Global Healthcare Quarterly: October

Trading outlook brightens after Covid-19 crisis tests resilience of hospital sector, some pharma segments. Credit outlook remains stable. With right coronavirus response, industry has opportunity to enhance its reputation.

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Executive summary

The sturdy healthcare-sector recovery which began in the third quarter is continuing. Most hospitals are open and functional again – in Europe and the United States – with new restrictions to contain the spread of Covid-19 likely to fall short of drastic lockdowns imposed by governments in March and April. For the hospital sector, we expect some catch up in demand lost due to previously delayed treatments and procedures even if it is too early to say that hospitals are back to business as usual. Vaccines and diagnostics remain growth segments given the priority now attached to health and hygiene by governments and consumers. Overall, we see no dramatic "v-shaped" post-lockdown recovery though there is momentum behind the sector's rebound from a difficult second quarter.

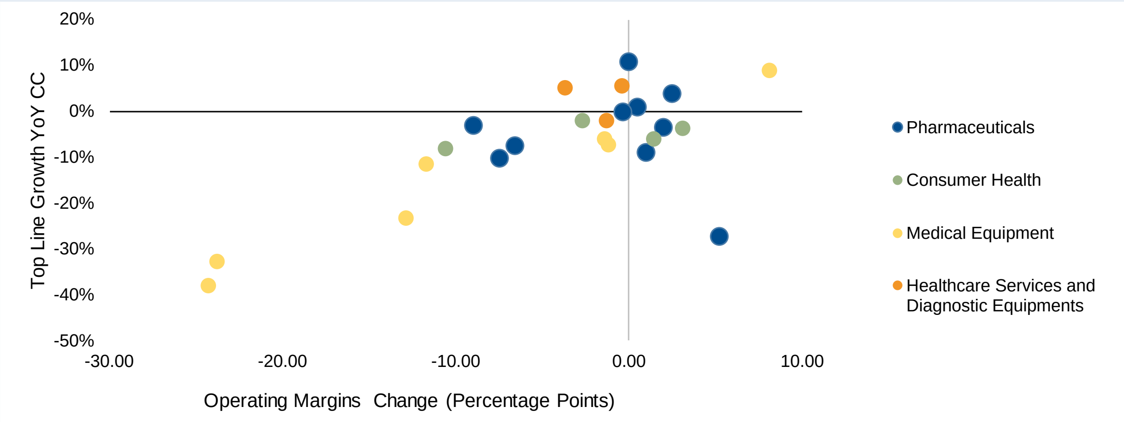
The present crisis may provide an opportunity for the pharma industry to restore its reputation as a provider of effective therapies and vaccines which can be rolled out at reasonable prices. An important factor today is that the governments are increasingly direct stakeholders in healthcare projects, giving the pharma companies the chance to show that they are reliable partners.

In this second version of our newly introduced quarterly, we also assess second-quarter results and focus on vaccines, notably the race for the first approved Covid-19 vaccine. Scope's healthcare team covers 20 global credits, including public and private mandates for large and smaller companies. Our two most prominent public mandates are Sanofi SA (AA/Stable) and Merck KGaA (A-/Stable).

The main trends we expect for 2020 are:

- We continue to see no sector-wide adverse impact from the pandemic, but there are important differences within the industry, particularly for companies with hospital-related activities.
- Vaccines and diagnostics remain growth segments given how public health has become the priority of governments worldwide, with consumers increasingly health-conscious themselves.
- We still feel that there needs be a good deal more circumspection about how quickly vaccine makers will be able to develop a vaccine against Covid-19 given the rigorous trials and testing required.
- Hospitals should continue to return to more normal operations despite the second wave of Covid-19 infections even if progress is uneven.
- Medical-device demand remains subdued, with exceptions: ventilators, interventional devices.
- Favourable Q4 trends - strong demand for vaccines, OTC drugs; less disruption of hospital-related business - should extend into 2021, helping underpin our stable credit outlook of the sector.

Figure 1: Healthcare sector snapshot by sub-sector in the second quarter of 2020



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Key trends in H1 2020

Healthcare companies faced unusually difficult operating conditions for most of the first half of 2020, particularly in the second quarter. While this was hardly unexpected as the coronavirus pandemic unfolded, details of how the health crisis affected the sector which emerged from the Q2 reporting season negatively affected sentiment.

The most exposed companies were those dependent on hospitals and hospital-related demand: drug manufacturers with a strong exposure to hospitals or hospital-administered products, related to cancer and multiple-sclerosis treatments, for example, or elective care; most medical equipment suppliers, except for consumable products like wound care. There were two main reasons for the significantly lower demand: a) hospital operators ordered partial closures to make room for potential coronavirus patients, and b) physical-distancing protocols limited the possibility of physical meetings between doctors and patients and doctors and drug-company sales reps.

In contrast, demand for many "easy-to-use," home-administered and non-prescription products held up better. Vaccine demand also shrank substantially in the quarter, for similar reasons in addition to the drastic travel restrictions imposed on many countries resulting in much lower demand for travel-related vaccinations. Supply-chain problems appear to have proved relatively minor so far this year: in general, there was over-stocking in the first quarter and a more mixed experience in the second. The industry's credit quality has held up, with abundant government support available for companies worst hit by the pandemic.

Outlook for remainder of 2020

We see the sturdy recovery which began in the third quarter continuing. Most hospitals are open and functional again – in Europe and the United States – with restrictions to contain the spread of Covid-19 likely to fall short of the drastic lockdown imposed by governments in March and April. Secondly, we expect some catch up in demand lost due to previously delayed hospital procedures though it is too early to say that hospitals are back to normal. Some hospital operators are reporting continued delays to treatments as many patients are fearful of catching coronavirus in hospitals.

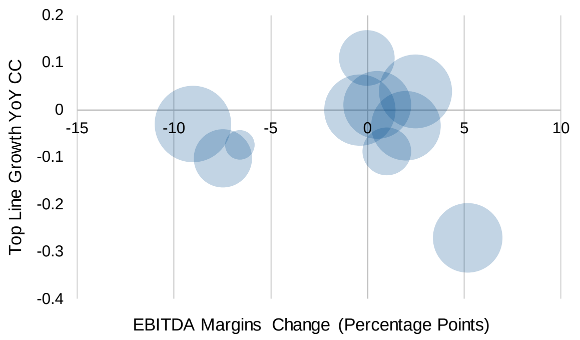
Overall, we see no "v-shaped" post-lockdown recovery but there is momentum in the sector's recovery. One factor is patients' increased awareness of self-medication options and healthcare companies' online services.

The general sector recovery over the coming quarters will of course be led by strong vaccine demand - see special section below – which is one consequence of the global dimension of the coronavirus crisis.

We believe that the present crisis may provide an opportunity for the innovative pharmaceutical industry in particular to embellish its reputation as a provider of effective therapies and vaccines for a perceived global pandemic which can be rolled out at reasonable prices. The crisis could provide a welcome chance for the pharma industry to repair its reputation for price-gouging.

An important factor today is that the governments are increasingly direct stakeholders in healthcare projects – the German government has invested in a local vaccine maker - thereby providing the pharmaceutical industry an opportunity to show it can be a reliable partner. Some pharma executives have become more positive on their guidance on the basis that this new private-public partnership promises better future growth in tandem with greater attention that consumers are now paying to their own health. Pfizer CEO Albert Bourla expects 6% compound yearly revenue growth until 2025.

Figure 2: Innovative pharma companies' positioning in Q2 2020 (bubbles indicate companies' sizes)



Source: Q2 reports, Scope Ratings

Near-term credit outlook: limited risk of downgrades

As we said in the previous healthcare quarterly, we believe that downgrades are unlikely as the most adverse effects of the pandemic appear to be behind us. Our expectations are for a gradual recovery through the second half of 2020, and possibly even an acceleration in some sectors like vaccines.

This segment stands to benefit from a record 'flu season this year, reflecting growing government concerns to protect people's general health during the pandemic – particularly children and the elderly – and increased healthcare awareness of the general population itself.

Demand for children's vaccines will likely be strong, as most parents are strongly motivated to make sure their children are safe from other viruses as Covid-19 continues to spread. Governments are in many cases urging parents to keep vaccinations up to date. The vaccines segment is one of the most profitable in the industry. If there are no second lockdowns, the industry will gradually get back to more normal business activity in 2021, ensuring rating outlooks remain at least stable.

Vaccines & Covid-19: truth vs fiction

The pandemic has thrust vaccines into the healthcare-sector spotlight with hopes riding high for the development of a SARS-CoV-2 vaccine soon.

Political attention, assuming fast R&D and regulatory approval for a new vaccine, has quickly turned to production and distribution in sufficient volume. We feel that there should be a good deal more circumspection about the development of a vaccine against Covid-19 anytime soon. Any new vaccine - similar to a new drug – needs to undergo three phases of research and development before it can finally be handed over to the regulators for approval. This process is very lengthy and can easily take up to 12-18 months. At the end of the process, approval is by no means a certainty. Regulators need to make sure that they weigh the benefits and potential risks in making a new medication available to the public. While they are undoubtedly under enormous pressure in some countries to "help" politicians announce much-awaited success, the downside can be significant if scientific scrutiny is sacrificed for the benefit of speed. A striking difference between the distribution and administration of a vaccine and a drug is that the latter is given only to sick patients, while a vaccine is administered to healthy people as a preventative measure. An overly short vaccine approval process which then compromised the health of large numbers of people in a vaccination drive could be catastrophic – quite apart from the reputational damage for politicians and companies if they are found to have wantonly made healthy people sick, even if the intentions were good.

The longer coronavirus spreads in an uncontrolled fashion, the greater the pressure will be on the authorities to help develop a vaccine or treatments to end the pandemic. We have already seen some signs of desperation, with Russia's approval of a vaccine in July, which was just tested randomly before being approved by the national regulator. In general, governments have found it hard to resist "vaccine nationalism" in trying to secure supply of an approved vaccine for their own population. The Food and Drug Administration (FDA) in the US has lowered the threshold for a vaccine approval to 50% efficiency, which is very low and hard to understand from a medical perspective – but probably more so from a political one.

The benefit for many companies involved in the vaccines and anti-viral segments is of course that there is a lot of money available upfront. Both public and private money is used abundantly to drive forward development of a new coronavirus vaccine. The German government taken a 23% equity stake in small biotech company CureVac AG which is developing a new mRNA-based Covid-19 vaccine. While problematic for competitive reasons, as just one vaccine developer has received such state support, this illustrates the pressure governments are under.

Pharmaceutical-company strategies in terms of producing an effective Covid-19 vaccine vary. We identify three main approaches:

Traditional:

- A weak dose of the virus is injected aimed at provoking a reaction from the body's immune system (Sinovac, Sinopharm);
- Recombinant vaccines involve development of an antigen to induce production of antibodies, boosted by an adjuvant (GSK/Sanofi, Novavax);

Innovative:

- Development of genetically modified and natural messenger substances (mRNA/ DNA) aims to spur production of antigens by the body's own immune system (CureVac, Biontech/Pfizer, Moderna, Inovio, Sanofi);
- Vector-based: a harmless virus is used as a transport vehicle for certain coronavirus proteins which would trigger an immune response from the human body (Johnson & Johnson, AstraZeneca);

Other:

- Drug-based treatments involve combining existing antibody treatments into "cocktails" to reduce individual viral loads (Regeneron, Eli Lilly).

The consensus for now appears to that that it will not be easy to find one "wonder vaccine" to immunize people against Covid-19. There are too many genetic profiles for the world's different populations so different vaccine doses and specifications will be necessary. Many companies think that only a combination of different vaccines might be effective.

As the innovative approach has never been proven in the vaccines segment before, we can expect a higher approval hurdle even in the case of promising late-stage clinical trials.

According to the World Health Organisation (WHO) there are about 200 coronavirus projects underway at present, 34 of them in clinical trials (R&D phases II and III).

We point out that availability of a new and effective vaccine is possible only after the test product has gone through a more complicated and protracted process than many people realise. There are only four large global vaccines manufacturers offering large and dedicated R&D and production capabilities as well as process knowledge. This is crucial, however, given the scale at which a future vaccine would have to be produced: GSK PLC and Sanofi SE in Europe; Merck Inc. and Pfizer Inc., whose vaccine positioning overall is comparatively narrow, in the US. In other words, significant experience and R&D capabilities are by no means widespread among companies. Smaller manufacturers may find it difficult to match larger rivals' efficiency and production capacity.

However, there is a disproportionally large number of rather small companies involved in the search for a Covid-19 vaccine, such as Biontech or Curevac of Germany. While they have partly teamed up with larger manufacturers to address problems of scale and expertise, Covid-19 has presented these companies a huge opportunity to bolster their reputations and attract funding.

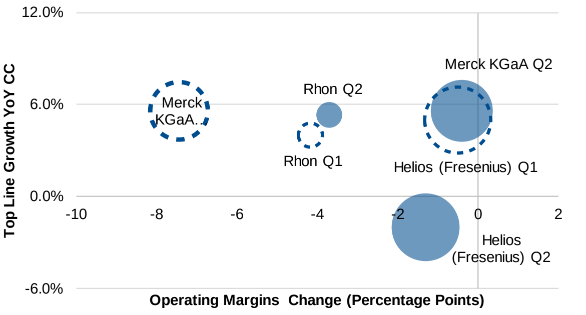
Biontech has entered the accelerated approval process of the European Medical Agency EMA for its mRNA based vaccine as has a trial vaccine from the AstraZeneca/ Oxford Universities partnership. The system involves a rolling approval process before the final phase III clinical trials have finished. Needless to say, this does not give any indication on eventual approval as the final outcome of the trial is not known yet.

We continue to expect final availability of a new Covid-19 vaccine not before the second half of 2021, even with a speedy approval process linked to the urgency of stemming the pandemic. Some players which had initially promised approval in August and September 2020 had to revise their guidance. Novel mRNA-based vaccines currently under development by a number of companies carry an additional risk in our view as no vaccine has ever been developed and approved using this technology before. In addition, failure rates for possible new vaccines typically run above 90% through the full development cycle: less than one out of every 10 new vaccine candidates make it through to commercialisation. This was underlined recently when both AstraZeneca and Johnson & Johnson said they had encountered significant safety issues in their clinical trials which they then put on hold.

Public expectations of a quick invention and approval of a new vaccine are one thing. Subsequent availability of a new vaccine is another. Logistics are one issue considering the sheer scale of rolling out vaccines to millions in treating a global pandemic. Other issues relate to what sort of vaccine is approved: any new mRNA based vaccine would have a short shelf life and require cold-temperature transport and storage.

Industry outlook: healthcare services rebound

Figure 3: Healthcare services companies' positioning in Q2 2020 (bubbles indicate companies' sizes)



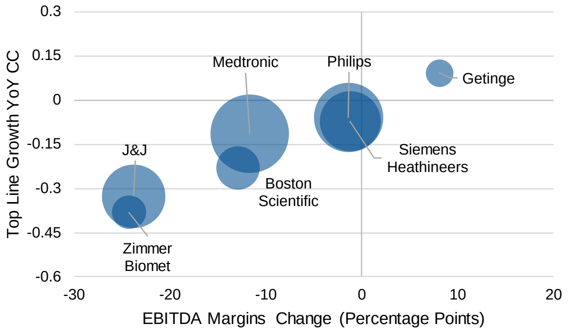
Source: Companies' Q2 reports, Scope Ratings

Healthcare-services markets are country-specific and depend, to a large extent, on factors such as public healthcare policies, government regulation, and levels of privatisation, as well as demographics and local economic and political conditions. The pandemic has reduced the predictability of revenue. Second-quarter reporting showed the unevenness of the economic impact of the pandemic extends to the healthcare sector. At German healthcare company Fresenius SE, for example, dialysis unit Fresenius Medical Care reported 4% organic revenue growth in Q2 compared with the same period in 2019. Postponements in elective care had an adverse impact on its hospital operator Fresenius Helios where revenue fell 4% in Q2 2020. In general, operators of hospitals and clinics have benefited from government compensation for lost revenue and extra costs associated with the pandemic, in some cases receiving a guaranteed payment for each additional intensive-care bed installed, in addition to shortened governmental payment cycles. The resumption of more elective procedures and medical check-ups since May 2020 should continue despite heavier Covid-19 caseloads.

The performance of pharmaceutical companies has proved far more resilient. Merck KGaA reported Q2 organic sales growth of 6.3% at its life sciences unit.

Medical devices: recovering from hospital shutdowns in Q2

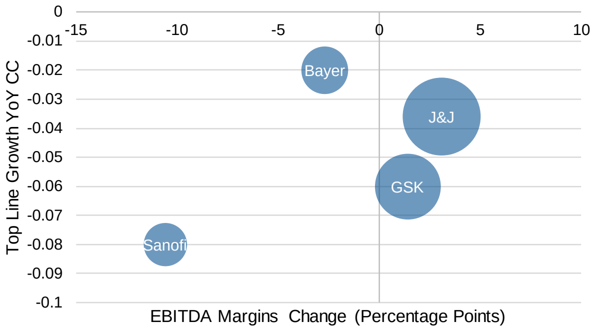
Figure 4: Medical device companies' positioning in Q2 2020 (bubbles indicate companies' sizes)



As expected, the pandemic had an adverse impact on the Q2 performance of medical-devices companies. One outlier was Swedish ventilator maker Getinge AB where demand for its advanced ICU ventilators surged. Otherwise, companies followed by Scope all reported lower revenue. In the US, Zimmer Biomet and Johnson & Johnson's medical-devices units reported decline in their orthopaedic, vision and cardiovascular businesses. Scope expects some segments to have rebounded in Q3 – J&J reported a better performance of its interventional-devices business – but otherwise for sales to remain under pressure.

OTC: also benefitting from the crisis

Figure 5: OTC companies' positioning in Q2 2020 (bubbles indicate companies' sizes)



Source: Company reports, Scope Ratings

For pharmaceutical companies, the lockdowns and other physical-distancing protocols have set back demand for over-the-counter drugs. Growth was robust in the first quarter before reversing in Q2. The shift partly reflected the Q1 build-up in inventory which was then run down in the months that followed. In line with the other health care markets, we expect that adverse Q2 trends reversed in the third quarter. Consumers raised health-awareness as the Covid-19 health crisis lingers should ensure the rebound in demand continues in the medium term.

Annex II: Related research

Scope affirms A-/Stable issuer rating on Merck KGaA 09 Oct 2020

Scope affirms AA/Stable issuer rating on Sanofi 09 Sep 2020

Global Healthcare Quarterly: Covid-19 tests sector resilience but creates opportunities 18 Jun 2020

European pharmaceutical outlook 2020: stable, benign outlook underpinned by innovation 28 Jan 2020

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