June 2013

STATE OF THE SECTOR

Health Care

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KEY TAKEAWAYS

- Throughout numerous business cycles and periods of extreme market volatility, health care has been one of the market's most consistent performers. Looking ahead, the advent of new medical breakthroughs could contribute strongly to the sector's near- and long-term results.
- Health care earnings growth was slightly negative for the third consecutive quarter, driven by patent expirations in the pharmaceuticals sector, which offset growth in other subsectors.
- Free cash-flow yield, one of several valuation metrics for the health care sector, continued to remain inexpensive relative to historical norms.
- *Research Spotlight:* The innovation cycle in health care appears to be improving, especially within biotechnology and health care technology. Companies in these industries create novel treatment modalities and will prepare consumers and payers for the transition of health care to a more value-based system.

Earnings Scorecard

Q1 2013	Earnings Growth Actual (%)	Initial Earnings Growth Est. (%)†	Revenue Growth Actual (%)	Initial Revenue Growth Est. (%)†
MSCI U.S. IMI 2500*	3.8	3.6	0.6	1.9
Health Care	**–0.3**	**0.6**	**5.2**	**5.5**
Biotechnology	2.3	9.1	7.9	8.0
Health Care Equipment & Supplies	1.4	4.4	–7.4	–6.3
Health Care Providers & Services	10.9	7.9	10.2	9.6
Health Care Technology	8.3	26.6	7.6	10.6
Life Sciences Tools & Services	6.6	5.4	3.7	4.1
Pharmaceuticals	–7.0	–6.2	–3.7	–1.3

**MSCI U.S. Investable Market 2500 Index represents the investable universe of companies in the U.S. equity market. Health care companies of the MSCI U.S. IMI 2500 are classified according to the Global Industry Classification Standard (GICS®). †Initial Earnings Growth Estimate and Initial Revenue Growth Estimate reflect a consensus of Wall Street analysts' expectations prior to the start of the quarter. Data reflect reported operating earnings/revenue for 93% of all companies and 95% of health care companies in the MSCI U.S. IMI 2500 Index, combined with earnings estimates for the remaining firms. Source: Fidelity Investments, FactSet as of May 31, 2013.*

Update on fundamentals

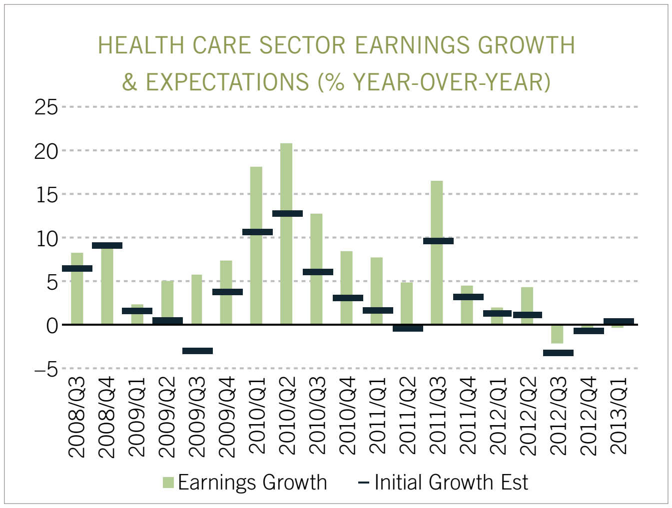
Macro backdrop

In Q1, equity markets—including the health care sector—largely shrugged off the lingering effects of the European sovereign debt crisis and U.S. fiscal woes, and rallied on the rebound in U.S. housing, improved consumer confidence, and the Federal Reserve's ongoing accommodative monetary policy.

Despite the uncertainty over the global growth outlook, the health care sector continued to perform well on an absolute return basis. This further emphasizes that the demand for health care continues to be very stable through multiple economic cycles, as an aging population consumes more health care, both in the U.S. and around the world, and people survive longer with chronic diseases. Emerging markets have also contributed to the sector's growth, responding to the growing demand for better health care from a burgeoning middle class. These secular trends should provide a similar investment backdrop going forward.

The combined earnings growth reported by health care companies fell slightly short of analysts' expectations during the

EXHIBIT 1: Earnings growth in the health care sector slightly trailed analysts' expectations in Q1 2013.



Earnings based on 95% of health care companies reported as of May 31, 2013. Initial Growth Estimate (i.e., "Expectations") reflects a consensus of Wall Street analysts' expectations prior to the start of the quarter. Source: FactSet as of May 31, 2013.

first quarter of 2013 (see Exhibit 1, right). This was largely due to the negative earnings growth in the pharmaceuticals industry. Pharma is by far the largest segment of the health care sector, representing more than 40% of the MSCI U.S. IMI Health Care 25/50 Index (the health care sector component of the broader MSCI U.S. Investable Market 2500 Index) as of May 31, 2013. The next largest industry component is health care equipment, at roughly 19%. Despite the sector's lackluster earnings growth in aggregate, health care was the market's best-performing sector on an absolute basis in Q1 2013, returning 15.7% and outperforming the 10.6% return of the broader market, as measured by the S&P 500.

Industry-specific highlights

A pattern of negative earnings results for pharmaceutical companies persisted in Q1 2013. The primary culprit was the ongoing expiration of valuable patents. Looking forward, much of this headwind is now behind the industry and, as product pipelines mature and expand globally, it should return the industry to growth. Pharmaceutical stocks outperformed the broader health care sector in Q1 2013, benefitting from large-cap companies with shareholder-friendly capital allocation policies. Certain pharmaceutical firms with high free-cash flow (FCF) and attractive dividend yields also delivered respectable returns.

Biotechnology continued to perform well, thanks largely to a strong and diverse pipeline of new treatments and the launch of multiple novel products across many disease categories. This potential high-growth theme is discussed in greater detail later in this report (see *Research Spotlight*, page 3).

Health care technology stocks have also done well. As health care payers begin to shift toward value-based purchasing and abandon fee-for-service payments, hospitals are leaning heavily on their IT systems to understand their cost structures and revamp their care-delivery models. Moving health care into the digital economy should drive productivity throughout the system and ultimately lower costs.

Health care equipment and supply companies face a difficult market in the U.S. due to an increased focus on cost containment. However, these multinational companies have enormous growth potential in emerging markets, as new hospitals are built and the health care infrastructure expands to accommodate millions of people who can now afford medical care. Providing health insurance to this emerging middle class is a national priority for many governments. Meanwhile, the health care providers and services industry posted a 10% revenue gain for the first quarter of 2013. However, mandatory spending cuts due to the federal government's budget sequestration could potentially reduce Medicare reimbursements by 2%, which would likely compress profit margins in the industry.

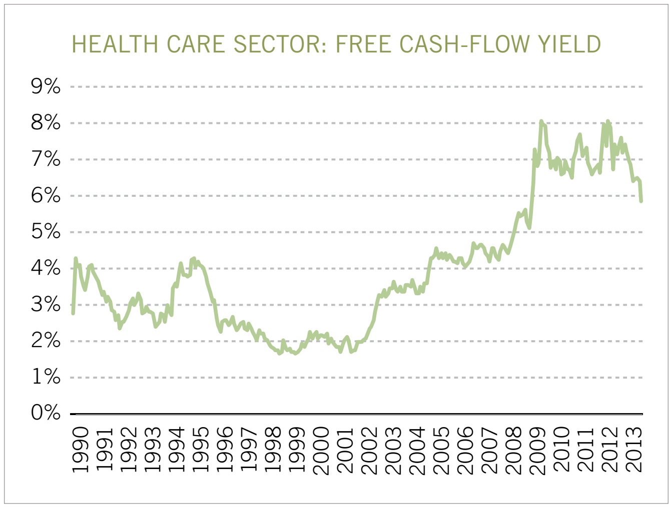
The Affordable Care Act, which begins its final phase of implementation in 2014, could have a positive impact on health care utilization, as approximately 30 million uninsured Americans will gain coverage. While insurance companies will likely benefit from an increase in enrollment, profitability may continue to come under pressure. However, other parts of the health care supply chain could see increased use of health care products and services.

The expansion of Medicaid should also be a positive for managed-care companies focused on the Medicaid population, which is expected to grow to an estimated 84 million people by 2022.[1] The rapid growth of Medicaid won't necessarily translate into free-cash flow for managed-care companies, so I view this group with a certain amount of skepticism given how difficult it will be to underwrite the Medicaid population and the industry's already slim profit margins.

Assessing valuations

Despite the strong performance in the first quarter of 2013, valuations within the health care sector remained low by historical measures on a free cash-flow yield basis. This method of stock evaluation measures a company's free cash flow compared to its market price. A high FCF yield usually represents a good investment opportunity, since investors would be paying a small price and getting high earnings in return. A company with a strong free cash flow has the ability to build its business by launching new products, paying off debt, or other investor-friendly measures. Currently, the FCF yield of the overall health care sector is above its historical average, which is indicative of strong investment value, but it has declined from recent highs as the stocks have appreciated (see Exhibit 2, below).

EXHIBIT 2: Free cash-flow yield in the health care sector remains high, but has fallen steadily since 2011.



Source: FactSet, as of May 31, 2013.

(continued on page 4)

RESEARCH SPOTLIGHT

Biotechnology and Information Technology: Creating the Next Breakthroughs in Medicine

Within the health care sector, the biotechnology and health care information technology industries are playing a leading role in advancing not only medicine, but also in reforming the U.S. health care system as providers seek to improve value, quality, and efficiency of care.

Biotechnology delivers inventive approaches to treating disease

Unlike pharmaceuticals' iterative approach to innovation (e.g., combining doses into a single pill or tweaking the formulation of an existing drug) biotech firms target diseases in fundamentally different ways, creating novel categories of drugs with entirely new mechanisms of actions—all at a rapid-fire pace. The innovation cycle in biotech is potentially hitting its sweet spot and has driven strong results.

The FDA approved 18 new biopharmaceuticals in 2012, and recent clinical trials in multiple disease categories have been promising. More than 40% of new drugs in development are biopharmaceuticals instead of conventional drugs.[2] Biologics already on the market have done well, underpinning biotech companies' sales, earnings, and free-cash flow. These drugs include Avastin, Herceptin, and Rituxan, which are among the world's top-selling cancer drugs. Biologics now comprise nearly one quarter of the $320 billion spending on pharmaceuticals in the U.S. each year.[3]

Products from biotech companies have become major game-changers in medicine. Pending approval from the FDA, a new drug will be launched this year that boosts cure rates for chronic hepatitis C. Other breakthrough therapies include those that treat several types of cancer, multiple sclerosis, and cardiovascular disease. These innovations fundamentally change the life expectancy and quality of life for patients with these diseases.

Biologics cannot be copied identically in a generic form, so these complex drugs currently don't face the same competition from generics that conventional drugs do. While this may change in the future, regulation continues to muddle its way through the political process. In addition, a considerable portion of research at biotech companies is funded with private market capital, making discoveries less vulnerable to federal cutbacks from the National Institutes of Health.

Biotech innovation involves more than creating new modalities to treat disease, however. The industry is also taking advantage of our newfound understanding of the human genome. Ten years ago, the first human genome was sequenced at the cost of $3 billion. Today, sequencing a subset of an individual's genes costs as little as $5,000.[4] This is providing biotech companies with a better understanding of the underlying causes of disease, which will eventually lead to smarter, more efficacious medicines.

DNA-based diagnostic tests are on the horizon that will determine which patients will respond to a particular therapy, thus eliminating costly and ineffective drug regimens. Molecular diagnostics may soon be able to screen for specific genetic mutations that cause one drug to be harmful and another safer for an individual. Such patient-centric medicine will save the health care industry billions of dollars a year and provide better and safer care.

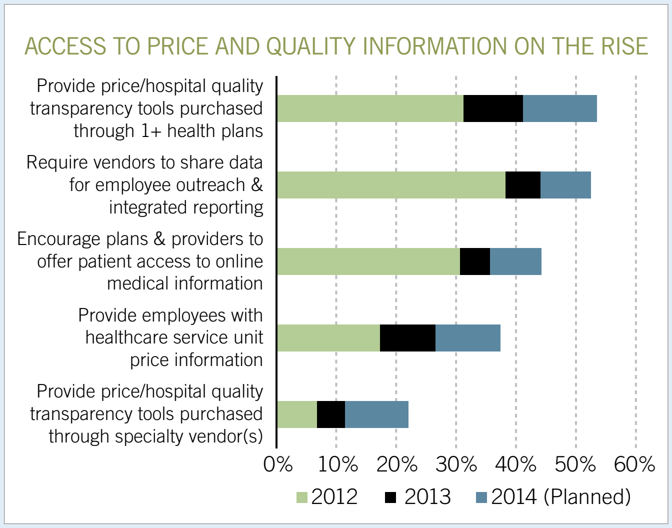
Technology helps drive innovation

As patients look forward to customized treatments based on their genetic makeup, they are also being given greater responsibility for individualizing their care. With employers moving employees into high-deductible health care plans, consumers will have to make more decisions about how to use their health care dollars effectively, since they will pay for a greater share of medical care out of pocket.

Companies that can help consumers get the most value for their health care dollars will be at the forefront of a powerful new trend toward consumerization of health care. Employers are looking to tech companies to give their employees the right tools to manage their health benefits (see Exhibit 3, below). Imagine going to an Amazon.com-like portal and being able to compare costs for knee-replacement surgery among different doctors.

Employers and other payers are also demanding more data on safety and outcomes from hospitals, and will require hospitals to share risk with providers through accountable care organizations. Hospitals look to health care tech companies to move them from the analog to the digital world to meet these data demands and to benefit from—rather than suffer the financial consequences of—a rapidly shifting payment model. Today, few software vendors can offer hospitals the solutions they need to adapt to the new world of payment reform, making these companies a potential sweet spot for investment.

EXHIBIT 3: Employers want today's health plans and providers to arm employees with the best tools and services available.*



**Percent of respondents to Towers Watson/National Business Group on Health (NBGH) Employer Survey on Purchasing Value in Health Care. Source: Towers Watson/NBGH, "Reshaping Health Care: Best Performers Leading the Way," March 2013.*

Outlook for health care stocks

The health care sector has the potential to continue to deliver strong performance in the months and years to come. Key investment opportunities will focus on companies that can provide innovative solutions to reduce the nation's rising health care costs, which, at 18% of current GDP, are on an unsustainable path. These companies typically have disruptive business models that can exert deflationary forces on spiraling health care costs.

As the U.S. health care system evolves into one where value—rather than overuse of medical care—is rewarded, the quality and efficiency of care will naturally follow suit. New businesses will form that help hospitals and physicians fundamentally rethink the way they approach medical care. Reimbursement will focus on performance and quality outcomes. Consumers will be asked to make more-informed decisions regarding their own health care, and technology companies will provide these enabling tools. For example, we may see pediatric clinics staffed around the clock, commanding higher reimbursement rates from payers who would rather have patients treated in clinics than in hospital emergency rooms. Families could find these clinics, read reviews, and see prices on their smart phones. This is the type of evolution I expect to see in the modern health care delivery model.

Author

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Endnotes

[1] Source: Congressional Budget Office estimate, Feb. 21, 2013.

[2] *BioProcess International*, "FDA Biopharmaceutical Product Approvals and Trends in 2012," March 2013.

[3] IMS Institute for Healthcare Informatics, "The Use of Medicines in the United States: Review of 2011," April 2012.

[4] *Nature News*, "Gene Sequencing Leaves the Laboratory," Feb. 19, 2013.

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