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The Healthcare Sector through a COVID-19 Lens

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Anu Rajakumar: The last few months have been a roller coaster of news updates and predictions around the path of the COVID-19 pandemic. With estimates of the impact changing daily, markets have seen a huge disruption that's being compared to the global financial crisis of 2008, with volatility at extreme highs. My name is Anu Rajakumar, and on this episode of "Disruptive Forces," we're joined by Terri Towers, Senior Healthcare Analyst on Neuberger Berman's Global Equity Research team, to talk through the progression outlook for COVID-19, as well as delving into the impact that this might have on the healthcare industry itself. Terri, thank you for being here.

Terri Towers: Absolutely.

Anu: Now, we've heard a number of updates from you over the past few weeks, but if you don't mind, could you give us a quick update in terms of where we are in the progression of the pandemic right now?

Terri: Oh, sure. If I think about what I said back then, I thought the U.S. cases would double in the short term. Unfortunately, while we had the direction right, we had the magnitude wrong. In fact, in a most unfortunate statement I have to make, the cases have tripled since then. We're over 172,000 cases in the U.S. at a fatality rate of 1.9 percent, or 3400 deaths now. Clearly this sounds horrific to anyone who's listening to us, but I just want to try to put this in perspective vis-a-vis other countries.

Folks have always said, oh my gosh, we're Italy, and we know Italy has an incredibly high fatality rate. If you look at all of these curves that folks are publishing, the U.S. cases recently crossed Italy as far as total cases. But what I would offer is, if you think about the U.S. versus Italy, we have 55 percent more cases as a number versus Italy, we're at one-fourth of the fatalities. So we can take some comfort there.

Likewise, if I pick one of a number of other countries in Europe, who are a bit ahead of us in this pandemic, if you look at France, we have four times the number of cases in France. Now I recognize the population is different, but we have a similar number of deaths as France as an absolute number. So again, pointing to that 1.8 to 1.9 percent fatality rate. I think this is just a tribute to the U.S. healthcare system.

Now, other countries that we're watching to see how this unfolds: Clearly the U.K. is very interesting to us, as in Canada; countries that have yet to feel the brunt of this, India, Brazil; clearly on our minds. I would also offer Sweden. Now, there's a country that is not implementing the social distancing like we are in the U.S. and in other countries like Italy, and their cases actually are quite low this morning. Let me get that number. They had just over 4000 cases and only 146 deaths. So that's one to watch.

Now to get back to the U.S., clearly New York State is the epicenter. We're carefully watching New Jersey, but according to commentary from Dr. Scott Gottlieb this morning – he used to be the commissioner of the FDA; now he's at the AEI institute. He's really concerned about Texas, Florida, Michigan, and Illinois. So we're going to keep our eye on those regions as well.

Anu: Great. As of today, China's still reporting no new cases. How long before we see the inflection points in other markets where new cases start to decrease?

Terri: So I would agree with you that China really did flatten that curve nicely, but what I would say is, it looks as though Italy is peaking, if not has peaked, with regard to new case adds. The experts would say that occurred any time between March 20th and March 25th, and now we're just flattening out. We're plateauing. So if in fact that holds, and I believe it will, we're probably about two weeks behind Italy in the rollout of the pandemic. So some folks are saying as early as April 3rd to as late as April 10th, Good Friday, for the U.S.

Now, I'm hopeful it's April 3rd, but what I will say is, to apply that to the U.S. holistically is probably not a good idea. I think you can apply that to the U.S. if you're looking at New York State. The growth rate of number of new cases has been slowing dramatically in the past week. If I look to the 22nd of March, new cases were growing in the high 30 percent day over day; and then as of the 29th, it grew 12 percent. So I say only. That's a much lower number, still growing. So the number of cases continues to go up, but at a slower rate. So it's the second derivative phenomenon.

We're going with, in the next week or two, we should flatten in New York State. Then how it applies to the greater U.S. is going to hinge on those states that I mentioned earlier that we're really watching.

Anu: I'd like to just pivot a little bit now to talk a bit about the impact this is going to have on how we invest in healthcare. So maybe just to start off short term, Terri, where do you see the stresses on the healthcare industry?

Terri: Yes. I think it's important to frame the performance year to date and since COVID-19 became part of our everyday reality. If we think about it, year to date I believe – I think these numbers are a day or two stale, but – the S&P 500 was down, gosh, 22 percent, whereas the healthcare index was down 19. So I understand down 19 percent is not good, but in our world, if you're a relative performer, you're actually being the benchmark.

But I'm saying that only to highlight how healthcare has held up better than most sectors across the S&P 500, [staying up only] to consumer staples and technology. I think they're only down 10 or 11 percent year to date. If I look within healthcare with that as the backdrop, it's not surprising to see therapeutic names such as pharmaceutical companies, biotech companies. They're down, but they're down far less than the market and far less than the healthcare index. They're down about 11 percent year to date for biotech, and I think it's about 17, 18 percent for pharma.

Now, put that in the context of managed-care companies and healthcare service companies, down around 20 percent; and then hospitals are doing the worst down 38 percent, medical device and tools down around 22 percent apiece. So if I think about what that is telling us, what is the market telling us in the short term? Clearly the market is worried about a recession. The market is worried about folks not going to the doctor's, not going to the hospital, not getting treatment, because they're afraid if they do, they'll contract COVID-19.

So I understand that, but for me, I think the best place to be within the healthcare complex is in the therapeutic space; not to say it's because they will have a therapy for COVID-19, and you're going to try to pick the winner – we hope all of these therapies I spoke about earlier, and vaccines, work – but more to say that, at the end of the day, you need to take your medicine for other clinical conditions that you have outside of the world of COVID-19. So they're going to do the best, in our view.

However, you asked about stressors. Clearly there are stressors across the industry, but stressors with regard to the therapeutics industry in particular would be, we're hearing of delays in new clinical trial starts and a pausing in the moment in ongoing studies. Well, clearly this is going to lead to a delay of new medicines across every disease state coming to the market. Now, that's unfortunate for society, but it also hurts revenue and future growth potential for these companies, because we all know the way it works. You launch a great drug. You have market exclusivity for so long, and then it goes off patent. You need to backfill with that pipeline.

So we see delays there, which right now is not proving a terrible problem; but it's something we're monitoring very carefully. We think, with regard to their balance sheets, these companies do have six to nine months of inventory on hand. After going through the COVID-19 pandemic, you can envision these companies starting to carry a higher, a longer, inventory on hand. Maybe that's 12 months. That does a little something to how they're managing inventory and their balance sheet, but these companies have great balance sheets, just to be clear.

You're going to look at folks looking at possible movement of the supply chain. Where do we manufacture, in what country? Where is our second backup source? Is it on a different continent? All of these things are going to become important. And then lastly, what I would say is more holistically, at the hospital system, clearly pandemic planning wasn't great if we ran out of masks and PPE so quickly; so I think hospitals are going to have to carry higher inventory. One would argue that can hurt profit for the for-profit hospitals. So all of these things, we have to monitor while, at this time, we're monitoring COVID-19.

Anu: Now, usually healthcare is fairly non-cyclical. With this pandemic and the limit placed on nonessential procedures, it does seem like the sector might be hit a bit more than you'd expect in a typical downturn. Can you just touch on what some of the longer-term implications are for the sector?

Terri: Yes. It's a great question, and to be fair, it's more applicable to the medical-device subsector of healthcare than any other, I would argue. So with regard to medical devices, what you're hearing is, please delay your elective procedures so we have capacity to treat all the COVID-19 patients. This is something that – we're very lucky at Neuberger. We have a team approach to healthcare investing, and I have a colleague who is a seasoned expert in covering the medical-device landscape. He's been my partner for close to 20 years now at the firm, so we clearly reach out to him and ask him how he's viewing COVID-19.

His projections suggest 80 percent of all orthopedic and spinal procedures will be delayed at least until the third quarter of this year, more than 50 percent of nonemergent cardiac procedures deferred – that one really surprised me – and then obviously a substance deferral of routine endoscopies, hernia surgeries, and anything with ophthalmology like cataracts procedures. So if you roll that together, I asked him, well gosh; we all know the first quarter will be down, but not as much as Q2; how do you think this rolls out? And his projections are, procedures for the year 2020 could be down as much as 25 percent; but that rests on procedures coming back in the fourth quarter. So that's where we have a little bit of wiggle room to see if it's going to be better or worse than that number.

Now with regard to medical suppliers – because they're lumped in with this sector – they clearly will hold up better, and in fact have been holding up better. Think of those companies that sell the masks, the gloves, the surgical gowns, things of that nature; the tubing for the ventilators. Any of those companies should hold up better now and for the long term, in our view.

Anu: Great. That's very helpful. You touched on some of the subsectors of healthcare. How long do you think it'll take for other sectors to recover from this downturn?

Terri: Yes. Med devices is where we focused first. We clearly think that's a second half '20; if not 4Q '20, 2021 event. If I think about life-science and tools type companies, it's a double-edged sword for them. Clearly these are the companies that have diagnostic divisions that are either developing the test, selling the test, selling the instruments, all the reagents that you need to run these tests. So in that regard, it's somewhat of a good guy, as I like to call it; but clearly, when you're telling folks to stay at home, scientists are not going to the bench and doing experiments.

So one would argue daily consumables at these companies would sell. That's just not happening; and when you think about it, consumables don't come back. Scientists don't go to the academic lab at Sloan Kettering or at the Rockefeller and then magically come back in a month and order all the supplies they would have used the month prior. That's just not going to happen. So we think, with regard to the tools names, clearly they're also tied to GDP. So when we look to our experts like Erik Knutzen and Joe Amato as to, are we hitting a recession; is it V, is it U recovery; that has impact on the tools names.

We are arguing that their first quarter will look okay. The second and third quarters, not going to look very good. They'll start to recover in the fourth quarter, but you really have to look at 2021 for those names; so a little bit delayed beyond the devices for recovery. And then, if I go back to therapeutics and big-picture therapeutic category, whether it's generic companies, specialty pharma, biotech, large-cap pharma and biotech, they're not going into the abyss, if you will, with regard to performance.

So they're going to hold up a little bit better, and in fact we're hearing a pull forward of inventory and folks running to get 90-day scripts. So their first quarter is probably going to look good, in our view. They are less impacted. We're staying the course as far as those investments go. We're not making any changes right now, because fundamentals are overshadowed by COVID-19.

On the upside for therapeutics, what I would offer is, prior to COVID-19, we were all worried about the presidential election and whether Senator Sanders or Senator Warren would be the nominee. I think that's largely put to bed, and it looks like Vice President Biden could get that nomination; and therefore that is somewhat a removal of an overhang, clearly on managed-care companies, but also on therapeutics; because we do think there's going to be activity, when this is all over, on drug-pricing reform, but not the draconian measures had Senator Sanders or Senator Warren gotten the nomination. So that's also going to help the sector do a little bit better, if you will, in the context of COVID-19.

Anu: That's great. Then finally, Terri, as we wrap up here, my last question is, what's your advice to investors as they look to navigate this very challenging environment at the moment?

Terri: Yes. So clearly, we're staying the course, our core investments in our healthcare books, our core investments. Also, we're really looking for opportunity, Anu, because some of these names have pulled back on fear. And while you're not going to go very far off on the risk curve, if you're truly a long-term investor, what we do is, we have those companies that are great companies. We think the future is bright outside of COVID-19. We've always wanted to own them, but we didn't love the valuation.

As long as their balance sheets are healthy, and we can see the cash flow not taking too much of a hit; and if they have a dividend, their dividend is secure; we have a little buy list, and we're waiting from price points to go in and establish our positions there.

Anu: Great. Well, Terri, this has been hugely helpful, so many thanks for taking the time to share so many of these very important insights with us today. Thank you.

Terri: Oh, you're welcome, and everybody stay safe and have a good day.

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