

Health-Care Outlook for 2010

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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

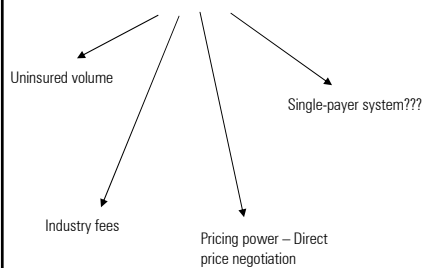
Morningstar Health-Care Stock Recommendations

- ▶ 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

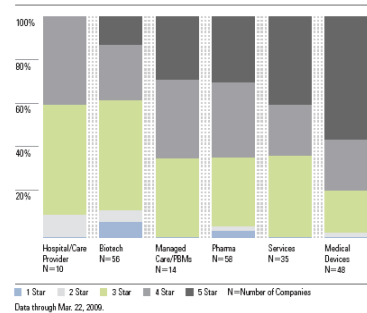
Key factors:

- ▶ 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



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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

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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
 - 13% of Glaxo's sales at risk to generics – the highest among peers
- ▶ Cost-cutting: an industry-wide boost to earnings
 - ▶ Synergies from major mergers + cost-saving restructuring plans = more efficient pharmaceutical sector going forward

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Stock Outlook: Top Pharmaceutical Recommendations

Stock	Moat	Price/FV	Star Rating	Uncertainty	Mkt Cap
Novartis (NVS)	Wide	.76	★★★★★	Low	\$123B
<i>Rationale:</i>	<ul style="list-style-type: none"> • Diversified drug platform (branded, generic, consumer, vaccine) Generics should improve in 2010 • Blockbuster launches in drugs and vaccines: FTY720, AC2885, Menveo/Men B • Strong in-line product group focused on oncology (Tekturba becoming a blockbuster) 				
Abbott Laboratories	Wide	.80	★★★★★	Low	\$83B
<i>Rationale:</i>	<ul style="list-style-type: none"> • Strong in-line products: Humira, Trilipix, Xience and modest patent exposure • Strong acquisition track record (Kos, Knoll, and likely AMO and Solvay's drug unit) 				
Merck (MRK)	Wide	.83	★★★★	Medium	\$118B
<i>Rationale:</i>	<ul style="list-style-type: none"> • Good price on Schering acquisition (we expect JNJ to modestly renegotiate RA deal) • Get Schering's pipeline (TRA, Golimumab, Asenapine, Boceprevir)/cost synergies (\$3.5B 2012) 				
Johnson & Johnson (JNJ)	Wide	.79	★★★★★	Low	\$175B
<i>Rationale:</i>	<ul style="list-style-type: none"> • Diversification protects the company from patent losses • Leading pipeline: Rivaroxaban, Telaprevir, Golimumab, CNTO 1275 • Most negatives behind the company: Epo, DES, Risperdal (Watch out for Concerta in 2010) 				

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M&A Key Theme for Biotechnology in 2010

- ▶ Biotech 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
- ▶ Biosimilar pathway in U.S. inevitable but terms look favorable
 - ▶ Legislation could offer a 12-year patent exclusivity
 - ▶ Least Exposed to Generic biologics - Roche
 - ▶ Most exposed - Amgen
- ▶ 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 takeover targets

Vertex VRTX	Vertex is close to commercializing telaprevir, a potential blockbuster treatment for hepatitis C that has demonstrated superior trial results when compared with the current standard of care.
Axillum Pharma AXLL	Xiaflex is nearing the market for two rare conditions, which would significantly boost the firm's profit potential.
Human Genome Sciences HGS1	Human Genome moved up from #32 on our list in 2009, thanks to impressive data for lupus drug Beelysta.
InterMune ITMN	Lead product candidate pirfenidone could reach the market in 2010, and it may be InterMune's key to unlocking the idiopathic pulmonary fibrosis market.
Celgene CELG	Hematological cancer blockbuster Revlimid has patent protection through 2026, and the firm's rapid growth and extensive pipeline leave it poised to remain a leader in blood-related cancer treatments.

Complete table is available in Morningstar's 2/2010 Healthcare M&A Outlook issue

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Stock Outlook: Top Biotechnology Recommendations

Stock	Moat	Price/FV	Star Rating	Uncertainty	Mkt Cap
Genzyme (GENZ)	Wide	.68	★★★★★	Medium	\$15B
<i>Rationale:</i>					
<ul style="list-style-type: none"> • Manufacturing overhaul and new hires bode well for recovery from manufacturing challenges in 2010 • New competition not enough to sway vast majority of Cerezyme 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
<i>Rationale:</i>					
<ul style="list-style-type: none"> • Monopoly position with 3 approved rare disease drugs • Steady Naglazyme and Kuvan growth will bring sustainable profitability in 2010 • Bullish on Phase II data in 2010 for key programs PEG-PAL (PKU) and GALNS (MPS IVA) • Large pharma interest in BMRN's rare disease expertise could make it an acquisition target 					
Data as of 2/16/2010					

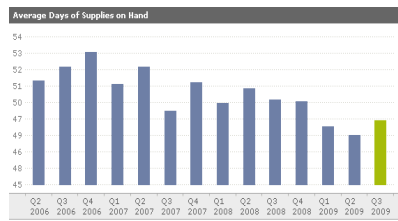
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Positives Abound for Medical Instruments

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

Stock	Moat	Price/FV	Star Rating	Uncertainty	Mkt Cap
Becton, Dickinson (BDX)	Narrow	.78	★★★★★	Low	\$18B
<i>Rationale:</i>	<ul style="list-style-type: none"> • Defensible competitive position due to massive manufacturing infrastructure, economies of scale, technological know-how • Robust cash flows from stable surgical business deployed into growing diagnostics segment • Emerging markets offer growth opportunities • Healthy balance sheet, history of returning capital to shareholders 				
Covidien (COV)	Medium	.73	★★★★	Medium	\$25B
<i>Rationale:</i>	<ul style="list-style-type: none"> • Recession-resilient product lineup; focus on innovation paying off, strong competitive positions • Shift away from non-core operations should yield strong top line growth and gross margin expansion • Rapid earnings growth on the horizon due to leverage, revenue momentum 				
Thermo Fisher (TMO)	Narrow	.66	★★★★★	Medium	\$20B
<i>Rationale:</i>	<ul style="list-style-type: none"> • Diverse product and customer base • Great growth avenues – diagnostics, environmental, emerging markets • Solid Cash flow generation 				

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%

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Stock Outlook: Top Device Recommendations

Stock	Moat	Price/FV	Star Rating	Uncertainty	Mkt Cap
Stryker (SYK)	Wide	.68	★★★★★	Medium	\$15B
<i>Rationale:</i>					
<ul style="list-style-type: none"> • 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
<i>Rationale:</i>					
<ul style="list-style-type: none"> • 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 					
<small>Data as of 2/16/2010</small>					

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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

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Stock Outlook: Top Managed-Care Recommendations

Stock	Moat	Price/FV	Star Rating	Uncertainty	Mkt Cap
UnitedHealth (UNH)	Narrow	.66	★★★★★	Medium	\$37B
<i>Rationale:</i>					
<ul style="list-style-type: none"> • 32 million medical members, more than 70 million people served • Wide diversification with respect to region, government/nongovernment business, large group/small group/individual policies • Strong portfolio of nonmedical benefit businesses – Ingenix, OptumHealth, Prescription Solutions • Scale that allows to effectively manage administrative costs • Healthy balance sheet, \$24 billion in investments 					
WellPoint (WLP)	Narrow	.61	★★★★★	Medium	\$27B
<i>Rationale:</i>					
<ul style="list-style-type: none"> • 34 million members – largest members network trailing only Medicare • Limited exposure to Medicare Advantage plans • Diversification with respect to geography and risk/nonrisk plans; massive scale • Doesn’t compete with nonprofit Blues plans in most states – operates Blues plans in 14 states • \$23 billion investment portfolio 					

Data as of 2/16/2010

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