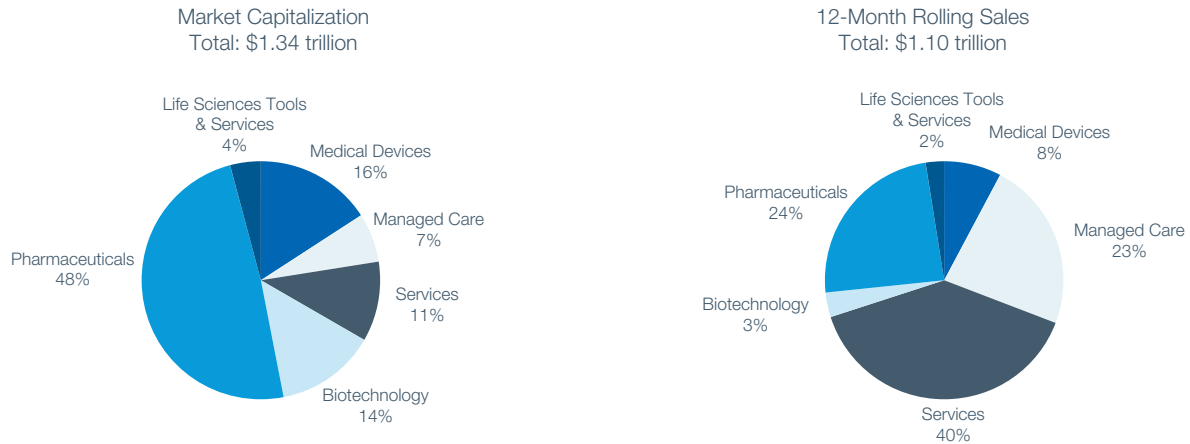
**Exhibit 2: Historical and Forecast Trends for the Absolute Number of Americans 65 or Older and Changes in the Dependency Ratio (5-year intervals from 1950 through 2085)**



The health spending projections are based on the 2007 version of the National Health Expenditures released in January 2009  
 Source: Social Security Administration, [http://www.ssa.gov/OACT/TR/2009/V\\_demographic.html#205410](http://www.ssa.gov/OACT/TR/2009/V_demographic.html#205410)



### Exhibit 3: Market Capitalization and 12-month Rolling Sales of Health Care Companies within the Russell 1000 Index



As of 31 August 2009

Source: Russell Investments

The charts above show the market capitalization and 12-month rolling sales of those publicly traded companies included in the health care sector of the Russell 1000 Index.

### Snapshot of the U.S. Health Care Industry

Within the broader U.S. health care industry, business models and profitability levels vary significantly, as illustrated in Exhibit 3. For example, the managed care sector, which accounts for 23% of industry sales, represents only 7% of industry market capitalization and carries an average EBITDA margin of just 7%. By comparison, the pharmaceuticals industry accounts for a similar level of industry sales (24%), but only for 48% of industry market capitalization. Obviously, despite the well-known drug industry problems of poor research and development productivity, patent cliffs, and declining revenues, the drug group remains very profitable, carrying an average EBITDA margin of 33%.

### Scenario Analysis

In assessing potential policy scenarios, we broadly see three types of outcomes, with different levels of probability among the three:

#### Policy Scenario A: Major Reform

We see major reform as significant government involvement in setting marketplace conditions for the health care industry. Key features of this scenario may include a public insurance option run by the federal government (for simplicity, an expansion of the current Medicare program), coupled with strict industry regulation and taxation. In effect, we see this scenario as a prelude to a single-payer health care system,

where private insurance plans would be unable to compete with a low-cost government provider, and health care suppliers—such as pharmaceutical and medical device companies—would become price takers as opposed to price setters.

The impact of this type of reform would vary by health care subsector. For example, the managed care sector would be one of the first to feel the impact. Specifically, with a public plan using Medicare payment levels, employer-based insurers would see their membership decline by 60% (or 119 million covered lives), as employers would find it more economical to pay a financial penalty to the federal government and offload their employees onto the public plan than to provide insurance coverage.<sup>1</sup> A consequence of this is that a large number of public companies could experience improved profitability.

On the opposite side of the spectrum would be the life science tools subsector, which provides products used to conduct basic life science research and drug discovery and development. We believe this group would be relatively insulated, as the subsector's exposure to university, academic, and applied end-markets would help to offset potential weakness from pharmaceutical and biotechnology customers, who would likely reduce research and development spending in the face of declining pricing power.

In general, this scenario is negative for the vast majority of health care companies. That said, we do not believe this is a likely outcome.



### Policy Scenario B: No Reform

A scenario where no legislation passes and the status quo is maintained would not solve any of the current problems in the health care system.

This potential outcome would be positive in the short term for the health care sector, but negative longer term, as reform would still need to be addressed. We believe this scenario is also not likely, given bipartisan agreement that there is a health care problem in this country and the current Administration's investment in driving some type of health care legislation forward.

### Policy Scenario C: Limited Reform

We believe that limited reform, or addressing some of the consensus problems within the current health care system without major government intervention, is the most likely scenario. In this outcome, we see coverage for the uninsured addressed through an expansion of the current Medicaid plan and the creation of non-profit cooperatives that are owned by the co-op members (although we note that the structure of the co-ops currently being proposed in Washington has yet to be defined). Items such as an insurance mandate for individuals and the creation of a national insurance exchange, where individuals would be free to choose from a variety of insurance plans, would also be components. The bill that Senator Max Baucus released during the week of September 14 appears to be a step in this direction.

## Potential Relative Winners and Losers Assuming the Limited Reform Scenario

Given a 12-18 month investment time horizon, we have established a framework that guides our research in assessing the investment implications to determine relative winners and losers.

We believe that limited reform would be positive for the health care sector overall, as markets have already priced-in significant changes to the health care system. However, longer term, we think the health care industry would still have a number of structural questions to address.

With respect to the relative winners, we see business models with the following characteristics as the most robust in a limited reform environment:

- Operational flexibility, particularly P&L flexibility
- Size and scale
- Innovative product differentiation that is tied to actual clinical outcomes

- Effective leverage of information technology—the so called “wiring” of health care—to drive efficiency

Taking a closer look at the impact this scenario would have on the sector, we see relative winners and losers within many subsectors. For example, in the pharmaceutical area, generic drug manufacturers would benefit from increased volumes of low-cost drugs deriving from the inclusion of millions of more individuals into the health care system, which would likely commence in about 5 years. By comparison, the branded-drug companies, while also benefiting from increased future volumes, would face an annual industry tax of \$2.3 billion starting next year and could ultimately be subject to pricing dictates from a proposed Medicare Commission charged with controlling Medicare's rate or per-capita cost growth. In this example, it is important to note there are further subtleties in assessing the impact of relative winners within a given subsector. Specifically, among generic manufacturers, there are varying exposures to sales and profits of branded drugs.

Another example is the medical device sector. While medical device utilization would increase with more insured individuals, again starting in about five years, companies that make high-tech devices—so called Class 2 or 3 devices, such as pacemakers, heart valves, x-ray machines, and orthopedic implants—could be subject to an annual industry tax of \$4 billion starting next year. However, companies making Class 1 low-tech devices—items such as tongue depressors, bandages, and handheld surgical instruments—could be relatively exempt from annual taxation.

## Conclusions

We believe that the current health care system is unsustainable, and note that none of the current bills in either chamber of Congress appears to address the fundamental issue of bending the cost curve to curtail the current health care spend trajectory. We see limited reform as the most likely outcome of the current legislative debate. In this context, we see business models as being the defining factors in determining relative winners and losers.

We are currently in a dynamic period of remarkable change for the U.S. health care system, where a thorough framework for assessing winners and losers, both between and within subsectors, is needed. Differentiation of superior business models has only just begun, which we believe will lead to a significant dispersion in investment returns.



## NOTES

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1. Based on an independent, non-partisan analysis done by the Lewin Group as of 4 June 2009.

## IMPORTANT INFORMATION

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