Drug Prices Causing a Commotion

HEALTH CARE SECTOR REPORT

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Buy-rated companies mentioned in this report:
Biopharmaceuticals:
Bristol-Myers Squibb (BMY - $61.85)
Johnson & Johnson (JNJ - $146.98)
Merck (MRK - $62.03)
Novartis (NVS - $86.88)
Pfizer (PFE - $37.18)

Medical Technology & Equipment:
Abbott Labs (ABT - $58.99)
Medtronic (MDT - $86.11)
Thermo Fisher (TMO - $211.48)

Health Care Services:
Cerner (CERN - $70.28)

Prices and opinion ratings are as of market close on 1/17/18 and subject to change.
Source: Reuters.

Investment Overview

The perceived high prices of prescription drugs have become an increasingly hot topic over the past couple years. While only about 10% of total health care costs are spent on prescription drugs, the average American adult fills more than 12 prescriptions per year (Kaiser Family Foundation), making pricing a very visible issue.

Pricing Pressure Is a Long-term Risk - While it is difficult to predict what, if any, changes will occur to how drugs are priced, the recent media attention, policy proposals, and polarization of public opinion have increased uncertainty. In our view, pricing pressure will be a continuous concern for investors and a long-term risk for the industry as payers look to reduce costs.

Certain Companies Are Better Positioned – In our view, companies diversified by product and geography, or have exposure to cash pay (products that aren’t subject to government/insurance reimbursement), will be better positioned to navigate potential changes. In addition, we recommend investors diversify across health care subsectors, which include biopharmaceuticals, medical technology & equipment, and health care services.

Spotlight Intensifies on Drug Prices

The S&P 500 Index is based on the average performance of 500 widely held common stocks. The S&P Health Care Index consists of 62 health care companies within the S&P 500 Index. The Nasdaq Index is based on the average performance of 2,551 stocks. The Nasdaq Biotech Index consists of 197 biotech companies within the Nasdaq. These are unmanaged indexes and cannot be invested in directly. Past performance does not assure future results.

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The relatively high prices of new, innovative specialty drugs (such as Gilead's hepatitis C treatment and new cancer medications), along with certain cases of steep annual price increases, have raised concerns. Following these events, media attention around drug prices has continued. In addition, the visibility of drug prices has increased as more drug costs are shifting to consumers.

Why do drug prices seem to be rising?

- **Pharmaceutical innovation** - There have been a number of exciting innovative new drugs, such as drugs that use the body's own immune system to fight cancers. We consider this a large positive for drug companies and patients who benefit from this innovation.

- **Drugs with limited competition** - Occasionally there are drugs that have unique drug-delivery systems, target diseases with relatively few patients, or have strong patent protection. EpiPen is one example in which a company was able to raise prices greatly due to a lack of competition, in our view.

- **Drugs losing patent protection** - Sometimes, in our observation, a company will raise the price of a drug that is about to lose patent protection. This usually is a short-term phenomenon that more than reverses itself when generic competition comes.

- **Higher Rebates** - Rebates are price discounts negotiated between drug companies and payers. There can be a notable difference between a drug's list price and what actually gets paid, and rebates have increased substantially over time following payer consolidation. In 2016, for example, list prices for prescription drugs rose 9.2% over the prior year, but net prices increased only 3.5% after accounting for discounts and rebates (IMS).

- **Manufacturer's coupons** - Drug companies can offer coupons to patients to alleviate some of the out-of-pocket costs. This, in our view, helps encourage demand for the product, but doesn't lower the list price.

Increased Scrutiny Causing Uncertainty

While it is difficult to predict what, if any, changes will occur to pricing, the recent media attention, proposals, and public opinion have increased the likelihood of change. In our view, pricing pressure will be a continuous concern for investors and a long-term risk for the industry as payers look for ways to reduce costs. Overall, we believe the focus on drug pricing will likely lead to increased transparency and drug companies being more conservative with price increases.

Politics remain a risk for the health care sector -
Along with concerns raised from physician groups, private organizations, and pharmacy benefit managers over drug prices, certain politicians have voiced concerns as well. Proposals focus on lowering drug prices and increasing transparency. These proposals include Medicare negotiation of drug prices, lowering drug prices for patients eligible for both Medicare and Medicaid and limits on out-of-pocket drug costs for certain patients.

If enacted, these proposals would have a negative impact on the profits of the biopharmaceutical sector. However, material changes could take years, and the majority of the provisions have been discussed previously, but not enacted. In addition, it will be difficult to come up with a solution to lower prices without impacting innovation. While actual changes are difficult to predict, the increased scrutiny, along with public opinion, has increased uncertainty. This uncertainty has led to lower price-to-earnings ratios (or how much an investor is willing to pay for each dollar of earnings) in the sector.

Impact of 2016 U.S. Election - In our view, the Republican sweep and the voting down of California's Prop 61 (which aimed to set price ceilings on state drug costs) make it less likely that state and federal governments will be focused on drug prices in the near term. However, we continue to believe that pricing pressure will be a long-term risk for the industry. The consolidation of payers and pharmacy benefit managers has created increased purchasing power that we believe will continue to be used to help lower costs. Going forward, we believe the drug industry will also play a role in lowering prices through increased self-regulation. As a result, we believe biopharmaceutical companies will be less likely to take annual double-digit prices increases.

Biopharma Continues to Have Positive Long-term Growth Drivers

In our view, positive growth drivers should outweigh the risks associated with future pricing pressure over the long term. We believe that we’re in the midst of an exciting time in health care innovation, where record numbers of drugs are being approved to treat or cure unmet medical needs. In addition, we believe growth will be driven by favorable demographics and increased spending in emerging markets.

Over the last decade, biopharmaceutical companies have turned their attention to developing innovative specialty drugs to treat unmet medical needs. While these tend to carry a higher price tag than the average primary-care drug, they often result in a greater improvement in the lives of patients. In addition, the list price of a new drug (and the price that captures headlines) is typically far higher than
the actual price after discounts and rebates. Over the next decade, the Centers for Medicaid and Medicare estimate that drug spending will increase by about 6% a year.

In our view, pricing power in the biopharmaceutical industry will need to continue in order to drive innovation. It can cost a drug company billions of dollars to develop one new drug, but there is the potential for attractive profits, which incentives innovation. As the evolution of health care continues, there will likely be a greater focus on whether a drug can improve the quality and quantity of life for a patient, and on a need for strong data that shows the cost-effectiveness of a drug, in order to support its price.

Certain Companies Are Better Positioned

While we believe the industry will continue to be rewarded for innovation, companies that are reliant on relatively fewer products could potentially be more impacted by pricing pressure. However, certain companies, in our view, are better positioned. These include companies that have a diversified product and geographic base or have exposure to cash pay (products that aren’t subject to government/insurance reimbursement). The table below lists our Buy-rated stocks that fit these characteristics.

• **Geographic diversification** - Most large health care companies have considerable international sales, which reduce the impact of any risks associated with changes to health care in the U.S.

• **Product diversification** - A diversified product portfolio minimizes the impact of increased competition or pricing pressure on a specific product or product category.

• **Payer diversification** - Companies with higher sales exposure to non-government payers (such as private insurance and cash pay) have more pricing power and less reliance on government reimbursement.

![Image of table with company names and diversification details]

Source: Edward Jones

**Valuation** - In valuing health care companies, we use various methods, including price-to-earnings ratios, dividend yields, discounted cash flow estimates, and return-on-investment calculations.

**Additional Risks** - General risks to consider when investing in biopharmaceutical companies include pricing pressure, product failures and liabilities, and political and regulatory risk.

Please see the full opinions of the individual companies mentioned in this report for additional information, including valuation and risks.

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