Part 8. The defensiveness of the Healthcare sector during covid-19 with John Wylie, Head of Healthcare

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John Wylie, Head of Healthcare
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Jennifer Herbert:

Hello and welcome to our new investment insights series, Magellan Minutes, in which our investment team dissects the markets and take a deeper look into sectors and stocks in our global portfolios. My name is Jennifer Herbert, key cap management at Magellan. And, over the next ten minutes, I'll be talking to Magellan's head of healthcare, John Wiley, about our current views on the healthcare sector. Thanks for joining us, John.

John Wylie:

Thanks Jen. It's a real pleasure to chat today.

Jennifer Herbert:

John, how defensive has the healthcare sector proven to be in the current environment?

John Wylie:

Well, Jen, at Magellan we segment our healthcare universe into three broad categories. The first is our globally diversified pharmaceutical bucket. The second is our healthcare infrastructure portfolio. And the third is our medical devices and specialty products franchise.

With respect to defensiveness in recent market conditions, demand for pharmaceutical products is highly inelastic. And what I mean by that is, you don't stop taking a lifesaving therapy in the event of either a recession or, indeed, a health care crisis. Those therapies are non-negotiable and you'll continue to fill your prescriptions. In the recent market conditions. We've also seen, not only patients continue to fill their prescriptions, but also fill them a little bit in advance. We've also seen some hospitals build inventory in advance of the current virus induced healthcare crisis. So, the global diversified pharmaceuticals have actually held up very well in the recent market environment.

The second and third segments that we spend our time on in the healthcare team have been rather more effected by the recent market conditions. With respect to our healthcare infrastructure portfolios, And what I'm thinking about there is our hospital type investments, those assets have been materially impacted by a global shutdown in elective surgical procedures. And that shut down is rather temporary in nature. These are procedures that must occur, but because they're not an emergency, it's possible to defer them. And given the fixed cost structure of a lot of those healthcare infrastructure assets, that's had a rather meaningful impact on shorter term earnings. And that's something that we're monitoring very carefully.

And then, I mentioned the third segment inside our healthcare universe where we're focused, and that's the medical devices and specialty product segment. That's been subject to many of the same adverse impacts as our healthcare infrastructure segment.

Jennifer Herbert:

The Magellan global fund has two key healthcare holdings, HCA and Novartis. Let's address HCA first. We were watching the political situation in the U.S. closely and then COVID-19 hit. What's our view on HCA now?

John Wylie:

Well, you're spot on, Jen. Very late last year, we became increasingly concerned about HCA's exposure to political risks in the run into the U.S. election later this year. In response to that concern, we spent quite a bit of time in Washington trying to unpack the puts and takes on that risk as it pertained to HCA. In response to that diligence, we actually made a decision to materially reduce our HCA exposure late last year. And so, we've retained a much smaller HCA position in the global fund coming into this crisis. And we continue to retain that position to date.

With respect to HCA's near term earnings drivers, we're very, very comfortable looking through the short term impact from the elected surgery deferral and the consequences that has on their earnings in the short term or short to medium term. But our key concern, with respect to our HCA holding, or the key risk we're managing, rather, is that in the U.S. private insurers pay hospitals considerably more than government payers or other alternative payers. So, in the U.S., because your employer typically pays for your private health insurance, if unemployment rises, then your ability to access private health insurance, and in turn HCA's ability to receive superior reimbursement from that private insurer relative to alternatives, could be compromised.

Jennifer Herbert:

Yes. That's interesting, John. How are you thinking about peak unemployment? In our last chat with [inaudible 00:00:04:59], he noticed that Magellan doesn't currently have a strong view on whether the recovery will be U shaped or somewhat more prolonged.

John Wylie:

That's quite right, Jen. And we work obviously very closely with our macro team as we try and frame up some of those inputs to our individual company models. HCA, as I mentioned, is acutely exposed to the degree of adverse mix shift from, as people become unemployed, they lose that private coverage and are forced to seek coverage via alternative payers. Because we don't have a great conviction with respect to the duration until peak unemployment, and indeed the duration of the subsequent unwind from peak unemployment, our response has been to run a whole load of different scenarios for HCA, such that we understand the impact on their profit and loss statement deeply under various scenarios.

And the output of that diligence was there are a number of scenarios where, at the current price, HCA is relatively attractively valued. And, of course, there is a tale of scenarios, even at the current price, which would make us far more concerned about our exposure to this particular investment. That said, given our current overlay with respect to our macro economic view, we currently feel we're being adequately compensated for the risk that we're bearing on this particular investment. But, given the acute sensitivity to this unemployment input, it's something that we're monitoring very, very closely as we go forward.

Jennifer Herbert:

Now turning to Novartis, the pharmaceutical company, has Novartis proven to be as defensive as we would have hoped in the current environment?

So, Jen, I think I touched on at the outset that demand for Novartis's products and big pharma in general has been particularly inelastic in this crisis, which has been a source of some comfort for us with respect to our Novartis exposure. The additional comfort for Novartis comes from the fact that they're uniquely diversified across six key therapeutic areas. So, some of those areas are more defensive than others. Novartis's primary exposures to oncology, immunology, and neuroscience have been a source of great comfort with respect to antibiotics exposure.

There is one therapeutic area for Novartis, which is their ophthalmology franchise. And that franchise has been significantly more disrupted than other parts of their business. Fortunately, that franchise only represents approximately 10% of their revenue, but the challenge for that particular franchise is, when you visit your optometrist, you're doing so to receive a therapy that's essential to retain your existing vision, but it's not necessary to conduct that procedure immediately. So, as economies have entered lockdown, because that procedure is deferrable in the short term, we've seen a material impact, and will see over the coming quarter, a materially impact on that particular slice of Novartis's business. But, as I said, their diversification across a whole load of different therapeutic areas allows us to look through some of that short term pain in one particular therapeutic area.

John Wylie:

That said, there are two risks that we're acutely focused on for Novartis. The first risk is Novartis has very recently brought a lot of interesting technology to the market that will improve the standard of care for a number of different conditions. And they've also recently acquired a number of interesting assets where they're shortly going to bring those drugs or therapeutics to market. And the dilemma they face as economies have gone into lockdown is it's really hard for patients to go and visit their physician. And it's also really hard for the physician to move the patient onto a better, highly efficace standard of care without visiting them in person.

So, until patients can freely see their physicians, and that's conditional on the duration of the lockdown in many economies, it will be hard for Novartis to build the launch traction they need on some of those recent drug approvals or recent acquisitions. It's important that Novartis execute on their launch profile for these recent drugs, after a relatively short lockdown duration, hopefully. Because these drugs are important to bridge patent expirees that are going to occur down the track. So, the growth profile of those new launches is important to try and offset that inevitable patent duration at some point, going forward.

The second risk that Novartis is exposed to that we're monitoring carefully is Novartis has some exposure to exactly the same unemployment mix impact that I was talking about with respect to HCA. Fortunately for Novartis, their exposure to that adverse mix effect is far less material than it is for a business like HCA. And that relatively lower materiality comes from the fact that only 35% of Novartis's revenue is earned in the U.S. And indeed, their mix of revenue in the U.S. we think is relatively favorable, certainly relative to a number of their different competitors.

Jennifer Herbert:

Do you think the stock is fairly priced? And what do you see as the risks and opportunities going forward?

John Wylie:

Well, Jen, I think I touched on a number of the risks that are on our mind for Novartis in our prior question. The key highlights for us, with respect to the Novartis investment thesis, is the comfort we derive from Novartis's diversification by therapeutic area, and also importantly, their diversification with respect to patent duration as well. And what those two things give us is they give us a lot more conviction that we're not exposing ourselves to binary scientific risks, which aren't easy to forecast with great accuracy consistently.

So, we have a set of relatively conservative assumptions for Novartis. And, on those assumptions, we have a view that the stock is currently fairly priced. But, outside those assumptions, we also have a number of cases where we attribute value to what we think is substantial unpriced upside, should Novartis continue to execute well on a number of the new technology platforms that they're currently rolling out and where we think they're early to market and have substantial competitive advantages. And I'd reference gene therapy is one of those unpriced options where we think we're able to capture future upside, should they continue to execute as we expect.

Jennifer Herbert:

John, thank you so much for your insights. If you have any questions, please do not hesitate to contact me on jennifer.herbert@magellangroup.com.au. And finally, please feel free to share this update with clients or colleagues as you see fit. Take care and stay safe.