Healthcare Stocks Under Pressure: Opportunity Knocking?

by Donna St.Amant, MBA
Portfolio Manager
Point View Wealth Management, Inc.
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Healthcare care stocks had been one of the best performing sectors for years, but that performance came to a halt last year as concerns in the sector have moved into the spotlight. The sector has underperformed the broad market, down 6.94% over the past year. For 2016 the sector is down 1.92% compared to the S&P 500 which is up over 2%.

The issues pressuring the stocks are not new. The worries have been further ignited by increased attention from the media and from politicians on the campaign trail.

Controls over drug pricing are of paramount concern. The sector was hit hard last September when Turing Pharmaceuticals raised the price of the generic drug Daraprim over 5000% overnight after the firm gained the marketing rights. Daraprim is used to treat a parasitic infection that can cause brain damage or to prevent the infection in individuals with HIV infection. The price hike was well publicized and the public outrage and media backlash intense. Presidential candidates vowed to control price hikes and make prescription drugs more affordable.

Although most widely known, Turing is not the only case. Other companies have also instituted sharp price hikes when obtaining new rights for certain drugs. As such, the market's fear of new pricing policies has continued to put pressure on the stock prices.

The price hikes have also brought more focus to the debate concerning the government's authority to negotiate drug prices, particularly on behalf of Medicare and Medicaid, directly with the manufacturers. Candidates from both parties have argued for more government control over pharmaceutical prices. The sector continues to underperform as this debate gains publicity due to constant rhetoric in the political arena.

Another drag on the sector was the recently blocked merger between Allergan and Pfizer. It was a wakeup call to the market that the government will take a tough stand on such mega mergers.

Uncertainty around government policy will likely cause continued volatility as candidates argue for healthcare reform, price controls, opposition to industry consolidation and government involvement in price negotiations. Investors are worried about the impact on healthcare companies. As a result the stocks have been out of favor.

However, after considerable re-pricing, there may be value in these names. Concerns in the industry are not new and have likely been overdone due to the attention given in the media. There appears to be more headline risk than actual risks. Although the volatility is likely to continue, particularly as we head into the election, the longer term trends in the sector are positive.

We see compelling value in some healthcare names. There are a number of factors that provide a positive backdrop and should continue to support the stocks over the long term.

Growing demand for healthcare services: Both the aging population and the advances in medical technology support an increase in the demand for medical services. The Affordable Care act brings many newly insured participants into the arena. A declining unemployment rate is also a positive as people that are employed are more likely to get elective medical procedures and keep up with preventive care.

Innovation: Innovation in all sectors such as medical devices, biotechnology and medical information technology will continue to present opportunities.

Consolidation/Restructuring: Consolidation in the industry is likely to continue to help lower costs and address the new regulatory pressures and financial challenges brought about by government reform. Pharmaceutical companies are restructuring and streamlining operations.

Less sensitive to the economy: The healthcare sector is considered to be defensive**.** Medical care is a constant need so the sector is less sensitive to fluctuations in the economy.

Price control issue overdone: The topic of government negotiation and price controls is complex. It is not nearly as straightforward as some of the political candidates make it seem. There is already considerable negotiation that goes into pricing. Although we may see some reform and controls around price gouging, the broader framework for pricing should not see immediate and drastic change.

Although the growth outlook is forecasted to slow from the robust levels of the past, the outlook still remains at a good pace. For this quarter the Health Care sector is expected to report the second highest revenue growth of all ten sectors, and all industries within this sector are expected to report growth. Trends toward cost cutting, share buybacks and product innovation should support growth. Some of the names to consider include:

Pfizer (PFE): PFE has a strong balance sheet and generates massive cash flow. At current valuations its attractive. PFE has one of the largest research and development pipelines in the world. The deal with Allergan was blocked, but PFE did close on a $17 billion acquisition of specialty drug maker Hospira last year.

This acquisition gives PFE a new line of injectable drugs to add to its established drug portfolio, as well as a leading position in the market for off-brand alternatives to top-selling biologic medicine. Just last month PFE announced the merger with Anacorp Pharmaceuticals (ANAC). PFE has demonstrated success in improving efficiency through advances in its manufacturing process.

Teva Pharmaceuticals (TEVA): One of the largest generic drug makers in the world, TEVA generates a tremendous amount of free cash flow and has been returning it to shareholders through buying back its stock and offering a 2.2% dividend yield. Generics are also a key component in combating spiraling health care costs. In addition, TEVA is well positioned in the developing world.

Allergan (AGN): AGN has a diversified portfolio of proprietary drugs and biosimilars, including the best known compound on the planet, Botox. Liquidity will be enhanced following its planned sale of its generic portfolio to Teva. Your investment has already been vetted by Pfizer, which wanted to buy the company at a much higher price, $352 in Pfizer stock.

Mylan Labs (MYL): MYL is the maker of Epipen and is also a major player in the generic drug market. The company has been caught in an M&A drama among itself, Perrigo, and TEVA. Current valuation is very cheap at 10.4x 2016 earnings. The company has a very strong balance sheet and generates a tremendous amount of cash flow.

In sum, the health care sector has strong growth prospects. We view the recent sell off in the sector as an opportunity to add top quality names to our portfolios at far more reasonable valuations.