Disruption in the Health Care Industry

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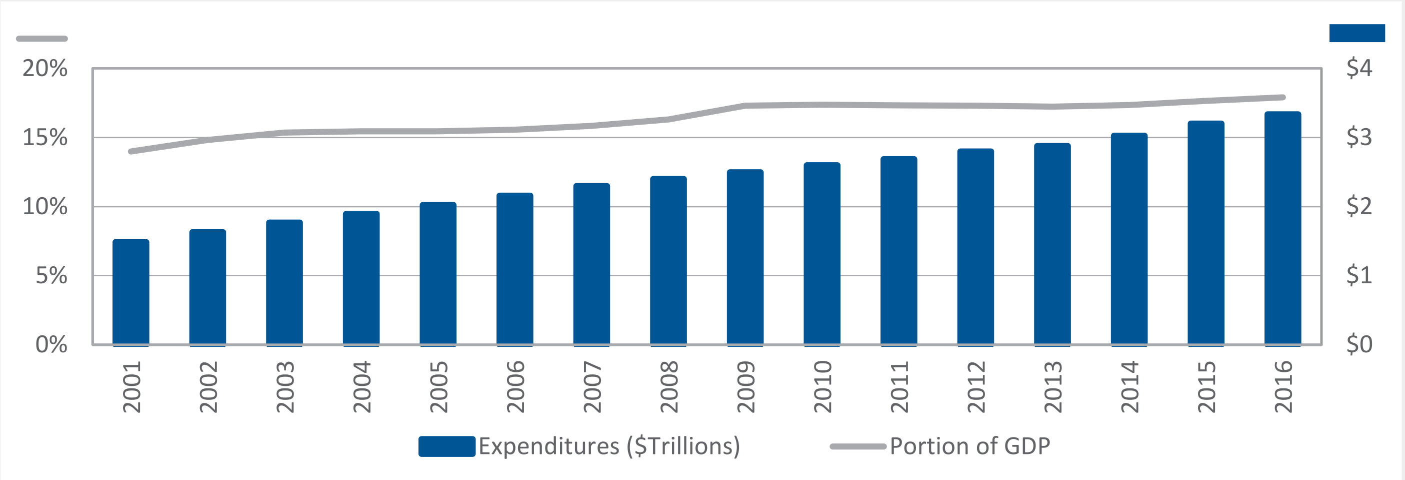
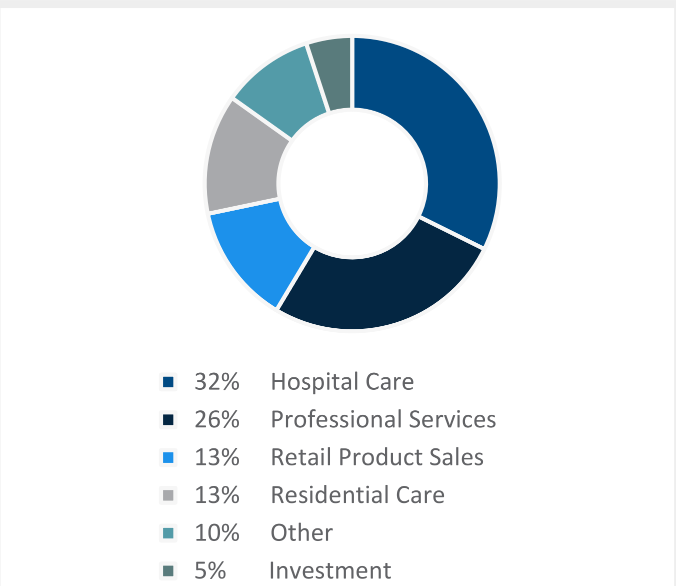
As complexities and expenses have increased, the US health care industry has become a growing target for disruption. Health care spending as a percentage of US GDP has more than doubled in the past 40 years, from 8.1% in 1976 to 17.9% in 2016.[1] Health care expenditures have also shifted across different categories over time, with hospital care now representing the single largest category. Retail outlet sales of medical products (pharmaceuticals and medical equipment), residential, home health, and nursing facilities administration have noticeably increased, alongside drops in research and investment spending.

NATIONAL HEALTH CARE EXPENDITURES (% OF GDP)



Source: CMS as of May 31, 2018

2016 HEALTH CARE EXPENDITURES



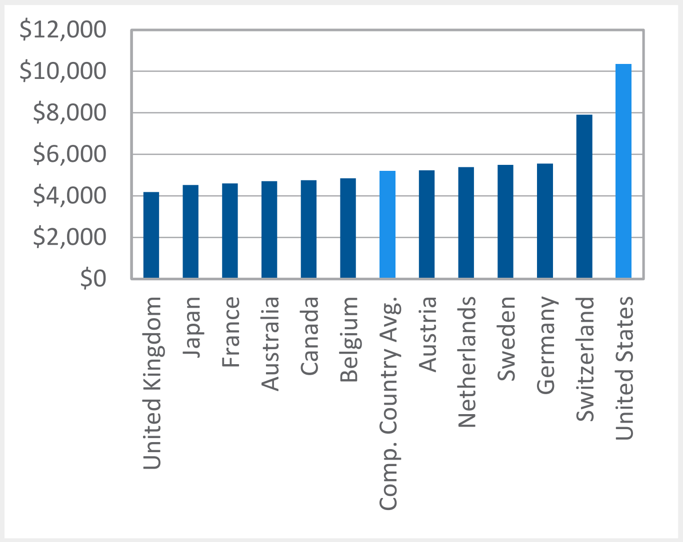
Source: CMS as of May 31, 2018

Disruption

We believe that technology, lack of price transparency across the health care supply chain, and general obscurity throughout the extraordinarily complex $3.3 trillion system have all made the industry a target for disruptive technologies. The issue has also become highly political, drawing the attention of the executive branch. In a recent speech, President Trump presented a blueprint, though light on details, for slowing the rise of health care costs.

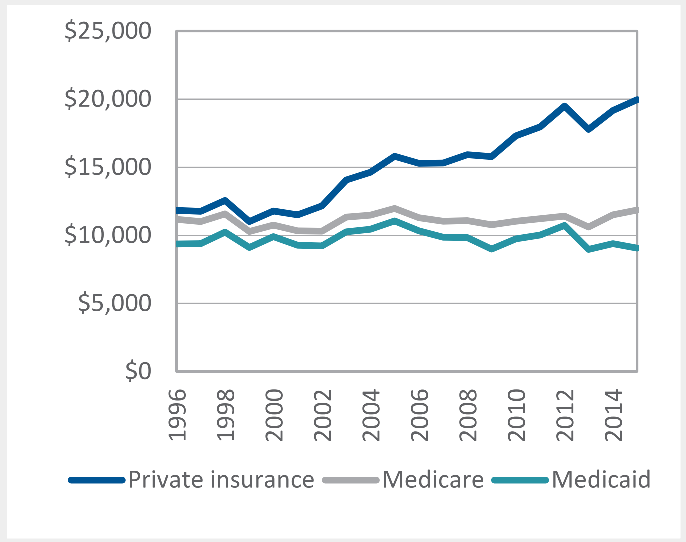
In February, Amazon announced that it was teaming up with two of the leading corporate giants across different verticals, Berkshire Hathaway and JPMorgan, to create an independent health care company for their US employees. And on June 20th, the next step in their partnership was announced with the appointment of Dr. Atul Gawande as its Chief Executive Officer, effective July 9th.

TOTAL HEALTH CARE EXPENDITURES PER CAPITA



Source: 2016 National Health Expenditures Account and OECD Health as of May 31, 2018

PRICES FOR INPATIENT BY PAYER



Source: Thomas M. Selden analysis of AHRQ's Medical Expenditure Panel Survey for the Kaiser Family Foundation as of May 31, 2018

The company will be "free from profit-making incentives and constraints" and focused on technology solutions to solve the problem of rising health care costs.[3] The consortium will be led by executives from the three companies. While the new company will initially serve the consortium's employees, it could eventually offer products to other consumers as well.

POTENTIAL MARKET IMPACTS

The near-term impact of this initiative looks limited as sub-sectors like health insurance benefit from a head start in terms of data, technology, network, business platform and pharmacy access. The health insurance space is also a very complex system with regulatory hurdles. Although the administration has attempted to pass regulatory reform, they have not yet been able to agree on changes. But the technological, operational and financial strength of the consortium may have significant potential to transform the industry over time. Currently, the three companies employ over 1 million individuals across the globe[4]. Amazon brings technical and consumer-related experience. JPMorgan brings capital markets and M&A expertise. Berkshire Hathaway brings regulatory experience and knowledge across diversified industries – from rails and utilities to industrials and insurance, although it lacks a health care subsidiary as of yet.

The entrance of disruptive forces in the health care space has caused companies to play defense. As a result, we are seeing vertical integration deal announcements as horizontal M&A deals were largely shut down by regulators a couple of years ago due to anti-trust concerns. CVS is currently in the process of acquiring Aetna, while Cigna is looking to acquire Express Scripts. One of the key risks for credits in the near term is how defensive positioning will impact balance sheets. CVS raised $40B in the debt capital markets to fund the Aetna deal, the third largest corporate bond deal to date as seen on the table on the left. It will see leverage rise and its ratings downgraded in the short term, with the goal of de-leveraging post-close. Cigna also plans to raise $22.5B in the debt markets to fund the Express Scripts deal, which will also increase leverage.

TOP 4 LARGEST CORPORATE BOND DEALS TO DATE	
Verizon (2013)	$49B
Anheuser Busch Inbev (2016)	$43B
CVS (2018)	$40B
AT&T (2017)	$22.5B

Market reaction tends to be sell first and ask questions later. Since last year, the fear of Amazon entering the health care space has sent ripples across the sector, similar to what transpired in the grocer space following Amazon's acquisition of Whole Foods. Although drug suppliers' share prices were initially impacted after the October announcement of Amazon's plans to enter the market by gaining pharmacy distribution licenses, they have since retraced some of the weakness related to the announcement.

LINGERING QUESTIONS

A flurry of mergers & acquisitions, tax reform, strong balance sheets, demographic shifts, and a severe flu season provided some uplift to health care stocks earlier this year. But health care inflationary pressures continue to be tackled. In January, three of the largest not for profit systems in the country including Ascension, Intermountain Health, and SSM Health announced plans to create their own independent non-profit drug company. The project will be done in consultation with the Department of Veterans Affairs[5].

Still, many unanswered questions could weigh until the risks are better understood.

- Will other employers join the Amazon consortium?
- Would the consortium look to partner with insurers?
- How will the consortium keep insurance costs competitive?
- Is this initiative in conjunction with other Amazon ambitions in the health care space?
- What actions will other health care names take in defense?
- How will disruption impact not for profit health care systems, which account for over two thirds of hospital beds in the nation?

We will continue to closely watch the health care space as these disruptions progress.

ENDNOTES

[1]"National Health Expenditures; Aggregate and Per Capita Amounts, Annual Percent Change and Percent Distribution: Selected Calendar Years 1960-2016," Centers for Medicare and Medicaid Services, www.CMS.gov

[2] ibid.

[3]Wingfield, Nick, et al. "Amazon, Berkshire Hathaway and JPMorgan Team Up to Try to Disrupt Health Care." The New York Times, The New York Times, 30 Jan. 2018, www.nytimes.com/2018/01/30/technology/amazon-berkshire-hathaway-jpmorgan-health-care.html.

[4]Johnson, Carolyn Y. "Amazon, Berkshire Hathaway and JP Morgan Chase Join Forces to Tackle Employees' Health-Care Costs." The Washington Post, WP Company, 30 Jan. 2018, www.washingtonpost.com/news/wonk/wp/2018/01/30/amazon-berkshire-hathaway-and-jp-morgan-chase-join-forces-to-tackle-employees-health-care-costs/.

[5]Byers, Jeff, et al. "Health Systems Wade into Drug Manufacturing, Eyeing Prices and Shortages." Healthcare Dive, 19 Jan. 2018, www.healthcaredive.com/news/health-systems-wade-into-drug-manufacturing-with-eye-on-reducing-shortages/515131/.

IMPORTANT DISCLOSURES

GENERAL DISCLOSURES

FORWARD-LOOKING STATEMENTS