Healthcare Outlook: H2 2022

Global sector remains a refuge from geopolitical, economic crises though the dynamic sales growth and earnings impetus from pandemic-related vaccine, treatment, diagnostic demand will slow sharply in 2023.

Corporates, Scope Ratings GmbH

Executive summary

The global healthcare sector is strongly positioned to cope with a likely significant decline in Covid-related revenue and cashflow next year after two years of dynamic growth.

Underlying growth remains robust. While levels of vaccination and immunisation worldwide are high, Covid-related business will remain an important source of revenue and profit – and depend on future rates of infection. The sector's credit quality will at least remain stable, even though there are sub-sectors under specific pressures, most notably hospitals, exposed to rising energy and staffing costs.

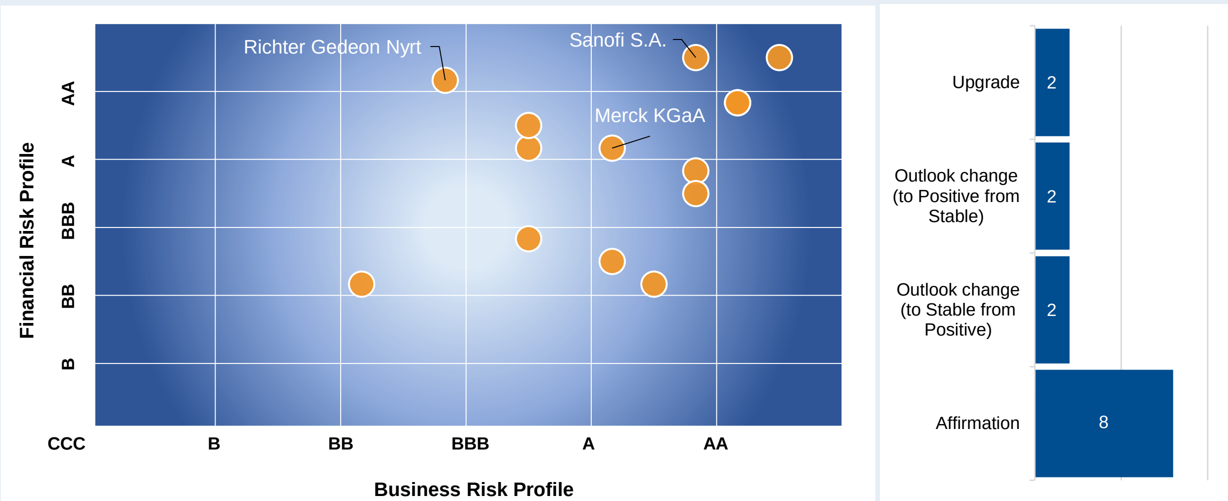
Trading conditions in the pharmaceutical sector continue to look good, though credit concerns might resurface if companies decide to use their strong balance sheets for largescale debt-financed acquisitions to offset declining pandemic-related revenues rather than the more bolt-on acquisitions typical of the past couple of years.

In this version of our healthcare periodical, we look at recent developments in the global pharma sector and lay out our expectations for the different healthcare segments. We compare the financial policies of leading European and US sector players.

The main trends we expect for the remainder of the current year and for 2023 are as follows:

- No further largescale Covid-related lockdowns look likely in the world's largest economies, China excepted.
- Covid treatments are likely to remain in demand in 2022, based on hefty government orders. Mid-term prospects depend on infection rates and hospital utilisation, but demand might peak this year.
- Repercussions from the pandemic continue to benefit providers of OTC drugs, diagnostics and medical equipment.
- Credit quality is supported by the favourable outlook for business risk; financial risks remain contingent on corporate strategy, notably M&A and shareholder remuneration.

Figure 1: Scope's Healthcare ratings universe and rating actions in past twelve months



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Scope's healthcare team covers a growing number of 20 credits on a global basis, including public and confidential mandates distributed across large and smaller companies in the pharmaceutical sector. Our three most prominent public mandates continue to be Sanofi SA (AA/Stable), Merck KGaA (A-/Stable) and Gedeon Richter Plc (BBB+/Stable).

Key sector trends to date

Pharma

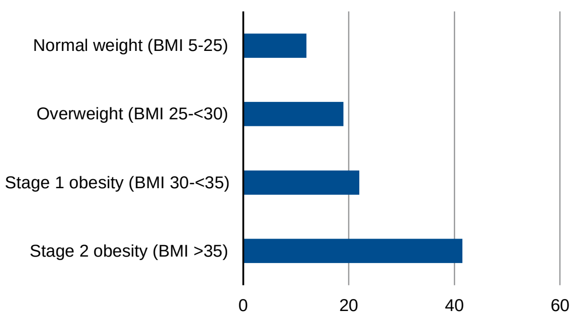
Most pharmaceutical companies reported strong operating trends in the first half of 2022. This was based on several fundamental factors:

- Strong rebound after pandemic lockdowns
- Increased healthcare and safety-focus of large parts of the population
- Rapid growth in direct pandemic-related sales
- Price increases
- High number of newly approved innovative drugs

The pharmaceutical sector's resilience stands out even though the healthcare sector at large has shown quite how resistant it is to crises through the pandemic and, for now, the aftershocks of Russia's war in Ukraine and Europe's energy crisis. The sector's potential vulnerability to logistics disruptions have not hindered the ability of vaccine producers to efficiently develop and deliver billions of anti-Covid doses around the world. The combination of ageing populations and unhealthy lifestyles continues to provide a favourable underlying set of circumstances for growth in demand for treatments and healthcare, despite the global focus on Covid. As the chart below shows, there seems to be strong correlation between body weight and vulnerability from Covid-19.

Notwithstanding the ultimate verdict whether Covid 19 was really a pandemic given relatively low death rates – well below 1% of the population even in countries like the US and Mexico where obesity is more of a problem – and an older and less healthy population's greater vulnerability to any kind of virus, the Covid-19 outbreak created significant extra demand for the sector.

Figure 2: Obesity main driver for Covid hospitalisations?



Honi soit qui mal y pense – Covid cynicism or realism?

Looking at the past two years' experience of the pandemic and the impact on pharmaceutical companies, the sector is set to benefit durably from more substantial demand related to infectious diseases than in the past. People have accepted that the price of protection from infectious diseases – even if it is only partial – is regular vaccination.

Politics also plays a role. No government wants to be accused of potentially underestimating the next wave of a killer virus especially if a neighbouring country has already adopted stronger measures. Memories are fresh of moments at the end of 2020 when the industry started delivery of the first Covid-19 shots and some countries felt left out when faced with more aggressive vaccine buying by other governments.

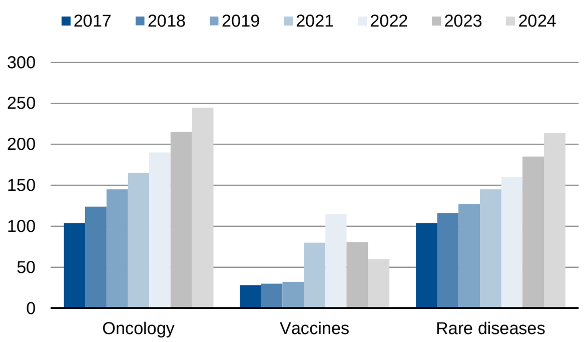
One way to look at how Covid has changed people's outlook is the focus on infection rates rather than death rates, with people and governments relying more on repeat vaccinations against virus strains than the body's immune system to adapt to the virus.

Commercially, this is close to optimal for vaccine producers, with every virus modification deemed risky enough to trigger new product development and shipment. The world's leading drug producers should record Covid-19 related revenues of about USD 115bn this year, up from USD 80bn in 2021, helped by large government orders. Sales of vaccines and treatments are likely to remain high at least in the medium term.

As **Figure 3** shows, the vaccines segment has benefitted significantly from pandemic-related demand, catapulting vaccines into the leading three treatment areas within the whole pharmaceutical segment.

Some caution is still warranted. Vaccines remain a smaller source of revenues than other blockbuster segments, while the Covid peak might have passed. Oncology and rare diseases – treatment for which involves so-called orphan drugs, only applicable for a limited number of patients worldwide – are two larger segments with good long-term growth prospects.

Figure 3: Largest pharma segments



Source: EvaluatePharma, own calculations

Peak-Covid looks as if it is behind us

US President Joe Biden recently called an end to the pandemic. This not pharma share prices sharply lower and signalled that politicians would not find it as easy as before to get majority consent for further multibillion-dollar funding of vaccination programs.

This market transition from public to private makes it more likely that – in the absence of a severe new outbreak – the size of the Covid-19 products market will shrink, potentially by a significant margin in 2023. Our base case scenario is for a one-third decrease of Covid-related product sales next year compared with 2022.

Some other long-term trends are favouring pharma

We see several other important industry trends:

- R&D remains concentrated on finding potentially high-margin specialised treatments such as orphan drugs and immune-oncology medicine.
- Pharmaceutical executives remain tightly focused on extracting shareholder value through more tightly defined core businesses – typically innovative medicines – partly by spinning off assets, for example: Pfizer Inc.'s merger of subsidiary Upjohn with Mylan NV, GSK PLC's demerger of Haleon, Novartis SA's spin-offs of Alcon and Sandoz Johnson & Johnson has also announced spin-off of its consumer health division to be named Kenvue).
- The cash-rich sector is likely to deploy some of its resources on another round of M&A despite high acquisition multiples.
- Mindful of supply disruptions during the pandemic, management will avoid single-sourcing and keep API production spread out in Europe.
- European pharmaceutical firms are moving more in line with US rivals in focusing on maximising shareholder value through M&A and generous shareholder remuneration – take Novartis and GSK
- though others -- such as Sanofi SA, Merck KGaA, Bayer SE, Boehringer SA – favour diversification and a more stakeholder-oriented approach.

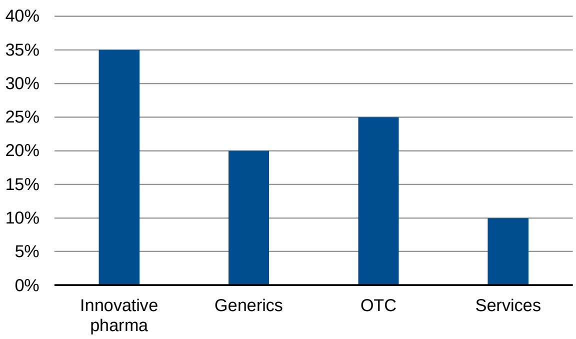
Inflation looks manageable

The impact of surging inflation on the pharmaceutical sector looks manageable. The sector is less exposed to rising energy and raw material prices than other industries while more vulnerable to wage inflation – admittedly to different degrees within the sector itself. The pharmaceutical sector's focus is not so much on production but rather on discovery and development where labour is still an important cost factor. Looking at the R&D-to-sales ratios on average for the industry and adding in some percentage for admin and related overheads, wages account for up to a quarter of total sales. Assuming most companies' policy to compensate their staff for today's high inflation, wages look set to increase by about 5% in the short term. This is equivalent to a margin contraction by about one percentage point, all other things being equal.

In the more labour-intensive healthcare services segment, labour costs are a much higher proportion of expenditure. Wages to account for up to half of total hospital costs, in some cases even significantly higher than that, in a sector whose profit margins are considerably lower than in the pharmaceutical sector (see hospitals paragraph below).

Another segment adversely impacted by inflationary pressure is the generic drugs industry. With a greater focus on production and distribution compared with innovative pharmaceutical firms, rising raw material, energy, wages and logistics costs are more likely to squeeze margins. As with hospitals, the generics sector has the challenge of passing on cost increases given selling prices and fees are often regulated, at best ensuring a lag between cost and price rises.

Figure 4: Indicative Healthcare segment margins



Source: Scope estimates

This issue is hanging over the pending IPO of Novartis' Sandoz generics unit, earmarked for 2023.

Hospitals suffering from input price inflation

Among the generally easy operating conditions in healthcare, the hospitals segment appears to be the only fly in the ointment with potential negative credit implications.

First, hospitals face the difficulty of passing on rising input costs to customers. Hospitals generally operate with a regulated income structure and fixed fees – take the 3.45% price increase negotiated in Germany for 2023 -- which cannot be changed quickly without the passing of new legislation.

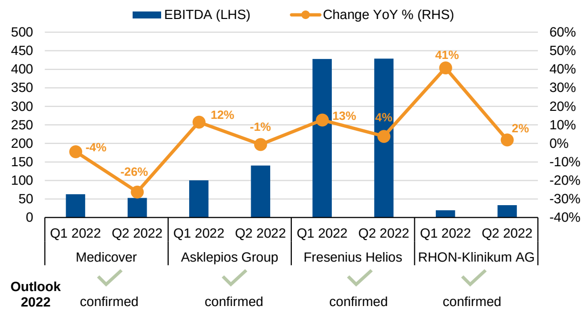
Secondly, the low availability and motivation of medical staff, aggravated by burn-out during the peaks of the pandemic, is pushing up labour costs while compromising capacity.

Industry representatives in Germany have called this a perfect storm, as about 60% of all public hospitals might be unprofitable this year. The figure could rise to 80% next year. Assuming a further acceleration of infections and pandemic emergencies from the autumn of this year, hospitals might find themselves under excessive strain.

The German medical sector faces increasing shortages of medicines. Gerald Gass, the chairman of the German Hospital Association, said hospitals should plan for a three-fold increase in expenditures because of the current situation.

Consequently, the association representing the largest private hospitals operating in Europe has stressed the need for regulatory decisions such as structural reform of the hospital market to minimize lags in regulatory price setting as a necessary response to fast increasing input prices.

Figure 5: Snapshot of European private healthcare providers operating performance (EURm)



The same pressures are visible in the US healthcare sector where there is a larger proportion of private and stock-market-listed hospitals and care organisations than in Europe. According to US Bureau of Labor Statistics, around 400,000 healthcare workers have exited the field since the pandemic began, due to a perceived lack of support, safety, and flexibility. The lack of nurses is particularly acute. Estimated wage inflation is running at above 10%. The American Hospital Association estimates that up to two thirds of the nation's hospitals are likely to report operating losses in 2022, compared with about half of that level in 2019.

US drug-pricing reform not yet material

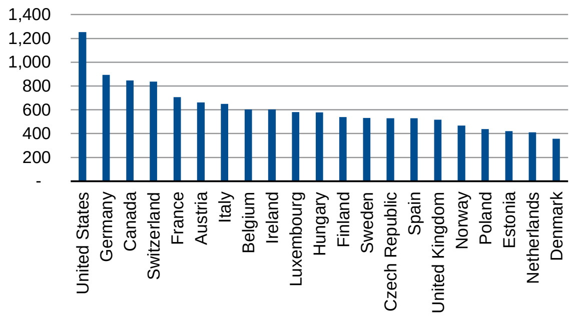
The US Senate has recently passed the new US drug pricing legislation in the framework of the Inflation Reduction Act (IRA) brought forward by the Biden administration. The aim is to allow the Medicare program (insurance cover for the elderly) to negotiate drug prices directly with manufacturers, which was not the case before.

The US administration's heightened efforts to control drug prices, which have also gone up significantly in the recent past, has been long in the planning. Change has finally made it on to the statue book as additional pandemic-related spending has strained the US healthcare budget.

Political pressure to control costs has grown significantly, given the prospect of future pandemics. Focusing the mind of legislators is the elevated annual per capita drug consumption in the US, twice as high as in Europe ($1,300 per capita in the US vs $ 600 in France, $ 800 in Japan, and $ 950 in Germany, for example).

The total healthcare budget in the US has increased significantly over recent decades, exceeding in relative terms that of other advanced economies', but with poor outcomes. US life expectancy which has trended down over recent years.

Figure 6: US outspending the rest of the world (average 2017-2021)



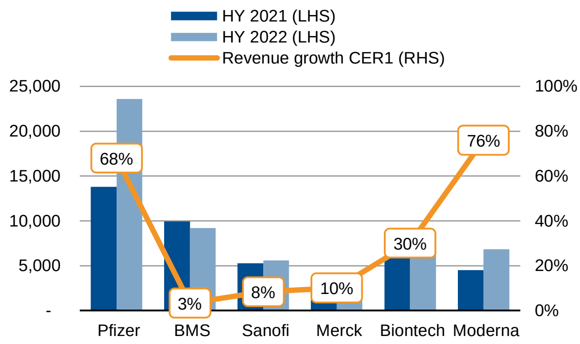
From a credit perspective, better control of drug-price inflation would feed through to drug makers' sales and profitability, though exposure to the US and to Medicare specifically varies from company to company. In addition, this new law could take four years to get enacted, allowing the industry to position itself accordingly.

Medicare represents about 48 million of Americans, which is just 15% of the population, although probably a group with higher-than-average health-care expenses. Thus, the immediate credit impact is nil, but the closer the time approaches to 2026, it is likely to become an issue.

Financial resilience improves

Almost all the world's largest pharmaceutical companies – and not only the ones exposed to Covid products) -- are likely to report further significant sales growth in the second half of 2022 and 2023 after a strong performance in the first half and last year (see **Figure 7**). This holds true for Bristol Myers Squibb and Sanofi, two large companies which missed out by not developing Covid vaccines. However, gains in sales and profit were more spectacular for those with direct Covid exposure, not least BioNTech and Moderna, small companies which developed Covid vaccines. Pfizer, the biggest pharma' company with Covid vaccine exposure, doubled its EBITDA in 2021 from the year before and reported a 70% increase H1 EBITDA. In contrast, Sanofi's lower profitability and growth reflect its greater diversification relative to the rest of the sector.

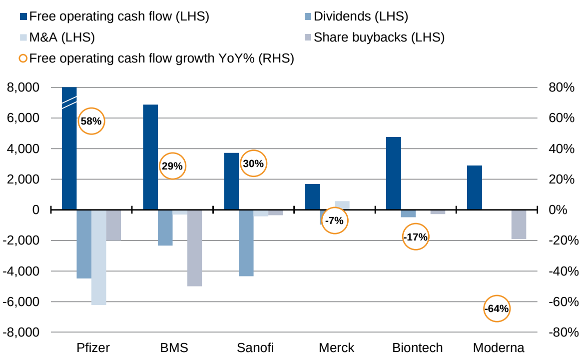
Figure 7: Recent EBITDA growth for selected global pharma players



Source: Annual reports, own calculations

The same trends in general held true for free operating cash flow (defined as operating cashflow minus capital expenditures and changes in working capital (**Figure 8**).

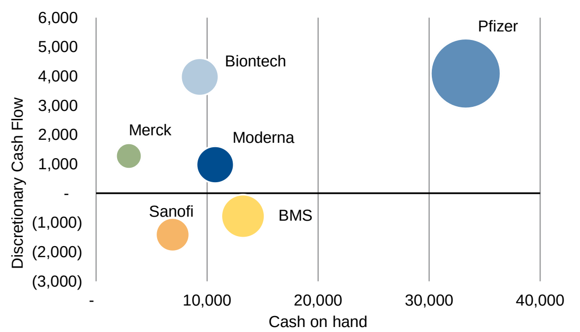
Figure 8: High levels of free operating cash flows



Financial policy key for credit outlook

The Covid pandemic initially squeezed the healthcare sector's cashflows as lockdowns in particular restricted elective care, but the situation abruptly changed in 2021. Most companies were able to not only generate significant levels of free cash flow, but also on a discretionary level, incorporating shareholder remuneration and M&A. Cash on hand has increased almost universally. Some companies do not report all the cash only on the 'cash' line of the balance sheet, but do also 'park' it elsewhere, mostly under 'other financial assets' or 'short-term investments'.

Figure 9: Favourable liquidity



Source: Annual reports, own calculations

The table above illustrates the presently very strong sector liquidity, presented as a combination of cash on hand (balance sheet liquidity at the end of June 2022) and discretionary cashflow: free operating cash flow after M&A and shareholder remuneration.

The question is to what degree and to what purpose management has made use of this cash.

The statistics above show that free cash flow generation in the second half of 2022 continued to grow almost everywhere with the exceptions of Moderna and BioNTech, where significant declines compared to the first half of 2021 were mainly due to deferred revenues in connection with government vaccine orders and related working capital effects.

Most big pharma companies do generate sufficient cash to allow for a significant level of discretionary spending on M&A. However, vaccine success has changed that.

In Pfizer's case, cash generated in first six months of the current year was equivalent to about 80% of all last year's business. The BioNTech-Pfizer Covid-19 vaccine (known as Comirnaty) generated about USD 22bn revenues in the first six months of 2022 for Pfizer and another EUR 9.5bn for BioNTech. Pfizer's new antiviral pill Paxlovid made about USD 8bn revenues in the second quarter – about on the same level as Comirnaty – and is poised to generate full-year 2022 sales of USD 22bn.

The two Covid-19 'pure plays' Moderna and BioNTech recorded strong FOCF generation in the period and are expected to continue to do so for the full year 2022, setting them up for larger-scale M&A.

Management at these big pharma firms mostly avoided larger-scale acquisitions in the past two years, keeping their powder dry during the crisis. An exception was AstraZeneca, with its purchase of Alexion in July 2021 for a total of USD 39bn (two thirds equity financed), which was orchestrated before the crisis. The industry's last mega deal - Bristol Myers Squibb's acquisition of Celgene and AbbVie's takeover of Allergan – goes back to 2019.

We cannot rule out the possibility of some renewed larger transactions, not least because of the industry's healthy cash flow generation. Acquisitions are more likely for the companies which benefit directly from the Covid-related business and for companies who want to tap the potential of mRNA though bolt-on deals like Sanofi's are most likely transaction we will see.

Big deals look less likely, in general. They might happen at Pfizer, though, which faces potentially significant sales at risk, now accelerated by the looming Covid downturn expected. The most important rationale for large-scale acquisitions in general is for a company to make up for a non-performing late-stage pipeline and a lack of growth. For now, this is not a problem that the pharma sector faces.

We see a similar picture when it comes to shareholder remuneration over the past two and a half years. US-based companies typically set greater store by higher dividend pay-out ratios and share buybacks, but the has been less divergence between US and European practice in recent years.

M&A ambitions are likely to be highest among smaller companies BioNTech and Moderna which, having benefited hugely from their success with Covid vaccines, now face pressure to diversify into other treatment areas, potentially via acquisitions, as Covid revenues start to tail off.

Among the industry leaders, Pfizer might also be tempted to use its strong balance sheet for deal making, given its projected direct exposure to Covid 19 products in 2022 might be around USD 55bn. Assuming 30% decline Covid-related revenue in 2023, and bigger decline in EBITDA, the company will find it hard to replace this contribution to earnings in the short term.

Favourable trading, credit outlook for Q4 2022, FY 2023

The fourth-quarter trading outlook for the healthcare sector is strong and stable. The long-running trend of growing drug demand linked to ageing populations and life-style trends, innovation, and the greater focus of consumers and governments on healthcare after the pandemic provide a favourable backdrop for growth.

Pandemic-related demand for drugs and services will start to decrease next year, possibly by a large percentage, but will far from disappear, given possibly continued high infection rates and rising hospital admissions through the northern hemisphere winter.

The implication for credit quality might be negative in some instances, depending on involved companies' ability to mitigate lower volumes with cost efforts or by shifting the focus on M&A. The latter is always a danger for credit quality given high sector multiples, the competition for quality assets, and the preference for debt-funded deal making.

For the companies least exposed to Covid products, most of them will maintain their credit quality as they have managed to achieve satisfactory growth rates elsewhere. We saw the impact of sustained R&D and high demand for monoclonal antibodies in strong second quarter comparable revenue growth compared with the same period last year at laboratory-equipment manufacturers such as Thermo Fisher Scietific (+13%) and Danaher (+7.5%), the two main US-based competitors to Merck's Life Science division which also recorded significant growth rates, +10% in the second quarter 2022, y-o-y.

Our positive credit outlook for healthcare remains unchanged. Most adverse macroeconomic and sentiment-driven factors have little impact on consumer demand for treatments and services. Most companies have built sizeable financial cushions, allowing them to increase debt in a measured way without immediate risk of credit downgrades, particularly given the favourable outlook for revenue and cash flow.

The exception appears to be the hospital sector which has significantly less favourable perspectives than the other healthcare segments given the regulated environment in which it operates and greater sensitivity to rising costs and staff shortages.

As ever, the one specific risk for the pharmaceutical sector would be a return to aggressive debt-funded acquisitions – possibly triggered by significantly lower Covid-related product demand – which would likely have negative credit implications. Multiples for M&A transactions in the sector are high, so any mid-sized or larger debt-funded acquisition could be negative for credit quality depending on the company in question.

Annex I: Related research

"Scope upgrades Merck KGaA's issuer rating to A/Stable from A-/Positive", published Oct 2022

"Scope affirms BBB+/Stable issuer rating on Hungarian pharmaceuticals company Gedeon Richter", published May 2022

"Scope affirms Sanofi's AA issuer rating and revises the outlook to Stable from Positive", published April 2022

"ESG considerations for rating pharmaceutical companies", published March 2022

"Pharmaceutical Outlook", published December 2021

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