Global Healthcare Quarterly: June 2020

Scope Global Healthcare Quarterly: Covid-19 tests sector resilience, creates opportunities.

Corporates, Scope Ratings GmbH

Executive summary

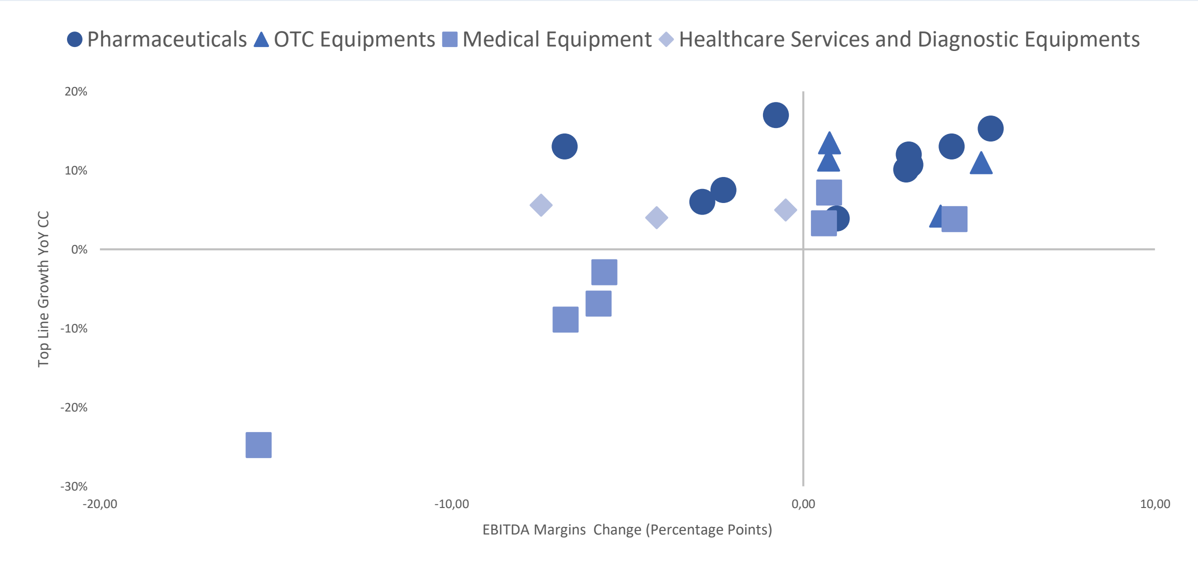
The healthcare industry has so far demonstrated its intrinsic resistance to economic shocks through the coronavirus crisis, so we have seen no need for any rating downgrades. On the contrary, most companies reported solid first-quarter results, though management at most companies did warn that business would be much slower in the second quarter.

In our first global healthcare quarterly, we look at recent developments in the industry and lay out our expectations for the sector's different segments. We assess the sector's first-quarter reporting, comparing European with North American trends. Scope's healthcare team covers a growing number of credits on a global basis, including public and confidential mandates distributed across 20 large and smaller companies in the pharmaceutical sector. Our two most prominent public mandates are Sanofi SE (AA/Stable) and Merck KGaA (A-/Stable).

The main trends we expect for 2020 are:

- **Most European drug manufacturers did not lower their guidance for the full year in contrast with some rivals in the US**
- **We see no sector-wide adverse impact from the pandemic, but there are important differences within the industry. Companies with vaccines and diagnostics activities tend to be beneficiaries while postponements of elective surgency and non-urgent care has hit medical equipment companies hard.**
- **Companies with relatively heavy reliance on hospital business are more vulnerable to pandemic disruption**.
- **Looking at 2021, we expect most healthcare segments to return to more normal business activity, assuming no increase in coronavirus fatalities.**

Figure 1: Healthcare Sector Snapshot based on sub-sectors



Scope Corporates Ratings

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Key trends for Q2 2020

One of the lessons of the crisis for the healthcare sector, among others, is a somewhat abrupt realisation of the risks of globalisation. More accurately, the pandemic has revealed the dependence of some companies on single-country sourcing, usually pursued in the name of efficiency and maximising shareholder returns. Many companies had initially encountered severe supply-chain bottlenecks as efforts to stop the spread of the disease led to lockdowns in China and disrupted transport links – though in India's case, significant bottlenecks are yet to materialise. Scope already puts great emphasis on diversification in its corporate rating assessments. European healthcare companies in general seem to be better placed regarding supply-chain risk than US counterparts. A good example is Sanofi's recent decision to create a European-based active pharmaceutical ingredients manufacturing and marketing company, the world's second largest by sales.

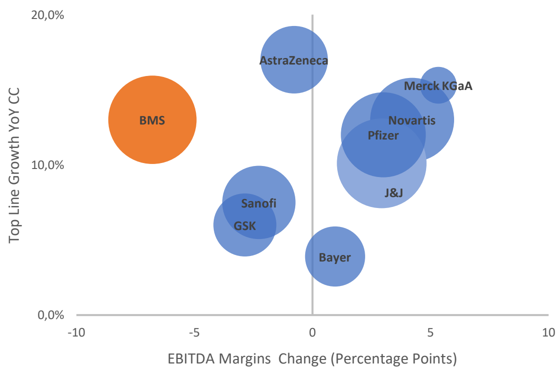
Calm before the storm: drawing conclusions from Q1 performance, guidance

Leading global pharma companies turned in robust revenue growth in the first quarter of 2020. However, the picture is flattering for two reasons.

First, customers undertook significant forward purchasing in the expectation of potential product shortages as the spreading Covid-19 outbreak threatened supplies of raw materials from China and India, two countries on which the sector's supply chains are heavily dependent.

Secondly, the crisis hit most companies' performance only from mid-March, thus very late in the quarter. Consequently, most management teams warned of a significantly weaker quarter to come, as lockdowns and physical contact restrictions were introduced in most countries from April.

Figure 2: Innovative pharma company positioning in the first quarter of 2020



Source: Q1 reports, Scope Ratings

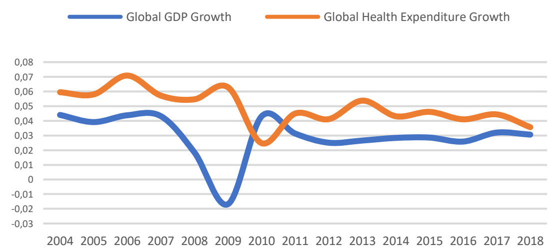
Given the limited visibility at the time of first-quarter reporting, many European pharma companies did not alter their former financial guidance for the full year 2020 in contrast with some US rivals, suggesting greater US sector exposure to supply-chain problems.

In the US, the world's biggest healthcare market by value, another factor for companies' greater caution appears to be a significantly reduced number of doctor-patient visits as authorities imposed lockdowns, leading to lower levels of prescriptions. In addition, the lockdowns and other healthcare protocols have ensured that pharma companies have not had the same freedom to make sales and marketing calls with doctors and hospitals, leading to possibly reduced future hospital-related business. In addition, governments have asked many hospitals to make room for coronavirus patients by postponing other non-life-threatening treatments and surgery to ensure their intensive-care activities were not swamped. These factors may have resulted in significantly lower pharma sales in the second quarter for healthcare companies supplying hospitals.

The second quarter could turn out to be a critical test for the industry in face of the Covid-19 natural disaster despite companies' contingency plans and some degree of flexibility in supply chains and clinical trial processes.

Near-term credit outlook: limited risk of downgrades

We believe the healthcare sector will avoid rating downgrades if the duration of negative economic effects of the pandemic can be limited to 2020. If we think that companies can get back to normal business conditions in 2021, ratings will very likely remain unchanged. Alternatively, if companies end up requiring significant additional debt funding in 2020, some ratings may be put under review for possible downgrade. The global economy has fallen into recession, with severe contractions in GDP in many developed countries. Healthcare spending is typically resilient in the face of economic downturns, which will limit any immediate negative impact on pharmaceutical sales. However, one of the longer-term side effects of the economic turmoil may be governments' and regulators' even greater focus on reducing the prices of drugs. There is plenty of discussion already about the appropriate pricing and distribution of any future vaccine against the Covid-19 virus.



Source: IMF, World Bank

Vaccines: crucial but time-consuming exercise to beat the pandemic

Many governments have stepped forward to pre-fund vaccine development – the German government even took a 23% stake a in small biotech company, CureVac AG, which is developing a new mRNA-based anti-Covid vaccine – while several companies have positioned themselves as potential leaders in the race to find a way to immunise populations against Covid-19.

We would caution 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, crucial given the scale at which a future vaccine would have to be produced: GSK PLC and Sanofi in Europe; Merck Inc. and Pfizer Inc., whose vaccine positioning is narrow, in the US. In other words, significant experience and R&D capabilities are by no means widespread. Smaller manufacturers may find it difficult to match larger rivals' efficiency and production capacity.

Vaccine development follows a similar pattern to drug development. There are three phases of clinical trials and only after the pipeline product's efficiency is proven can it then be forwarded for approval to regulators. This process can easily last two quarters or more, though it should be shorter for the large vaccine manufacturers.

However, we do not expect final availability of a new Covid-19 vaccine before the second half of 2021, even including a speedy approval process due to the urgency of coping with a pandemic. Novel mRNA-based vaccines as currently under development by US-based Moderna Inc. and CureVac AG from Germany are very topical at present but do carry an additional risk in our view as no vaccine has ever been developed and approved using this technology before. In general , and adding to the risks present, failure rates for possible new vaccines run above 90% through the full development cycle: less than one out of every 10 new vaccine candidates makes it through to commercialisation.

One risk which vaccine manufacturers are running is that if it takes about a year to develop a new product, the main threat of the pandemic might be gone by then. In that light, the cost-sharing vaccine-development tie-up between GSK and Sanofi does make sense, from a commercial point of view. As mentioned above, Sanofi has just announced a more than EUR 500m investment into a new France-based vaccine production site.

The jury is out as to which company will be able to produce a vaccine first, and if it does, how it can be manufactured and distributed in an efficient and non-discriminatory way to the population. We assign a greater likelihood of success in the search for a workable vaccine to Sanofi and GSK than to the smaller companies involved, given the complexity of successful vaccine development and ultimate deployment on a global scale.

Generic drugs: the effect of forward buying will have faded

Suppliers of off-patent drugs showed some positive trends in the first quarter of 2020, though not as prominent as for vaccines and innovative drugs. This was based on forward buying, coupled with significant Chinese orders in line with a new centralised drug-purchasing programme. Merck KGaA's anti-diabetes drug Glucophage increased first quarter 2020 sales by more than 30%, year-on-year. The two largest generic drug manufacturers Teva (+5%) and Sandoz (part of Novartis, +11%) showed strong sales growth in the first quarter of 2020 on a year-on-year basis.

However, generic drugs are increasingly important in most large countries' health budgets, so a general reduction in the number of doctor-patient visits will have reduced volumes of generic drugs sold in the second quarter. Production of non Covid-19-related drugs continues despite some supply-chain bottlenecks. As of end of March 2020, only limited spot shortages of drugs had been reported in certain areas and product types, despite China and India playing a critical role in the supply of APIs and generics. That may well change as the pandemic evolves and if factories don't get back to full production soon, forcing pharma companies to reassess the integrity of their supply chains and manufacturing capabilities.

Most companies can weather any short-term disruption as they typically have reserves of at least a few months or as much as a year in some cases. Disruptions to the supply of raw ingredients could trigger price increases globally, particularly for generics, as healthcare providers compete to secure supplies. The Covid-19 crisis could also result in generic drug makers bringing some manufacturing back to the US and Europe from China and India, where it is heavily concentrated, to reduce supply-chain risk.

Healthcare services: Covid-19 disruption of non-urgent hospital care will have knock-on effects

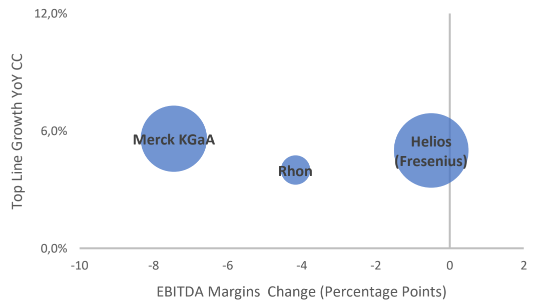
For companies in the healthcare services sector – including hospitals and nursing homes – the picture is mixed. In Europe, some companies reported good growth in revenues: Helios, the largest German private hospital operator, said revenues rose 5% in the first quarter compared with the same period in 2019; fellow operator Rhön Kliniken reported a 2.6% rise.

The pandemic has led to the postponement in many countries of non-urgent treatment of other conditions. In some cases, patients have been reluctant to attend consultations for fear of contracting coronavirus or have had to comply with government quarantine measures to contain the spread of the virus. In other cases, hospitals – under increasing pressure to accommodate Covid-19 in-patients – have suspended elective surgeries and other treatments and closed certain services to manage capacity. Despite some measures like tele-consultations, it is expected that delays in treatment will reduce volume growth in the short term, especially in the hospital sector. Face-to-face interaction between healthcare professionals and pharmaceutical industry representatives has already fallen in many countries and has been suspended in some in line with Covid-19 protocols, making it hard for drug makers to promote products.

Diagnostic sector: testing, laboratory services in higher demand

Suppliers of laboratories for testing and general equipment, such as Merck KGaA's Life Sciences unit, have painted a more bullish picture of economic conditions. In Merck's case, the division increased revenues by 5.6% in the first quarter compared with the same quarter a year ago, led by 13.2% growth in its process solutions business, which sells products and services for the entire pharmaceutical production chain. We expect this trend will continue through the current quarter and into the next as more companies position themselves in the diagnostic and vaccines markets.

Figure 3: Healthcare services and diagnostic equipment company positioning in Q1 2020

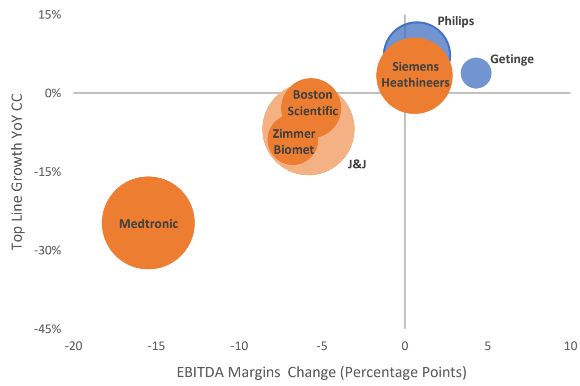


Source: Q1 Reports, Scope Ratings

Medical equipment: postponement of elective surgency, non-urgent care hits hard

We expect the Covid-19 pandemic to have a negative impact on global medical device companies' financial results in 2020; recovery is expected to start from the beginning of next year. Unlike most of the pharma companies, some of the medical device companies Scope has analysed reported negative growth in Q1 and are expecting gloomy financial results in Q2 This has especially affected business lines related to elective surgeries for revenue generation as hospitals prioritised emergency care. This is expected to continue throughout the whole of the second quarter. According to EvaluatePharma, companies exposed to orthopaedic and cardiovascular (4th and 2nd largest sub-sectors, respectively) are hit hardest mainly driven by delays to non-urgent procedures and subsequent lower orders from healthcare service providers. This was confirmed by Medtronic, which reported a 26.4% YoY CC sales decrease in Q1 2020; followed by Zimmer Biomet and Boston Scientific. Philips, Siemens Healthineers and Getinge medical devices businesses remained in the positive growth rates area in Q1 2020. The wound, respiratory and monitoring machines and diabetes products representing a 10%-15% share of total medical devices market benefited from a drastic increase in demand in anticipation of potential supply-chain bottlenecks. We see potential postponed payments to medical device companies that are not related to critical care caused by likely tighter hospital budgets as more of a temporary issue.

Figure 4: Medical equipment company positioning in Q1 2020

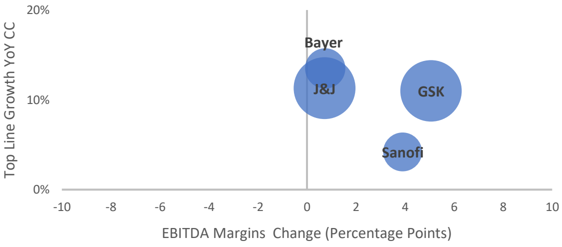


Source: Q1 Reports, Scope Ratings

OTC products: also benefiting in the first quarter

In the over-the-counter segment of the healthcare industry positive demand effects have also been broadly visibly in companies' first quarter results. This segment, which entails prescription-free products generally sold in pharmacies catering for general well-being (vitamins, minerals, anti-ageing products, nutritionals and others) also benefited from the effects of the Covid crisis. Many companies partly attributed significant revenue increases during the first quarter (Bayer +13.5%, GSK +14%, on a like-for-like basis, respectively) to inventory build-up for main customers in anticipation of potential bottlenecks arising from supply-chain disruptions expected in the coming months. While this has not happened to our knowledge so far, people's increased health conciousness amid the pandemic is creating an additional element of demand for perceived healthy products linked to strengthening consumers' immune systems. GSK reported an increase in the high teens for product group vitamins, minerals and supplements inside its OTC division in the first quarter of 2020, in a year-on-year comparison. Similarly, the group's OTC respiratory health product group appeared to have benefited significantly from the same effects, having reported a mid-teens comparable revenue increase in the first quarter 2020 compared with same period a year ago. Whether these effects are sustainable for the coming quarters remains to be seen. If the inventory build-up effect was the dominating factor behind the strong sales inceases in the first quarter, corresponding weaker results are to be expected in the second quarter.

Figure 4: Medical equipment company positioning in Q1 2020



Source: Q1 Reports, Scope

Annex II: Related research

"Covid-19 pandemic's economic impact: significant risk as the world economy falls into recession," published April 2020; available here.

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