Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

Health care in a pandemic

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | SEPTEMBER 2020

In a previous GEO (Compounding in Health Care, September 2019), we wrote about some of the virtues of the health care industry; one being the predictability of the sector. Selling essential, non-discretionary products means that health care companies are relatively immune to economic turbulence in a way that most companies are not.

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The current crisis has tested conventional wisdom in all manner of ways, including what to expect of health care companies. On aggregate the sector has proved resilient, particularly in a relative sense. Indeed, consensus 2020 earnings for the sector are down only 3.8% since the beginning of March, versus -26.7% for the MSCI World Index. However, beneath the headline numbers are some unusually large variations. Some companies have proved fairly predictable, while others have recently reported results that were scarcely imaginable just a few months ago, both to the upside and the downside.

"Selling essential, non-discretionary products means that health care companies are relatively immune to economic turbulence"

Short-term hurdles from social distancing measures offset by some opportunities

The major negative for the sector has been that hospitals and doctors' surgeries have been avoided for all but the most urgent and essential procedures. The result has been a particularly tough environment for medical device producers. For traditionally predictable businesses selling, for example, joint replacements, having 30% chopped from their 2020 earnings estimates is, surprisingly, not unusual. Even product categories that one would have previously considered as not at all discretionary, such as pacemakers, have proved vulnerable to declining sales (one leading company's division was down 25.7% organically in the second quarter). Hospitals have also been clearly impacted by this dynamic, as well as companies providing diagnostic tests. Furthermore, life science companies have suffered as researchers have been away from their benches and social distancing has limited the ability to install new equipment.

Pharmaceutical businesses have generally fared better, although certain products that need to be administered by doctors have suffered. Generally, the story of the year so far has been very strong demand in the first quarter as people panicked about the availability of medicines, followed by a weaker second quarter driven by destocking as the panic proved a little excessive.

"The sector has proved resilient, particularly in a relative sense"

The crisis has also served as a reminder of the purpose of health care companies. While the sector is frequently criticised by politicians, especially in the build-up to elections, and analysts are quick to point out environmental, social and governance risks, it sometimes seems to be forgotten that these companies provide life-enhancing and often life-saving products and services. It is these companies that are at the forefront of finding solutions to the current crisis. Time will tell whether the political winds become any more favourable, but a few highly innovative companies are already benefitting from these dynamics, particularly those able to provide accurate COVID-19 tests, as well as those in a position to help pharmaceutical companies research and develop treatments and vaccines. One of the team's health care holdings provided initial guidance for its second-quarter results of flat to -15% organic growth, and in the end reported +11% while guiding for 15% growth in the third quarter.

Looking ahead

Ultimately, the questions we are asking ourselves are whether those companies that have been negatively impacted by COVID-19 have had any permanent impairment to their earnings, or whether 2020 will turn out to be an aberration. For those that are benefitting from COVID-19-related developments, we are trying to establish how enduring these new revenues will prove.

As to if/when there will be a successful treatment or vaccine, and which companies will benefit the most, we generally find these types of predictions fraught with risk. We are, however, reasonably confident that our portfolios' companies will participate, given any successful development will require the assistance of the world's leading life science companies and likely the world's leading needle and syringe manufacturer. Also, given the difficulty of manufacturing vaccines at scale, it is not outrageous to suggest that the world's two leading vaccine manufacturers, may have a part to play.

"Any successful vaccine development will require the assistance of the world's leading life science companies"

Impact on our portfolios

Overall, we cannot claim the health care portion of our global portfolios has proved entirely protected from the negative consequences of the pandemic, but certain parts have benefitted materially, and on aggregate we feel it is providing the resilience we aim for; consensus 2020 earnings for our health care holdings are down 2-6% for our global portfolios since March, compared to -4% for the MSCI World Health Care Index, and -27% for the MSCI World Index;[1] this despite minimal exposure to the particularly defensive but lower quality pharmaceutical and biotech sub-sectors. Crucially, given the essential nature of the products and services the portfolio's companies provide, we feel confident that the more affected areas will bounce back relatively quickly—such that there is no material impact to the long-term earnings or compounding these companies can deliver.

[1] Source: FactSet, August 2020. The MSCI World Health Care Index measures the performance of large- and mid-cap health care stocks across 23 developed market countries.

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