

## VIEWPOINT

## Is This Going To Hurt?

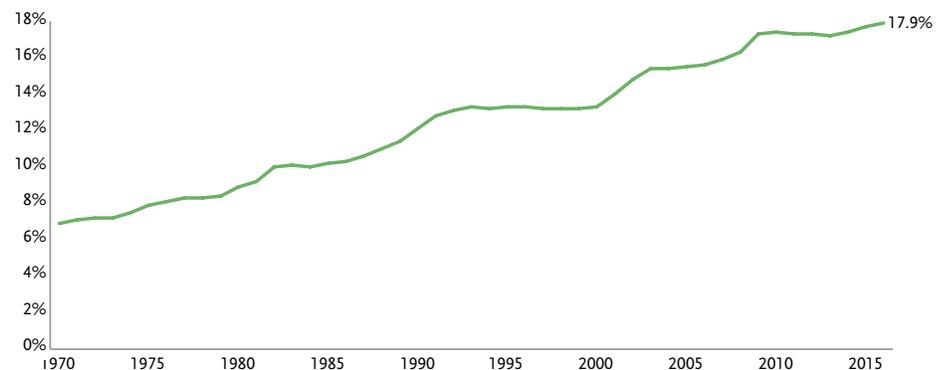
PATRICK J. BARRETT | JUNE 1, 2018

Much of the public commentary around the U.S. healthcare system is focused on the role of government and an unsustainable cost trajectory. Politics aside, a more clinical assessment reveals a number of private sector initiatives underway that are driving meaningful cost reductions and improving profitability for healthcare companies.

Despite some structural flaws, the healthcare ecosystem provides investment opportunities with less cyclical cashflows. TCW sees evidence of private sector innovation shifting the healthcare landscape and presenting opportunity for investors.

**Strong Vitals**

The U.S. healthcare sector has grown more rapidly than the broader economy, accounting for 17.9% of GDP as of 2016. While some portion of this growth results from the demands of an aging population, structural flaws have enabled unchecked pricing power by some service providers and excessive use of medical services (excess utilization) by insurance policy holders.

**Health Expenditures as Percent of Gross Domestic Product, 1970-2016**

Source: Kaiser Family Foundation analysis of National Health Expenditure (NHE) data from Centers for Medicare and Medicaid Services, Office of the Actuary, National Health Statistics Group.

**Cost Ailments**

Prescription drug costs attract substantial media attention, yet pharmaceuticals account for only 10% of U.S. health expenditures. Hospitals and physician services, referred to as “provider care,” are actually the more significant portion of health spending, accounting for 52% of costs on a combined basis.

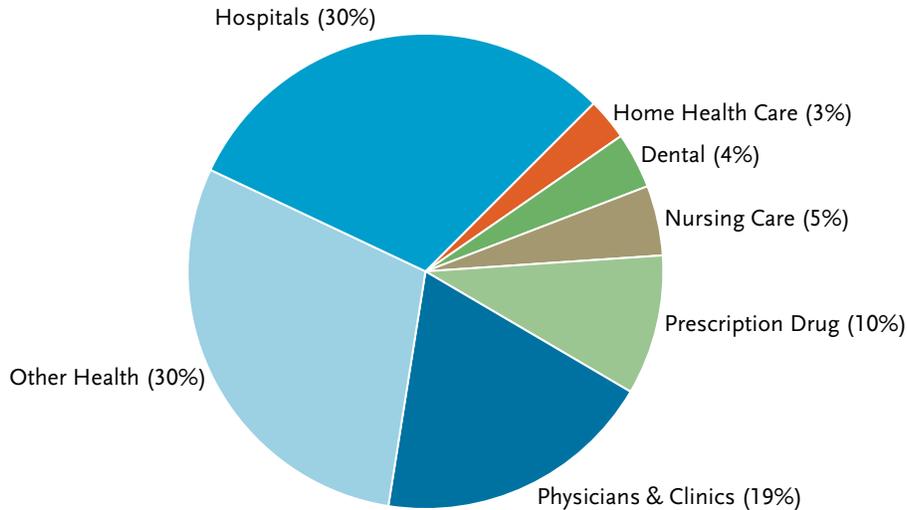
The provider care subsectors are plagued by inefficiencies, and thus have invited innovation and competition.



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Mr. Barrett joined the TCW Fixed Income group as a Credit Analyst in 2016 and is responsible for credit research in the healthcare sector. Prior to joining TCW, he was a member of the Investment Strategy Group at Goldman Sachs, where he focused on asset allocation and portfolio management topics for institutional clients. Mr. Barrett holds a BA in Economics and Political Science from Boston College and an MBA from Columbia University.

Relative Contributions to Total U.S. Health Expenditures, 2016

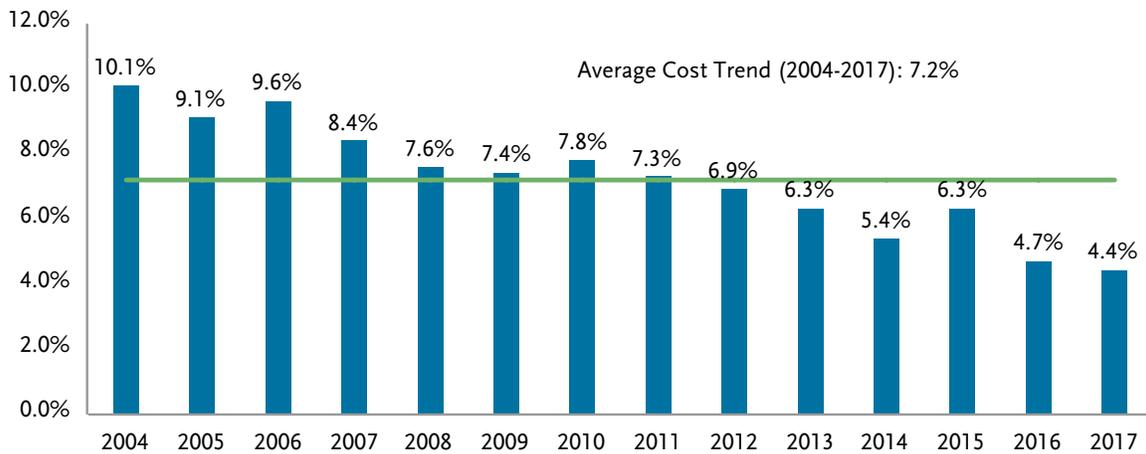


Source: Kaiser Family Foundation analysis of National Health Expenditure (NHE) data from Centers for Medicare and Medicaid Services, Office of the Actuary, National Health Statistics Group.

Market Remedies

Despite industry growth above that of the Consumer Price Index, healthcare cost inflation has actually been decreasing in recent years.

Medical Cost Trend



Source: Milliman Medical Index (MMI) and Bank of America Merrill Lynch.

We attribute improvements in the cost trend to several developments from both the payments side and the provider side.

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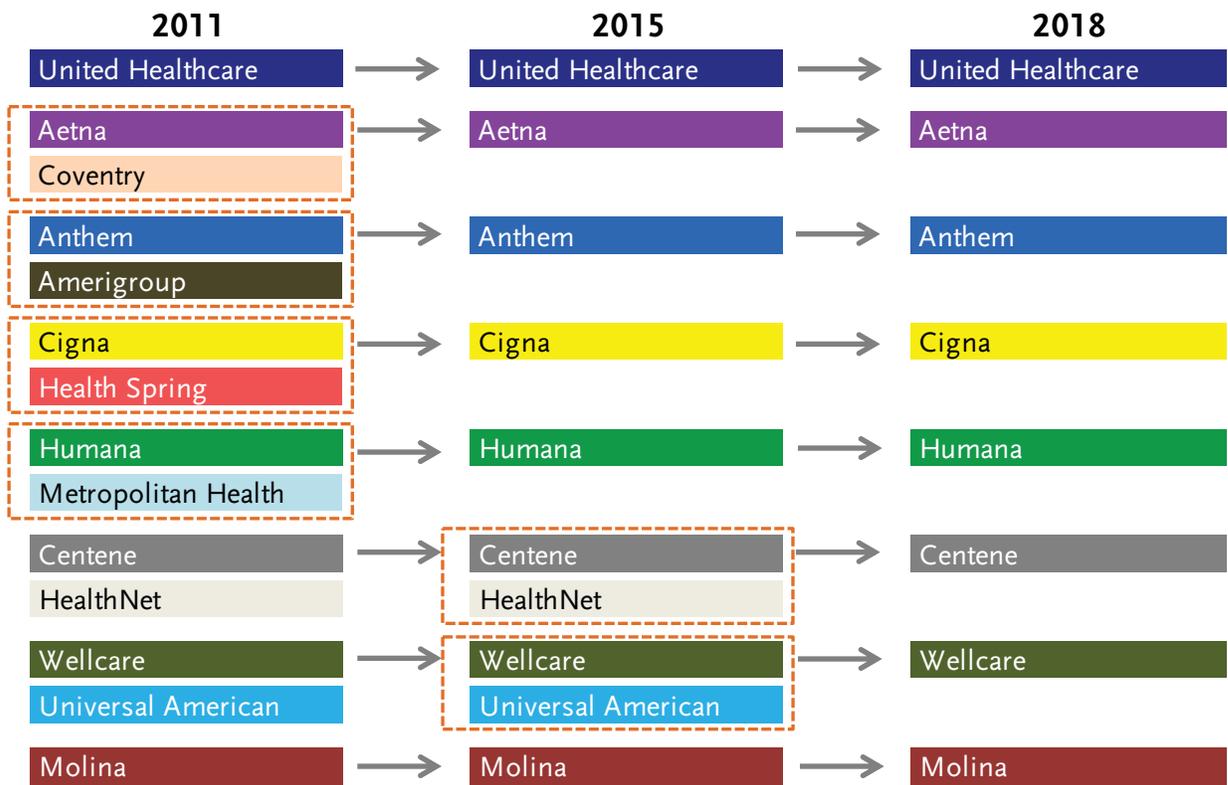
## Payer Evolution

On the payments side, publicly traded health insurance companies have grown substantially through mergers and acquisitions. Facing the problem of above-market cost inflation, these companies have pursued consolidation to achieve economies of scale and to improve negotiating leverage vis-à-vis hospitals and physicians.

Hospital prices for everything from a simple check-up to a complex surgery are set on a bespoke, negotiated basis. Hospitals maintain a “charge master” that lists a sticker price for every procedure and diagnosis code. Health insurers must negotiate volume discounts off of these sticker prices, based on the ability to deliver patients through an approved network arrangement.

Consolidation has gradually improved the relative negotiating leverage of the health insurers, while the provider side of the equation has remained highly fragmented by comparison.

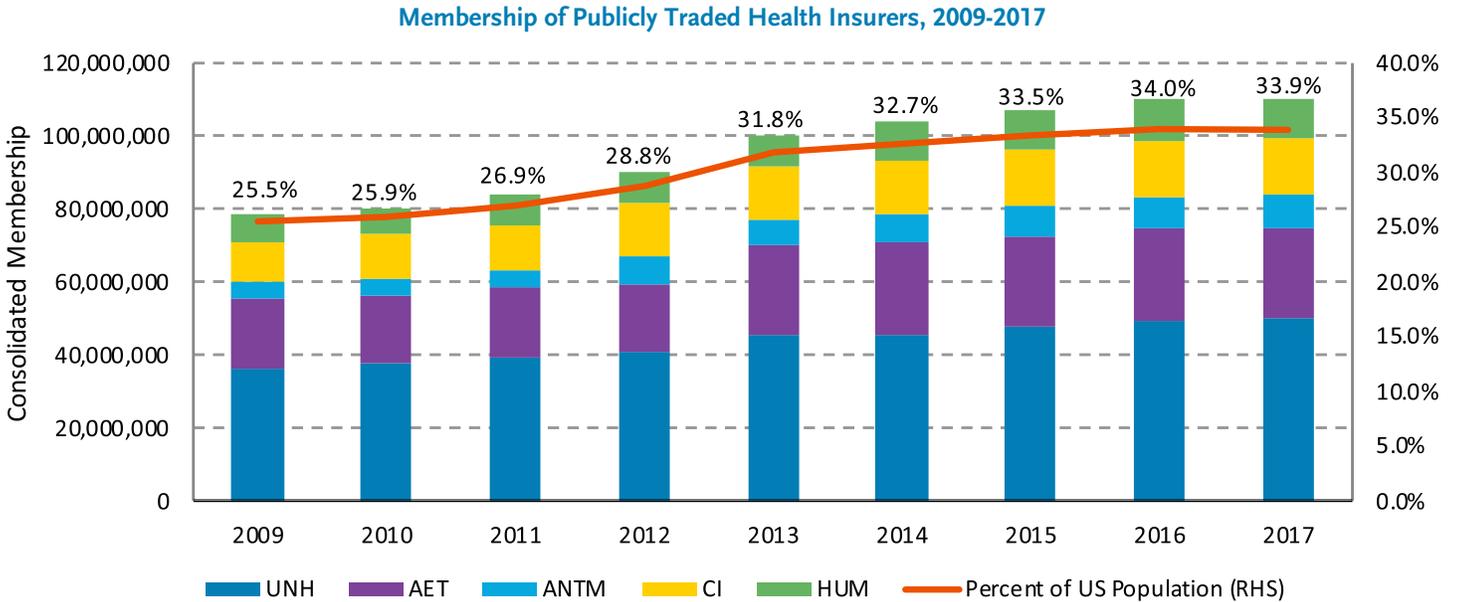
Consolidation in Health Insurance, 2011-2018



Source: Bloomberg

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The five largest publicly traded health insurers now cover nearly 34% of the total U.S. Population.



Source: Bloomberg, U.S. Census Bureau.

In addition, the widespread adoption of electronic health records has enabled insurers to more directly address excess utilization. Real time claims data have enhanced negotiating leverage, and led to interventional measures such as “prior authorization approvals.”

Health insurance companies have also passed the burden of medical cost inflation onto plan members. The increasing prevalence of high deductible health plans has cultivated a consumer awareness of the price/value trade-off associated with medical care. As healthcare becomes more consumer-oriented, we see a rising demand for cheaper and more accessible treatment options.

This consumer price sensitivity has been met with private sector investment in lower cost, alternative care settings.

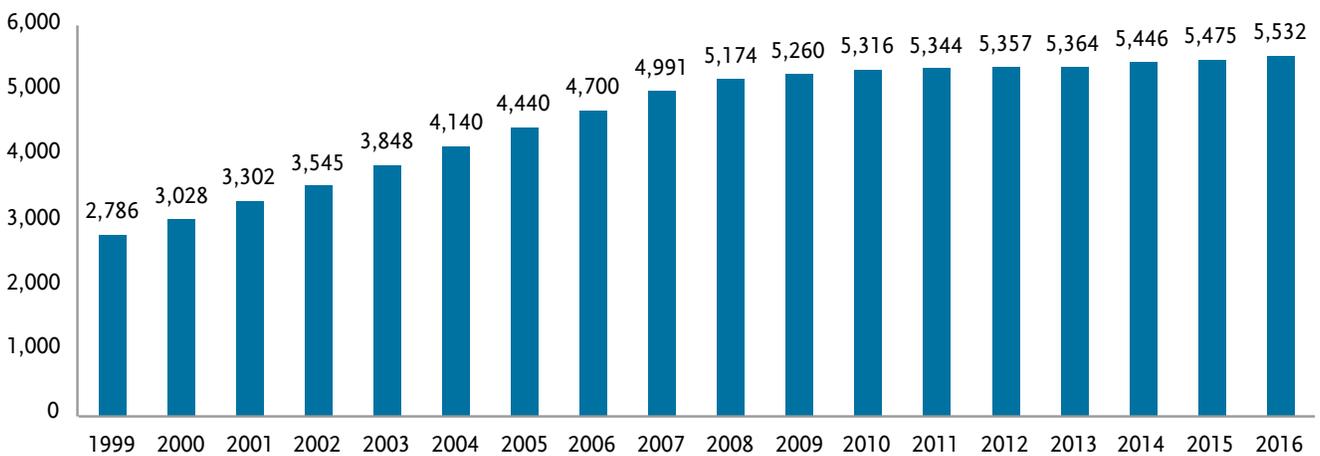
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## Provider Evolution

Advancements in medical technology have allowed many forms of surgery to be safely performed outside of a traditional hospital setting. Without the fixed costs associated with operating a multi-disciplinary hospital, a stand-alone surgical center can accept lower prices on a per-procedure basis.

Free standing surgery centers have thus emerged as a lower cost option for many common procedures, putting downward pressure on aggregate health expenditures.

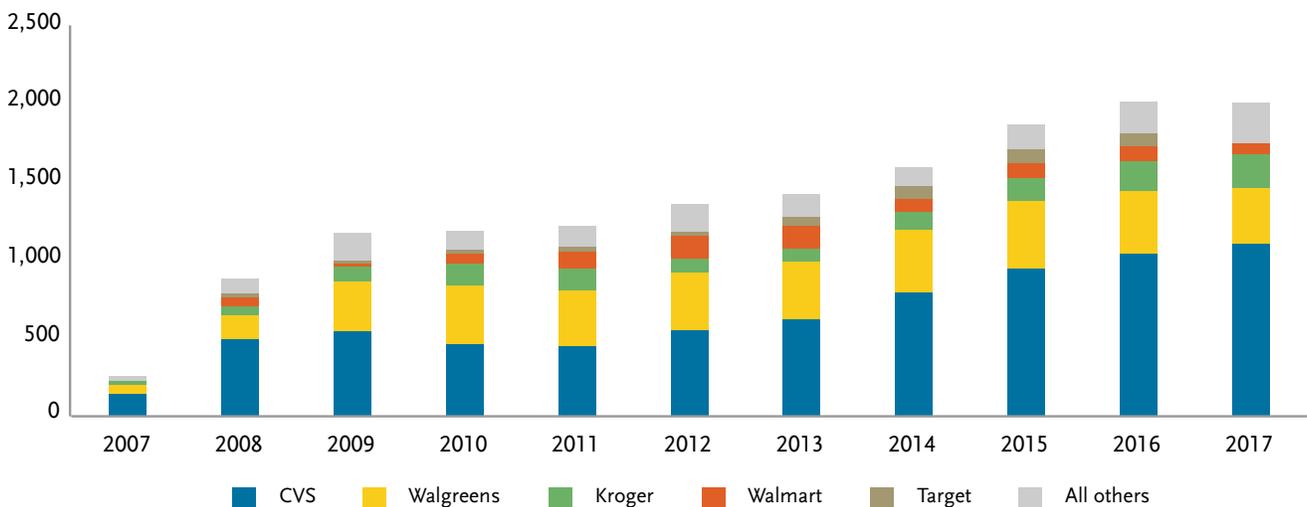
Growth in Medicare Certified Surgery Centers



Source: MedPAC. Data set included the CMS definition of Ambulatory Surgery Centers (ASCs).

In addition to surgery centers, substantial investment has been made in urgent care facilities, and retail clinics as well.

Growth in Retail Clinics



Source: Bank of America Merrill Lynch, Drugs Channels Institute and The Huffington Post.

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Hospital emergency rooms historically faced little competition for the full spectrum of patient volumes. Lack of competition, along with an implicit subsidy of uninsured patients, resulted in excessive pricing for the treatment of many minor conditions.

## Hospital Treatment Costs for Common Conditions



Source: CityMD Marketing Materials, May 2017.

In many cases, an urgent care center can provide the exact same treatment as a hospital at only 10%-20% of the cost.

## Non-Hospital Treatment Costs for Common Conditions



Source: CityMD Marketing Materials, May 2017.

When considering the cost and unpleasant experience associated with a hospital emergency room visit, it is no wonder that a consumer would opt for an alternative treatment option.

As a result, traditional hospital business models now confront a new paradigm – reduced pricing power and heightened competition for patients.

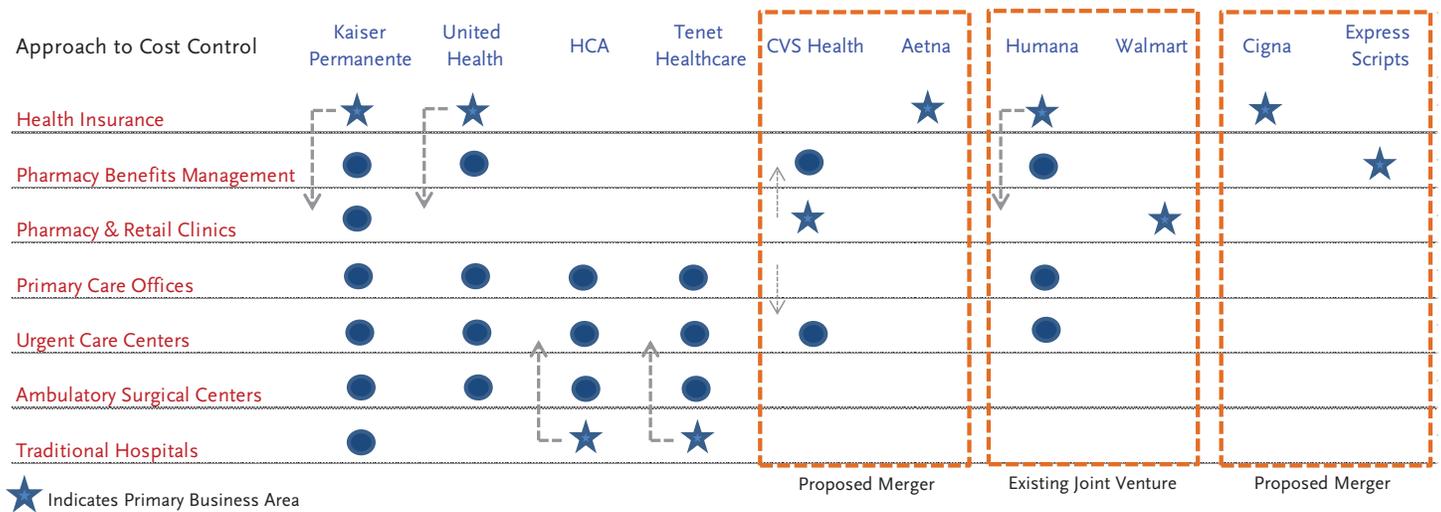
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## A Prescription for Success

TCW sees opportunity in today’s healthcare sector as companies implement effective cost containment strategies. In particular, TCW continues to have a favorable view of those pursuing an “integrated care” approach, whereby an insurer owns provider-side assets in order to more holistically manage total healthcare spending.

Various organizations have approached the integrated model in different ways:

- Kaiser Permanente (a non-profit) is the clearest example of a fully formed integrated care organization, owning a health insurer as well as a full suite of provider assets.
- United Healthcare has approached this from the payer side as well, gradually adding provider assets to help internalize the cost of care for health plan members.
- HCA and Tenet Healthcare have approached this from provider side origins. As hospital volumes have stagnated, these companies have added lower cost treatment centers in order to remain competitive.
- Recently announced mergers between CVS Health and Aetna, Humana and Walmart (rumored), and Cigna and Express Scripts have each sought to add capabilities to more fully serve the healthcare continuum.



While TCW takes a more cautious view of those focused solely on the provider side, we do see enduring demand for differentiated assets in areas such as oncology and complex surgery. Opportunity remains for providers that are able to distinguish themselves either through specialization, or by offering lower cost care.

The role of government in the healthcare system is not to be taken lightly, as regulations create operating challenges as well as barriers to entry. TCW focuses primarily on the economic characteristics of this industry; where a history of innovation and relatively non-cyclical cashflows can offer solid returns on capital for the careful investor. ■

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