

Leyue Wang  
Itay D Feldman

## Sector Report

equal weight

February 6, 2002 HEALTHCARE

### Outlook

We believe the healthcare sector will grow inline with Standard and Poor's estimate of 11%. This is consistent with recent historical averages, and we consider it to be a fair estimate. The healthcare sector is seen as a defensive play in a recessionary environment, and hence the sector has outperformed the S&P 500 index over the last year. It is a wide held consensus that the US economy has been in a recession since March of 2001, which can be seen as a positive sign for the industry; however, we believe that industry is at the top of its pricing cycle and therefore believe that we need to move with caution. An important positive factor for the industry is the sharp reductions in the Federal Funds rate which will have a strengthening affect of foreign currencies against the dollar. This is seen as a positive trend as the pharmaceutical and medical equipment makers have 50% of their sales outside of the US market.

### 1-Year Daily Chart of the Healthcare, Cyclical Index vs S&P 500



### S&P 500 Global Industry Classification Standard (GICS) Sectors As of January 31, 2002

|                            | Number of Cos. | % of Market Capitalization |
|----------------------------|----------------|----------------------------|
| Consumer Discretionary     | 87             | 13.2%                      |
| Consumer Staples           | 34             | 84.0%                      |
| Energy                     | 24             | 6.3%                       |
| Financials                 | 74             | 17.9%                      |
| Health Care                | 45             | 14.4%                      |
| Industrials                | 68             | 10.8%                      |
| Information Technology     | 79             | 18.1%                      |
| Materials                  | 38             | 2.7%                       |
| Telecommunication Services | 13             | 5.1%                       |
| Utilities                  | 38             | 3.0%                       |

Itay D Feldman  
feldmita@rice.edu

## Sector Report

over weight

**February 6, 2002 HEALTHCARE EQUIPMENT AND SUPPLIES**

### Outlook

We are bullish on the healthcare equipment and supplies sector for 2002. Standard and Poor's foresees 15% annual growth, above historical averages. We believe this estimate to be fair. Furthermore, the introduction of new products and the stabilization of the exchange rate will have a positive affect on the sector. The sharp reductions by the Federal Reserve of its Federal Funds rate will finally stop the strengthening of the dollar against foreign currencies. The stabilization of the exchange rate will stop dragging equipment makers revenue, as 50% of their sales are made in international markets. New product approvals, especially in the cardiovascular market will lead strong demand for cardiovascular, orthopedic and spinal repair products.

### Trends

The continuing aging of the industrial nation's populations is seen as a key long term driver. Today only 13% of the US population is 65 and older, but they represent 40% of healthcare expenditures. The US Census Bureau projects that 18% of the population will be over 65 by 2030. Worldwide, it is expected that over 65 segment of the population will balloon to 800 million from 370 million today. This trend will particularly benefit cardiovascular products as 61 million of Americans suffer from some type of cardiovascular disease (CVD). CVDs include high blood pressure, heart attack, stroke, and congestive heart failure. In 1998 there were 949,619 deaths from CVD. Other sectors that will benefit from the graying trend of the industrial nations populations are orthopedic implants and advanced imaging products like MRIs and Computed Tomography (CT) products.

In the short term, the sector faces pressure from managed care providers, internet based medical product and supply auctions, budget deficits in France and Germany and the stagnant Japanese economy. Managed care and internet based auctions function as a one-two punch on the ability for the industry to raise prices. The increase pressure from managed care providers has resulted in an increase of 5% in outpatient visits to 573 million. This trend does not have to be perceived as purely negative as it led to an increase in use of portable medical units. However, the managed care pressure has resulted in a decrease of non-critical use of procedures by healthcare facilities that get paid a flat fee per patient from the managed care providers. The healthcare facilities only option to increase profitability is to reduce costs and hence the reduction in the usage of advanced imaging products and other non-essential testing. These domestic pressures are compounded by the budget deficits in France and Germany, which between the two countries represent 50% of Europe's healthcare expenditures. The increasing budget deficits have put pressures on the two governments to decrease healthcare expenditure. Furthermore the stagnant Japanese economy is not helping the industry, as Japan represents 10% of worldwide healthcare expenditures. All this has been compounded by the increasing strength of the dollar, which in 2001 shaved 400 basis points of revenue due to currency exchange.

The future nonetheless, looks positive, as managed care providers will spend on new procedures that will lessen inpatient costs. The industry is also about to experience another series of product introductions. Particular interest has been observed in the cardiovascular devices, which are coming with a new generation of drug coated coronary stents that use the drug Rapamune, from American Home Products.<sup>1</sup> These new implants will reduce the number of secondary procedures needed by dramatically reducing the reclosure of arteries following angioplasty. There are currently four companies pending FDA approval for

---

<sup>1</sup> The Wall Street Journal reported on Feb. 5 2002, that Johnson & Johnson had two patient deaths in a study of drug coated stents in the Netherlands.

these new devices, Johnson and Johnson Cortis Unit, Boston Scientific Group, Cook, Inc, and Guidant Corp. There is also interest in the new mechanical hearts by AbioCor. These are self contained mechanical heart implants. Currently, over half of the heart recipients die while still on the waiting list for a new heart. This product could act as bridge product while recipients find a suitable donor. The only sector that looks particularly soft is the laser eye and plastic surgery. These sectors are highly sensitive to economic conditions due to the fact that they are not covered by most health plans.

## Current Holdings Review

**Cooper Company (COO)** – COO through its subsidiaries CooperVision (CVI) and CooperSurgical (CSI) provides underserved niches in the healthcare market with proprietary products. CVI provides 77% of COO's revenues through the sale of corrective lenses in the high margin astigmatism. CSI provides 23% of COO's revenues through the sale of women's healthcare products. Among products CSI provides are gynecological and surgical instruments, accessories and related devices.

COO is trading near its 45 and 200 day averages. The company has seen a deceleration in its growth rate most likely associated with the general market downturn. However, the company's capital expenditure is still significantly bigger than its depreciation, signaling that management still believes that the company is a growth stage. The company has 2002E EPS of 3.02. The fact that the company has done well in this downturn is a testament to the company's strategy of targeting the more lucrative and less volatile astigmatism market.

### COO 1-Year Daily Chart



Itay D Feldman  
feldmita@rice.edu

## **Sector Report**

**equal weight**

**February 6, 2002 HEALTHCARE MANAGED CARE**

### **Outlook**

We are slightly bullish on the healthcare managed care providers sector. Standard and Poor's industry reports foresees 11% to 13% medical costs growth. We expect the managed care sector to be able to raise premiums by a spread of 50 to 100 basis points over medical costs. Furthermore we foresee favorable valuations as the recessionary environment will help highlight the health of the healthcare managed care sector. In addition, the sector is expected to have 2002E EPS growth of 24%. That is a very good result, considering the environment. Meanwhile, medical costs are stabilizing, compounded by the exodus out of Medicare for the large companies. The patients bill of rights, although seem to be benefit patients, also have pay out caps which would highly benefit the managed care sector. Furthermore, the industry giants will improve margins by reducing enrollment of low margin or loss making customers. Again, we see the graying of the population as a key long term driver. Other key drivers are the trend toward more open plans and the introduction of new drugs, devices, and procedures. Some negative drivers are medical cost inflation, costly litigation, and an unfavorable political environment, taking the form of a patient's bill of rights.

### **Trends**

Current important trends in the industry are the way that all stakeholders are trying to deal with the increasing medical cost inflation. Managed care providers are increasing premiums above medical costs, and now employers are trying to shield themselves from the rising costs. In the last few years due to the tight labor market, employers had little bargaining power. Now trends can be identified were employers are trying to push some of the costs unto the employees. The employers are not being very successful due to the fact the unemployment rate is still quite low. Furthermore, this trend does not affect managed care premiums. Other trends are the move to preferred provider organizations (PPOs) and away from HMOs and Medicare. Drug utilization is also increasing, as more expensive drugs are being introduced into the market. Pharmaceutical costs already account for 25% of medical costs, and are expected to increasingly be a larger share of the ever increasing medical costs.

The two main reasons that we are slightly bullish on the managed care sector is their central position in the healthcare market. Managed care providers serve as aggregators of information which compounded with their concentration, and economies of scale give them undue buyer power when bargaining with the rest of the medical industry. The managed care providers will have this buyer power in particular with small clinics and individual physicians who do not have very good information. An interesting player in this saga will be Seibel Systems, which on February 6, 2002 announced the introduction of Seibel eMedica, an eBusiness applications for the medical products industry. It is expected that Seibel Systems will introduce an information aggregator system to support the small clinics and doctors. The introduction of this product shall change the balance of power between the managed care providers and the physicians.