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Health care convalescence

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Health care stocks are playing catch-up after about six quarters of underperformance, with many stocks still in the bargain bin, particularly beaten-up biotechs. Is health care a buy? We believe in a selective approach; a dynamic of haves versus have-nots means that health care is increasingly *all* about stock picking.

Highlights

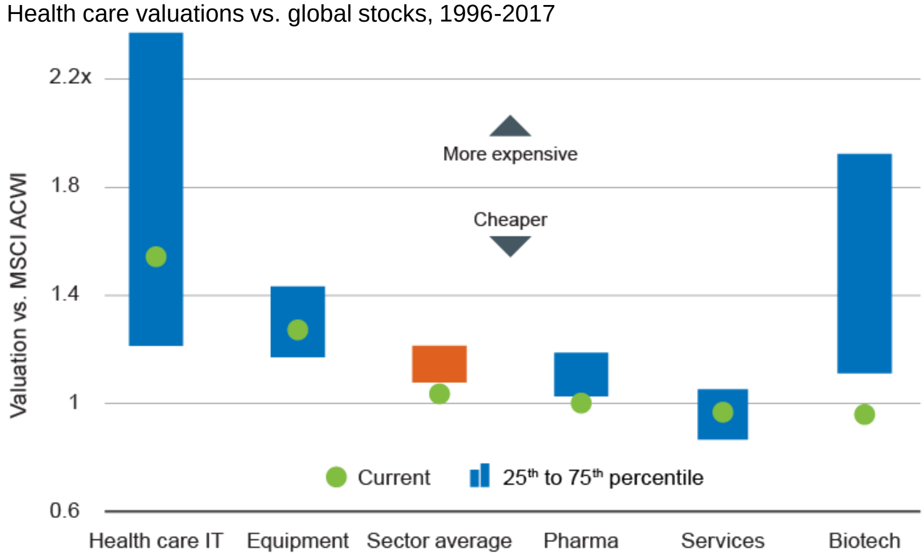
- Health care stocks look cheap compared with their own history and other sectors. This reflects drug pricing pressures, waning growth opportunities with few blockbuster drugs in pipelines and uncertainty over U.S. health care reform.
- We see innovation, a lifting of U.S. health care policy uncertainty and industry consolidation as potential catalysts. U.S. tax reforms encouraging repatriation of overseas cash could trigger M&A as large-cap drug makers seek to “buy growth.”
- Health care has higher dispersion and lower stock correlation than other sectors. This reflects variation in innovation cycles, drug patents and pipelines. It reinforces the importance of picking winners and avoiding losers. We currently see the most opportunities in biotech, medical devices and the U.S. managed care industry.

Out of favor

Health care stocks have historically traded at a premium to the broader equity market, partly reflecting their growth characteristics and popularity as a source of income. Yet today some sub-industries such as biotech sell at a discount. Many trade near the bottom of their historical valuation range, as the *Bargain bin* chart shows.

Bargain bin

Health care valuations vs. global stocks, 1996-2017



Sources: BlackRock Investment Institute, MSCI, Institutional Brokers' Estimate System and Thomson Reuters, March 2017. Notes: The dots show the current premium or discount of selected health care sectors to the MSCI All-Country World Index, based on forward price-to-earnings estimates. The bars show the range between the 25th and 75th percentiles since 1996. A reading greater than one indicates a premium to the broader market; less than one reflects a discount. Services include distributors, service providers and facilities. Past performance does not guarantee future results. This information should not be relied upon as investment advice for any particular fund or security.

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Pricing problems

The need to care for aging populations means health care is a growth business. Costs have surged over the past two decades. In the U.S., health care spending totaled more than 16% of gross domestic product in 2015, up from single digits in the 1970s and about 12% in 1995. Germany, France, Japan and the UK tell a similar story. See the *It's a growth business* chart.

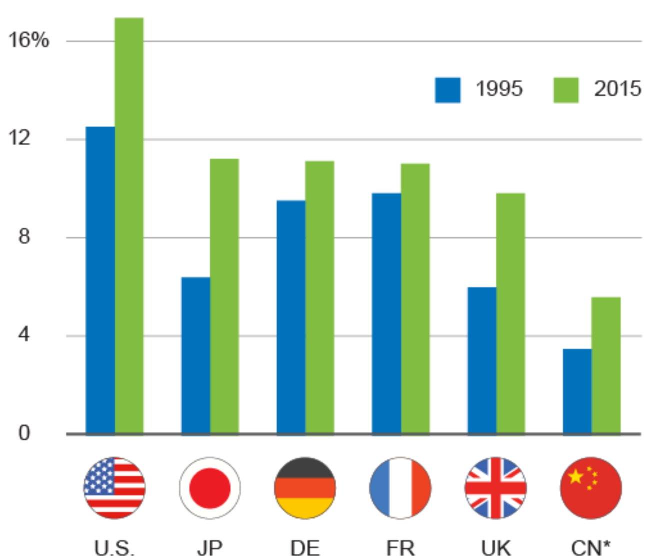
Health care is growing beyond developed markets as well. China's spending as a share of GDP has almost doubled over the past two decades – albeit from much lower levels than in the developed world – and is set to head higher as its population becomes more prosperous and older.

The challenge for drug makers is that politicians, regulators and consumers are increasingly clamoring to curb growth in drug prices. U.S. prescription drug prices rose 5.2% in 2016, the largest increase since 2001, according to the Bureau of Economic Analysis. This makes pharma and biotech easy targets, particularly given average gross margins of more than 90% in the latter, according to Bloomberg data as of March. In the U.S., a Republican attempt to "repeal and replace" Obamacare leads to more political uncertainties in the U.S. market for some health insurers and hospitals.

Pricing pressures are spreading to the emerging world as governments work to expand safety nets and cap price increases. Emerging markets were once seen as the industry's savior, but are now morphing into a volume game. As in Europe's developed markets, companies benefit from increased sales while the ability to raise prices vanishes. The ultimate defense against drug pricing pressure? Innovation. Innovative products command higher prices. This is why we believe it is key to assess the product pipelines of individual companies.

It's a growth business

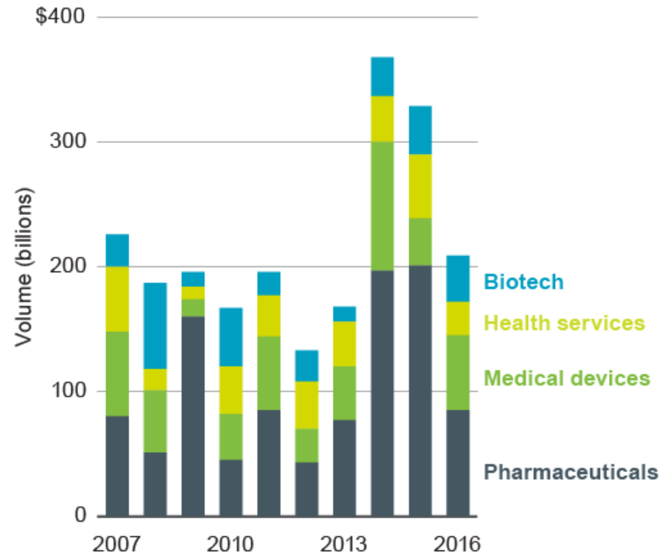
Health care expenditures vs. GDP, 1995 and 2015



Sources: BlackRock Investment Institute and OECD, March 2017. Notes: The bars show nominal health care expenditures as a percentage of a country's nominal GDP. * The green bar for China is for 2014.

Doing deals

Global health care M&A volume, 2007-2016



Sources: BlackRock Investment Institute and Bloomberg, March 2017.
Notes: The bars show actual M&A deal volume, as compiled by Bloomberg, and broken down by pharmaceuticals; medical devices; health care providers; and biotechnology. Medical devices includes supplies. Providers includes health care providers and services.

Taking the pulse

Many big drug makers are struggling to maintain past rates of growth. There is not enough in the product pipeline to replace yesterday's blockbuster drugs, many of which will come off patent in the coming years and face competition from generics. This is reflected in sluggish earnings estimates for the health care sector overall. Consensus forecasts point to earnings-per-share (EPS) growth of just 5% globally in 2017, according to Thomson Reuters data. Only telecoms and utilities have poorer growth prospects.

We also see M&A activity acting as a catalyst for industry consolidation. With most large-cap pharma companies in the "mature" stage of product development, many are seeking to *buy* growth. We think M&A will pick up in the health care sector after dipping in 2016. Pharmaceutical companies may dominate the activity in 2017 if history is a guide. They were responsible for more than half of deals in the 2014 and 2015 boom years. See the *Doing deals* chart.

Health care is about more than just drug makers. We see opportunities in medical device makers, for example. The innovators here offer similar characteristics to consumer staples companies, yet more growth and cheaper valuations, we believe. We also like selected companies in the U.S. managed care sector, a type of low-cost health insurer that stands to benefit from deregulation and efforts to curb overall health care costs. Lastly, we see indiscriminate selling in the biotech sector dragging down some companies with strong pipelines and higher growth potential. Despite politicians' tweets decrying the high price of many popular drugs, we do not expect any systemic changes to U.S. drug pricing policy. Another potential positive is a proposal by President Donald Trump that could help streamline drug approvals.

Dissecting deals

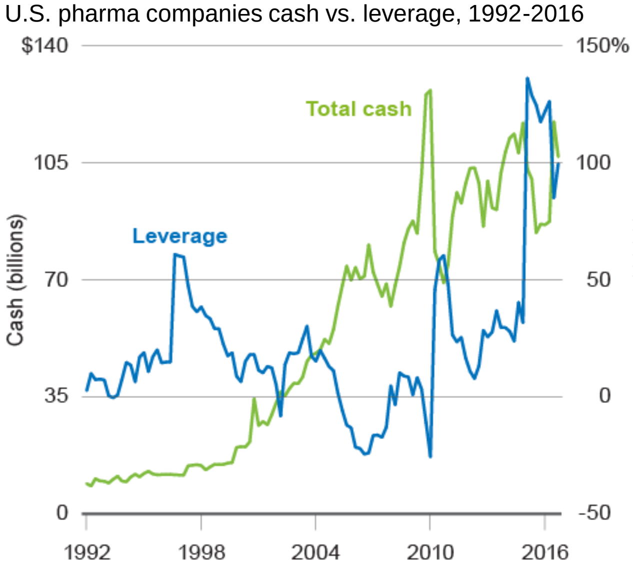
Large drug companies generate huge amounts of free cash flow. U.S. companies have parked much of this cash overseas to avoid high U.S. corporate taxes on repatriated earnings. Meanwhile, they have been taking advantage of still-low rates to pay for dividends, share buybacks, capital expenditures and, during the 2014-2015 boom, deals. The surge in M&A during that period was accompanied by a spike in corporate leverage as well as a decrease in cash. See the *Cash-rich borrowers* chart. Rising interest rates could make debt-financed deals less attractive.

U.S. tax reforms look likely to include a one-off tax on overseas cash. This could prompt companies to bring much of their cash home, providing a catalyst for another wave of industry consolidation. Few targets are big enough to make a difference to a mega cap's revenue growth. The small- and mid-cap players with products that could hold sway over entire markets, so-called "category killers," are set to benefit. Some are already looking pricey, however. Price-earnings ratios of biotechs in the mid-cap S&P 400 have jumped by 64% since November, Thomson Reuters data show.

What happens if few deals get done? Companies might return more cash to shareholders in the form of dividends or share buybacks. We do see opportunities in pharma for income investors seeking dividend growth. Yet selectivity is key; average payout ratios in the sector stand at 46%, the highest in more than two decades, according to Bloomberg data as of March. The bottom line is companies need to find ways to generate growth. We advocate considering undervalued companies with promising drug pipelines – and waiting for a crystallizing event such as a regulatory approval, successful commercial adoption or takeover.

Cash-rich borrowers

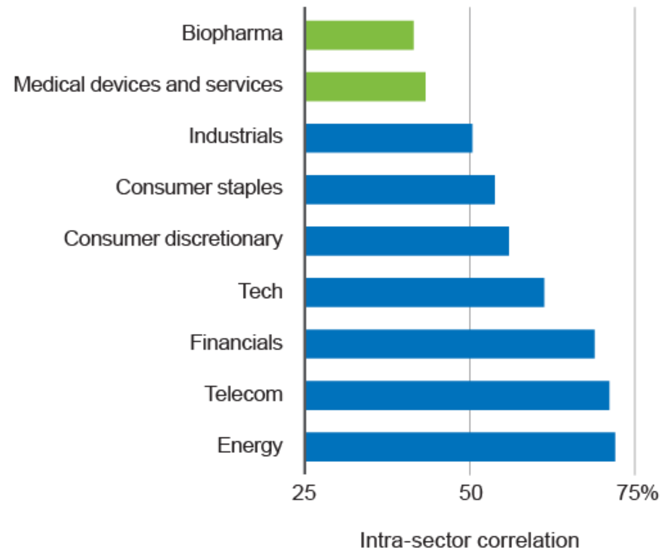
U.S. pharma companies cash vs. leverage, 1992-2016



Sources: BlackRock Investment Institute and Bloomberg, March 2017. Notes: The green line shows total cash balances for members of the S&P 500 pharmaceutical index while the blue line shows net debt as a percentage of earnings before interest, tax, depreciation and amortization (EBITDA).

Stock pickers welcome

Average intra-sector stock correlations, 2000-2017



Sources: BlackRock Investment Institute, S&P Global and Thomson Reuters, March 2017. Notes: The bars show the average 60-day intra-sector stock correlation for selected S&P 500 sectors. A low reading implies greater variation in stock performance within a sector. A high reading means companies within a sector move almost in lockstep. Biopharma includes biotech, pharma and life sciences tools and services. Medical devices and services includes health care equipment and supplies, health care providers and services and health care technology.

To have and have not

Health care means different things to different investors. It has been seen as a refuge (especially after the financial crisis), a source of income, a high growth area and sometimes a volatile sector subject to the whims of politicians' tweets. But we believe an appropriate strategy is focusing on the merits of individual stocks rather than the attributes of the entire sector. The health-care sector is made up of the haves (those with potential category-killer medical products including drugs, devices and diagnostics) and the have-nots (companies in areas that face generic competition or product obsolescence).

The low correlation of companies' stock performance within the biopharma and medical devices and services subsectors since 2000 supports this idea. See the *Stock pickers' welcome* chart. This makes health care a happy hunting ground for stock pickers. The picture is different for energy, telecoms and financials, where companies within the same sector have historically tended to move more in lockstep.

Our bottom line: We see demand for health care products and services rising in both developed and emerging markets. Worries about drug pricing and other policy risks are largely reflected in valuations, in our view. We see opportunities in biotech, medical device makers, U.S. managed care companies and selected big pharma with promising drug pipelines. Investors can wait for a catalyst such as a takeover (selected small and mid caps) or pocket steady dividends until the market reprices the value of the pipeline. Our key view: Be selective when investing in health care.

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