Investment Insight

Healthcare: A Compelling Opportunity for Long-term Investors

Healthcare has been an important source of opportunity for our World Stars Global Equity strategy. At the end of 2023 our exposure to the sector was 16%.

The global healthcare market is a substantial part of the global economy. It is valued at approximately US$166 billion and projected to exceed US$283 billion in 2027, while global health spending is forecast to rise by more than 40% over the next two decades according to the US health institute IMHE. Healthcare accounts for around 18% of US GDP alone.

It is a diverse sector, encompassing an array of different businesses ranging from medical services, manufacturing equipment, drugs and facilitating patient care, to name but a few. We are highly selective about the companies we invest in, preferring companies that are in medical diagnostics or equipment, tools, and ethical pharmaceuticals.

We recently contributed to an article published in Forbes magazine entitled "How to invest in healthcare" and were asked to answer several questions that would help inform its readers. We wanted to share Forbes' questions and our responses with you in full for this month's investment insight.

Healthcare sector performance

The sector's performance since 2020 has been significantly impacted by pandemic factors including the closures of hospitals to non-urgent treatment as healthcare systems prioritised Covid patients. Having benefited from Covid testing and treatment revenues during the pandemic there has since been a sharp decline in revenues. Although the underlying growth of our companies remained strong, challenging comparisons (from Covid-related sales) to the prior year led to muted results in 2023.

The medical technology sector has also more recently suffered from indiscriminate selling pressure because of investor fears of a reduction in the total addressable market as a new class of weight-loss drugs, known as GLP-1, entered the healthcare mainstream. Created to treat diabetes these drugs have demonstrated significant metabolic improvements in multiple medical conditions such as cardiovascular disease, sleep apnea, progression in diabetes and kidney disease, to name just some.

We expect the drag from Covid-related revenues to continue to fade as the underlying strength of companies in the sector becomes ever more evident. We believe that as investors digest GLP-1 data, they will become more selective on which companies will benefit from its presence. Whilst the healthcare system is moving towards normality, we believe that the accumulated backlog over the pandemic years is likely to keep demand for some parts of healthcare services elevated.

The case for investing in healthcare

The biggest driver for the demand for healthcare is the ageing population in the developed world and the rise of income in emerging markets. We believe this structural trend of rising demand will continue for many years to come. The number of people aged 60 or older is projected to double, reaching nearly 2 billion by 2050, with most of the increase in developing countries, according to the World Health Organisation. By 2030, The American Hospital Association estimates that more than 60% of the Baby Boomer generation will be managing more than one chronic condition, leading to increased financial demands on healthcare systems. Innovations and better treatments to meet unmet medical needs will drive value-added benefit to both the healthcare system (by saving more lives and lowering the overall cost of care) and the companies that offer them.

Historically, the healthcare sector has been inefficient for several reasons, including its labour intensity and the high degree of regulation of data sharing. There is a significant scope to do better in terms of cost by deploying data, AI and digital solutions across the spectrum, from R&D, sales and marketing and back office to manufacturing, to improve profit margins and profitability.

On the other hand, healthcare expenditure in major developed economies has been rising above GDP. For example, in the US, the Centers for Medicare & Medicaid Services (CMS) projects healthcare expenditure to grow 5.4% pa between 2021 to 2031 and as a share of GDP to increase from around 18% in 2022 to 20% in 2031.

In the UK, where the National Health Service (NHS) provides most of the care, access to innovations is more measured. Prices tend to be significantly lower than those in the US because they are negotiated in bulk at the national level. Healthcare expenditure as a share of GDP, though lower than that of the US, still stood at 11.3% in 2022 (ONS).

Rising costs have put pressure on governments and private payers to seek price concessions through price negotiation, tendering, value-based procurement (VBP), and adoption of the use of generic and biosimilar drugs.

Governments have also started to look at ways to reduce the scope of intellectual property and shorten the exclusivity period. The Inflation Reduction Act in the US is one example of this. The CMS has started the process of drug pricing negotiation for the highest-cost ten small molecule drugs that have been on the market for the past nine years, regardless of whether the patent has expired. The CMS is expected to release its pricing in the autumn of this year, while the final pricing will be decided after further negotiations and ready for implementation in 2027.

What this means is that the industry will be facing more price pressure going forward and that only truly innovative products that offer significant value to the healthcare system will still command premium pricing.

Besides the bigger picture, from a company perspective, clinical development and its success or failure can cause significant share price movement. Reimbursement and wide access to the product are also key factors underpinning whether a product will be a commercial success.

Healthcare highlights from the World Stars portfolio

We hold *Alcon*, a leading medical device company in eye care providing equipment, consumables and lenses for cataract surgery, as well as contact lenses and ocular care solutions for dry eyes, glaucoma and allergies. Spun off from Novartis in 2019, the newly independent company has a clear sharp focus on improving its performance through innovations to accelerate revenue growth. Over the past two or three years, the management has invested in state-of-the-art manufacturing and launched several new products, and operating margins have started to improve. We are on the multi-year journey of receiving the benefits from these efforts. We expect the company to deliver superior revenue and earnings growth in the next several years.

Another holding is *Thermo Fisher*, the world's leading life sciences company with a 15% share in its addressable market. The life sciences industry benefits from strong structural growth trends, including demand for biologics, robust pharma pipelines and a growing focus on precision medicine. *Thermo Fisher* has been a consolidator in a still fragmented industry, with an exceptional track record in integrating acquired assets. It has a strong innovative track record within its core businesses, supported by the highest R&D budget in the industry at US$1.5bn, underpinning its pricing power and gross margin structure.

It offers the broadest portfolio in the industry, with products and services across the value chain. The strength of the operating model became clear during the Covid-19 pandemic with the company participating in over 250 projects related to research and vaccine development as well as offering a wide range of testing solutions. In so doing it generated over US$23bn in revenues in the period 2020-23 that it reinvested in R&D, organic capacity expansion and acquisitions. This included the US$17bn purchase of clinical research provider PPD, further entrenching its leadership position within the sector and expanding its addressable market.

The outlook for healthcare

We expect the drag from Covid-related revenues to continue to fade as the underlying strength of companies in the sector becomes ever more evident. This sets the scene in 2024 for the return to the fundamental drivers of healthcare. We do not see major structural changes in the sector but as investors continue to digest data from GLP-1, they will become more selective on which companies will benefit from this important new class of drugs.

Over the medium-term, the healthcare sector will innovate and come up with devices that address new and unmet medical needs. As an example, statins have been prescribed not just to lower bad cholesterol levels but also to reduce the risk of heart attack and stroke. Today, more than 200 million people globally are on statins since the first statin was approved. The US presidential election in November will cast some clouds over the pharma sector as the drug pricing debate and the first set of price negotiations under the Inflation Reduction Act (IRA) are important political topics. This may impact the performance of the sector over the short term.

However, over the long-term, we see constructive opportunities, driven by the strong demand of the ageing population in the developed world and the rise of incomes in emerging markets. We believe companies with true innovations that address unmet medical needs and save and improve lives will continue to thrive despite increasing pressures on price.

Zhixin Shu, CFA
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J. Stern & Co.

The Value of Long-Term Investing