alphinity
INVESTMENT MANAGEMENT

Sector Spotlight

June 2020

COVID & Healthcare

Who: Stuart Welch
Role: Portfolio Manger
Industry experience: 19 years

The Australian Healthcare market is diverse with different companies exposed to different segments of the healthcare supply chain. **Stuart Welch** shares his views on who will be the winners and losers as we recover from the pandemic.

The attractions of investing in healthcare

Demand growth for healthcare services is not tied to the economic cycle, which all else being equal, has historically made healthcare companies attractive investments, particularly during cyclical downturns. This downturn has been somewhat different, however. Healthcare companies were some of the hardest hit by COVID-19, particularly initially, although the impact wasn't consistent across the sector.

Different outcomes

We have previously written about the diverse nature of the Australian healthcare sector, which includes a variety of companies exposed to different segments of the healthcare supply chain. When COVID-19 emerged, this heterogeneity resulted in a wide range of outcomes for the sector.

Some companies have benefitted. For example, Fisher & Paykel Healthcare (FPH) manufacture humidification systems for ventilators required to treat COVID-19 patients. Thankfully for COVID-19 patients, FPH conservatively adds manufacturing capacity well ahead of requirements which has allowed them to scale up production rapidly. In addition, FPH's other respiratory products, such as high-flow nasal cannulas, have increasingly become first line COVID-19 treatments. Likewise, Ansell has benefitted from increasing demand for their gloves and other protective wear.

However, most healthcare companies have suffered to varying degrees as governments imposed restrictions and patients altered behaviours in response to COVID-19 fears. For example, global mobility restrictions, together with patient concerns, have resulted in few patients visiting their GP. This has reduced associated referrals to pathology and diagnostic imaging providers such as Sonic Healthcare and Healius, albeit offset by higher COVID-19 related testing volumes. Governments globally imposed elective surgery restrictions impacting private hospital volumes, including those for Ramsay Healthcare. The collapse in volumes across the healthcare sector reduced demand for medical devices and consumables, including cochlear implants and sleep apnea devices. In March the financial outlook for much of the Healthcare sector was dire.

How governments and companies have responded

Ordinarily these businesses would respond by urgently reducing costs, however governments appreciated their importance to both the COVID-19 response and the broader economy. Governments needed these businesses functioning smoothly, particularly if the healthcare crisis escalated. Therefore, they responded quickly with a combination of measures.

Medicare rapidly implemented telehealth GP consultations, despite historically resisting this change. This allowed patients fearful of COVID-19 to still access their GP.

Guidance was issued instructing GP practices to only offer telehealth consultations for patients with respiratory symptoms and, where appropriate, to refer these patients directly to pathology collection centres for testing. This avoided potential COVID-19 patients visiting GP practices where they could infect others, including doctors that have been so important to the COVID-19 response. One of the initial fears was that COVID-19 could reduce the available healthcare workforce by 20% if not appropriately managed. Thankfully that didn't happen.

Medicare approved funding for COVID-19 pathology testing at favourable rates to support pathology providers otherwise struggling with lower regular testing volumes. The state government also directly underwrote minimum pathology testing volumes, although the exact details of these arrangements have not been made public. This ensured pathology companies remained solvent and retained their entire workforce throughout this crisis. This was essential as the cornerstone of the COVID-19 response has been widespread pathology testing to firstly understand the extent of COVID-19's spread and to effectively contain it.

State governments also agreed to underwrite private hospital costs in return for private hospitals agreeing to maintain their full workforce despite undertaking no elective surgeries. While public hospitals were designated as the primary COVID-19 response centres, this effectively kept private hospitals on standby in case the crisis escalated and they were required.

Despite these unprecedented efforts by government, some healthcare companies still raised equity to help them weather the storm, and in some instances, to potentially let them capitalise on distress within the sector. These included Cochlear and Ramsay Healthcare.

Recovering from COVID

The outlook for certain healthcare companies has evolved rapidly throughout this crisis, particularly as governments have imposed and subsequently withdrawn restrictions, and patients have changed their behaviours. Fundamental analysis and consistent communication with companies has been important for us to keep pace with the changes.

Today, new COVID-19 cases have almost stopped, with most states reporting little, if any, community transmission for extended periods. We have been asking ourselves how the government will loosen restrictions and what will be the impact for the healthcare investment universe.

As we stand today, private hospitals will be allowed to return to full operations in all states by the end of July. Early indications are that private hospital activity is ramping up quickly, led by cardiac and orthopaedic work. Doctors in the private system only get paid when seeing and operating on patients, so they are eager to get back to work. What remains to be seen is how quickly patients re-engage with the healthcare system.

If patients don't see their GP for fear of getting COVID, they cannot be referred on for diagnostic testing (pathology and imaging) and to specialists. It is worth considering how much of the current flurry in activity relates to patients that were already in the system and scheduled for operations relative to the pipeline of new patients. We are watching this closely and expect patient reengagement to track improvements in new COVID-19 cases with some lag. In this regard, we expect Australia will lead the way, followed closely by Europe, with the US trailing. All else being equal, this means we prefer domestically focussed operators currently.

A similar analysis applies to CSL. While CSL initially appeared largely unaffected by COVID-19, it appears similar concerns are keeping plasma donors out of CSL plasma collection centres. This is creating near term headwinds for CSL. CSL collects most of its source plasma in the US and industry sources indicate plasma collection volumes there are down 25% relative to last year. Given the 6 months processing time required, lower plasma collection volumes will impact immunoglobulin and albumin sales in the second half of FY21.

Assuming we continue to keep COVID-19 under control, the government will not need to reimpose restrictions and patients should increasingly reengage with the healthcare system, allowing the defensive growth attributes of the sector to shine through again. As has historically been the case, this will prove valuable as the economic fallout from recent events settles.

An attractive opportunity

Our recent research efforts have balanced finding companies most insulated from COVID-19 impacts and those that offer the most leverage to a COVID-19 recovery. Ramsay Healthcare (RHC) is one company that should emerge from COVID-19 impacts well. RHC's long term fundamentals are favourable given a growing and aging population, the increased prevalence of chronic conditions and the availability of innovative new treatments that improve health outcomes.

In the short term, COVID-19 has created a large back log of patients (both public and private) requiring elective surgery. Clearing the back log will take much longer than it took to build. For example, assuming private hospitals ordinarily operate at 90% capacity utilisation, it will take 10x longer to clear than to create any back log. Any further elective surgery restrictions or delays in patient reengagement will only add to the back log.

Public hospitals will also lean on private hospitals to help clear their waiting lists, particularly as they reserve some capacity in case of a COVID-19 second wave. NSW & QLD already have arrangements in place to outsource public elective surgeries to private hospitals. This will require longer operating hours, potentially including weekend theatre lists, which will improve capacity utilisation and put upward pressure on both revenues and margins.

RHC should also benefit from better pricing from health insurers following the coalition election victory last year which removed the risk of health insurance premium caps. Longer term there is also potential for regulatory reform supportive of greater health insurance participation rates.

More information

To find out more, please visit **www.alphinity.com.au** or email us: **contact@alphinity.com.au**

42247/0620

Important information

The information in this document is current as at the date of publication and is provided by Alphinity Investment Management ABN 12 140 833 709 AFSL 356 895. It is intended to be general information only and not financial product advice and has been prepared without taking into account your objectives, financial situation or needs. Past performance is not a reliable indicator of future performance.