Health-Care Outlook for 2010

Damien Conover, CFA
Healthcare Strategist

March 16, 2010

Executive Summary

2009 a Challenging Year for Healthcare Industry
- Macro impact more severe than in prior recessions
- Uncertainty surrounding healthcare reform

Industry Outlook for 2010 Varies by Sector
- New drug launches and patent losses determine pharmaceutical sector’s winners and losers
- M&A a dominant theme for biotechnology companies
- Devices could be hit by more stringent approval standards and comparative effectiveness requirements; impact of fees and higher costs likely to be passed onto consumers
- Instruments recover from weak 2009 - easy comps, hospital re-stocking, emerging markets, and NIH stimulus spending bode well for the industry
- Improvement in managed-care outlook largely result of more prudent underwriting; h/c reform failure a large positive (reduced uncertainty)
- Generic drugs – boom times through 2014

Morningstar Health-Care Stock Recommendations
- Big Pharma: Novartis, Pfizer, Johnson & Johnson, Abbott Laboratories
- Biotechnology: Genzyme, BioMarin
- Medical devices/instruments: Thermo Fisher Scientific, Stryker, St. Jude Medical, Becton, Dickinson, Covidien
- Insurance: WellPoint, UnitedHealth
2009 Recap: Pressures Abound, Low Valuations

Key factors:
- Macro-pressures surprisingly strong - unemployment bolstering uninsured ranks, decline in discretionary spending, budgetary woes (Medicaid cuts)
- Credit crunch and freeze in hospital spending
- **BIG** unknown - Healthcare reform

Results?
- Precipitous decline in revenue for most sectors
- Hospitals on the verge of bankruptcy
- With the exception of biotechnology, valuations depressed

Uninsured volume

Industry fees

Pricing power – Direct price negotiation

Single-payer system???

Healthcare Reform – Dire Outlook

- MA Senate election jeopardizes passage
- Support shaky even before MA particularly with mid-term elections approaching
- Comprehensive reform now unlikely due to numerous sticking points – individual and industry taxes, individual mandate, Medicare cuts, government involvement
- Marginal changes remain likely – focus on preventative care, expansion of coverage to children and Medicaid eligibility, industry concessions, closing of the “donut hole”, bio-generics, comparative- and cost-effectiveness programs, investment in healthcare IT
Focus on Drug Launches and Patents for Pharmaceutical Industry

- Reform overhang removed; investors can focus on industry- and company-specific issues
- Prospects for new drug launches vary widely within industry
  - Winner: Johnson & Johnson
    - Four potential blockbuster launches with Simponi (RA), Xarelto (cardiovascular), Stelara (immunology), and Tapentadol (pain)
  - Loser: Abbott
    - Only one drug launch in 2010; new drug portfolio an Achilles heel for otherwise strong company
- Game-changing clinical data expected
  - Winners: Pfizer (JAK inhibitor), Bristol-Myers Squibb (dapagliflozin), J&J (telaprevir, Xarelto), Merck (boceprevir, Vytorin, TRA)
  - Losers: Bristol/Pfizer (apixaban), Merck (anacetrapib)
  - Wildcard: Pfizer/J&J (bapineuzumab)
- Several crippling patent losses on the horizon
  - Winner: Abbott (ABT)
    - Morningstar Pipeline Analysis ranks Abbott the highest with regards to patent losses
  - Losers: GlaxoSmithKline, Merck, AstraZeneca
- Cost-cutting: an industry-wide boost to earnings
  - Synergies from major mergers + cost-saving restructuring plans = more efficient pharmaceutical sector going forward

<table>
<thead>
<tr>
<th>Stock Novartis (NVS)</th>
<th>Moat</th>
<th>Price/FV</th>
<th>Star Rating</th>
<th>Uncertainty</th>
<th>Mkt Cap</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Wide</td>
<td>.76</td>
<td>⭐⭐⭐⭐⭐</td>
<td>Low</td>
<td>$123B</td>
</tr>
</tbody>
</table>
| Rationale:           | • Diversified drug platform (branded, generic, consumer, vaccine) Generics should improve in 2010
                       | • Blockbuster launches in drugs and vaccines: FTY720, ACZ885, Menveo/Men B
                       | • Strong in-line product group focused on oncology (Tekturna becoming a blockbuster) |

| Abbott Laboratories  | Wide | .80      | ⭐⭐⭐⭐⭐     | Low         | $83B    |
| Rationale:          | Strong in-line products: Humira, Trilipix, Xerecise and modest patent exposure
                       | Strong acquisition track record (Kia, KnoX, and likely AMO and Solvay’s drug unit) |

| Merck (MRK)          | Wide | .83      | ⭐⭐⭐⭐     | Medium      | $118B   |
| Rationale:          | • Good price on Schering acquisition (we expect JNJ to modestly renegotiate RA deal)
                       | • Get Schering’s pipeline (TRA, Golimumab, Asonapine, Boceprevir)/cost synergies ($5.5B 2012) |

| Johnson & Johnson (JNJ) | Wide | .79      | ⭐⭐⭐⭐⭐     | Low         | $175B   |
| Rationale:           | • Diversification protects the company from patent losses
                       | • Leading pipeline: Rilonacept, Telaprevir, Golimumab, ONTO-1275
                       | • Most negatives behind the company: Epo, DES, Riopental (Watch out for Concerta in 2010) |
M&A Key Theme for Biotechnology in 2010

- Biotechs largely insulated from economic and regulatory pressures; large-cap firms relatively valued
- Reduced Part D Donut hole likely to benefit makers of expensive non-biologic therapies
- Celgene and OSI Pharmaceuticals stand to profit
- Legislation could offer a 12-year patent exclusivity
- Celgene and OSI Pharmaceuticals stand to profit
- Legislation could offer a 12-year patent exclusivity

- Pipelines take focus
  - New diabetes options rise to the surface
  - Upcoming cancer data critical to long-term growth of established franchises
  - M&A should accelerate in this space in 2010
- Top 5 biotech takeout targets

Least Exposed to Generic biologics - Roche
Most exposed - Amgen

Stock Outlook: Top Biotechnology Recommendations

<table>
<thead>
<tr>
<th>Stock</th>
<th>Moat</th>
<th>Price/FV</th>
<th>Star Rating</th>
<th>Uncertainty</th>
<th>Mkt Cap</th>
</tr>
</thead>
<tbody>
<tr>
<td>Genzyme (GENZ)</td>
<td>Wide</td>
<td>.88</td>
<td>★★★★☆</td>
<td>Medium</td>
<td>$15B</td>
</tr>
<tr>
<td>Rationale:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
|             | • Manufacturing overhaul and new hires bode well for recovery from manufacturing challenges in 2010
|             | • New competition not enough to sway vast majority of Genzyme patients
|             | • U.S. Lumizyme launch (mid 2010) to bring Pompe disease sales in line with demand (currently free drug in US)
|             | • Late-stage pipeline outside of rare diseases is strong (MS, high cholesterol, cancer) |
| BioMarin (BMRN) | Narrow | .67     | ★★★★★       | Medium      | $2B     |
| Rationale:  |       |          |             |             |         |
|             | • Monopoly position with 3 approved rare disease drugs
|             | • Steady Naglizyme and Kuvan growth will bring sustainable profitability in 2010
|             | • Bullish on Phase II data in 2010 for key programs PEG-PAL (PKU) and GALS3 (MPH IVA)
|             | • Large pharma interest in BMRN’s rare disease expertise could make it an acquisition target |

Data as of 2/16/2010 © 2010 Morningstar, Inc.
Positives Abound for Medical Instruments

What happened?
- The capital spending environment deteriorated significantly between the fourth quarter of 2008 and the second quarter of 2009.
- Main drivers:
  - Hospitals lose access to credit
  - Pharmaceutical companies delay purchases
  - Anticipation of an uptick in unemployment
  - Hospitals teetered on the brink of bankruptcy. Hospitals started slashing inventory in 2008, but severe destocking persisted into 1Q-2009

Turnaround year for the industry
- 2010 offers compelling comparables
- Pent-up demand should propel sales of capital equipment
- NIH stimulus expected in first half of 2010
- Emerging markets offer expansion opportunities
- Leaner infrastructure, more efficient operations → earnings expansion
- M&A activity likely to accelerate – conglomerates expand presence in the space?
  - Potential targets: Millipore, Perkin-Elmer, Mettler-Toledo

Stock Outlook: Top Medical Instruments Recommendations

<table>
<thead>
<tr>
<th>Stock</th>
<th>Moat</th>
<th>Price/FV</th>
<th>Star Rating</th>
<th>Uncertainty</th>
<th>Mkt Cap</th>
</tr>
</thead>
<tbody>
<tr>
<td>Becton, Dickinson (BDX)</td>
<td>Narrow</td>
<td>.78</td>
<td>⭐⭐⭐⭐⭐</td>
<td>Low</td>
<td>$18B</td>
</tr>
<tr>
<td></td>
<td>Rationale:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Defensible competitive position due to massive manufacturing infrastructure, economies of scale, technological know-how</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Robust cash flows from stable surgical business deployed into growing diagnostics segment</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Emerging markets offer growth opportunities</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Healthy balance sheet, history of returning capital to shareholders</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Recession-resilient product lineup; focus on innovation paying off, strong competitive positions</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Shift away from non-core operations should yield strong top line growth and gross margin expansion</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Rapid earnings growth on the horizon due to leverage, revenue momentum</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Covidien (COV)</td>
<td>Medium</td>
<td>.73</td>
<td>⭐⭐⭐⭐⭐</td>
<td>Medium</td>
<td>$25B</td>
</tr>
<tr>
<td></td>
<td>Rationale:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Diverse product and customer base</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Great growth avenues – diagnostics, environmental, emerging markets</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Solid cash flow generation</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Thermo Fisher (TMO)</td>
<td>Narrow</td>
<td>.66</td>
<td>⭐⭐⭐⭐⭐</td>
<td>Medium</td>
<td>$20B</td>
</tr>
<tr>
<td></td>
<td>Rationale:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| Source: Morningstar. Company Reports
New Dynamics Emerging in Devices

- New markets and products serve as company-specific catalysts for 2010
  - Medtronic to launch first ever MRI-compatible pacemaker in the U.S.
  - Zimmer’s surgeon exodus halted; new products to energize growth

- Stringent approval standards on the horizon
  - 510(k) approval process scrutinized; more frequent use of Premarket Approval application process could mean slower approval times and higher R&D costs

- Comparative effectiveness is a big unknown

- Reform failure should help valuations
  - Industry tax not detrimental to valuations, but coupled with potential pricing pressure could reduce valuations by 10-20%

Stock Outlook: Top Device Recommendations

<table>
<thead>
<tr>
<th>Stock</th>
<th>Moat</th>
<th>Price/FV</th>
<th>Star Rating</th>
<th>Uncertainty</th>
<th>Mkt Cap</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stryker (SYK)</td>
<td>Wide</td>
<td>.68</td>
<td>★★★★☆</td>
<td>Medium</td>
<td>$15B</td>
</tr>
</tbody>
</table>

Rationale:
- Favorable demographics (aging population, younger patient base, obesity)
- Strong position in the oligopolistic orthopedic field; new spine products provide growth avenues
- The potential unfavorable reform impact largely offset by inflow of new patients
- Healthy balance sheet

| St. Jude (STJ) | Wide | .67 | ★★★★☆ | Medium | $2B |

Rationale:
- Strong positioning in the emerging therapeutic areas of atrial fibrillation and neuromodulation
- Healthy balance sheet; robust cash flows
- The number and scientific strength of patents in top 10 of medical devices
Managed Care Biggest “Beneficiary” of Reform Setback

- Major overhang on MCOs’ valuations removed; share prices rebound
  - Reform relative failure means managed-care will remain a key participant in the U.S. health delivery system
- That said, our MCO thesis prior to reform setback suggested the fears were overblown
  - 5-star recommendations for two largest MCOs – WLP and UNH; WLP and UNH nearly doubled since mid-Feb lows
- Now what?
  - Few regulatory risks remain
    - Medicare Advantage reimbursement cuts are likely (particularly negative for MCOs with great Medicare concentration – Humana, Coventry, HealthSpring, WellCare)
    - Weak (or no) individual mandate + “anti-discrimination” legislation → adverse selection problem
  - Underwriting and Medical Cost Ratios (MCRs) in focus for 2010
    - COBRA and H1N1 will pressure MCRs in the first half of 2010
    - Stabilizing and improving MCRs for UNH and WLP a result of underwriting discipline – both firms are Morningstar’s only MCOs with economic moats
    - Administrative costs are key to future competitiveness
    - Commercial enrollment should improve as economy turns → strong cash flow generation trends in 2010

Stock Outlook: Top Managed-Care Recommendations

<table>
<thead>
<tr>
<th>Stock</th>
<th>Moat</th>
<th>Price/FV</th>
<th>Star Rating</th>
<th>Uncertainty</th>
<th>Mkt Cap</th>
</tr>
</thead>
<tbody>
<tr>
<td>UnitedHealth (UNH)</td>
<td>Narrow</td>
<td>.66</td>
<td>★★★★★</td>
<td>Medium</td>
<td>$37B</td>
</tr>
<tr>
<td>Rationale:</td>
<td>32 million medical members, more than 70 million people served&lt;br&gt;Wide diversification with respect to region, government/non-government business, large group/small group/individual policies&lt;br&gt;Strong portfolio of nonmedical benefit businesses – Ingenix, OptumHealth, Prescription Solutions&lt;br&gt;Scale that allows to effectively manage administrative costs&lt;br&gt;Healthy balance sheet, $24 billion in investments</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>WellPoint (WLP)</td>
<td>Narrow</td>
<td>.61</td>
<td>★★★★★</td>
<td>Medium</td>
<td>$27B</td>
</tr>
<tr>
<td>Rationale:</td>
<td>34 million members – largest members network trailing only Medicare&lt;br&gt;Limited exposure to Medicare Advantage plans&lt;br&gt;Diversification with respect to geography and risk/non-risk plans; massive scale&lt;br&gt;Doesn’t compete with nonprofit Blues plans in most states – operates Blues plans in 14 states&lt;br&gt;$23 billion investment portfolio</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Morningstar Health-Care Team

<table>
<thead>
<tr>
<th>Name</th>
<th>Function</th>
<th>Phone Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alex Morozov, CFA</td>
<td>Medical Instruments</td>
<td>312-696-6159</td>
</tr>
<tr>
<td>Damien Conover, CFA</td>
<td>Pharmaceuticals</td>
<td>312-696-6052</td>
</tr>
<tr>
<td>Karen Andersen, CFA</td>
<td>Biotechnology</td>
<td>312-384-4826</td>
</tr>
<tr>
<td>Julie Stralow, CFA</td>
<td>Devices/Orthopedics</td>
<td>312-696-6278</td>
</tr>
<tr>
<td>Debbie Wang</td>
<td>Devices/CRM</td>
<td>312-384-3937</td>
</tr>
<tr>
<td>Bill Buhr</td>
<td>Healthcare Services</td>
<td>312-696-6042</td>
</tr>
<tr>
<td>Matthew Coffina</td>
<td>Managed Care/Distributors</td>
<td>312-696-6864</td>
</tr>
<tr>
<td>Patrick Dunn</td>
<td>Healthcare IT</td>
<td>312-384-3767</td>
</tr>
<tr>
<td>Lauren Migliore</td>
<td>Biotech/Specialty Pharma</td>
<td>312-244-7048</td>
</tr>
<tr>
<td>Meera Venu</td>
<td>Biotech/Life Sciences</td>
<td>312-244-7014</td>
</tr>
</tbody>
</table>