DIAMOND HILL

INVESTED IN THE LONG RUN

Assessing the Health of Health Care

May 2022

As the 2020 pandemic unfolded, many health care companies rapidly shifted focus to slowing the spread of COVID. If we think of the pandemic like an acute event such as a heart attack — a sudden emergency that requires immediate attention — we're hopefully entering the chronic or endemic phase that's akin to high blood pressure: it's concerning and should be treated, but it's not an emergency.

As we adjust to an endemic world, we believe it's an opportune time to holistically look at trends in the health care space and understand how companies have weathered the pandemic and, more importantly, where they go from here. Ultimately, the pandemic has demonstrated that best-of-breed companies with strong management, differentiated product portfolios and prudent capital allocation can thrive in troubling times.

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Bigger Players Get Bigger

Many larger health care companies were beneficiaries of the pandemic given the nature of their businesses and have emerged even stronger. These companies are generally established, diversified businesses that investors view as safe havens during challenging economic environments. They often have resilient core businesses, with products that patients need regardless of economic conditions. From a revenue perspective, COVID positioned many of these companies for future success due to a rise in profits generated from testing and vaccines. Some companies plan to use those profits to fund acquisitions while others have invested internally to drive new product development.

Pfizer has become the poster child for the health care industry's rapid and effective response to the pandemic with its COVID vaccine and antiviral treatment. The company is in a stronger position today than it was two years ago, having sold over $35B in COVID vaccines in 2021, and it plans to use this excess capital on acquisitions — in fact, Pfizer has stated its intention to add $25B to 2030 revenues all through acquisitions.

We've seen recent declines in biotechnology indexes as investors have become concerned about these companies running out of cash, which could give large cap pharmaceutical companies, like Pfizer, the opportunity to acquire assets at more attractive valuations. On the R&D side, Pfizer now has more experience with mRNA vaccines — which were viewed as experimental before COVID — with an opportunity to leverage that technology for other viruses. Additionally, its COVID vaccine and antiviral treatment create upside opportunity should we face additional COVID waves.

Abbott became an early leader in COVID testing by developing a rapid diagnostic test (BinaxNOW), which is sold over the counter. Without this widely available test, many people and organizations would have been uncertain about their illness status and forced to choose between isolating or continuing with their social and work activities. As such, the company sold a substantial number of tests ($7.7B in 2021) and, like Pfizer, built up excess capital reserves. The additional cash infusion has allowed Abbott to increase funding for internal product development, including leadless pacemakers and continuous glucose monitors, which has already resulted in new product launches. Pre-pandemic, the company had industry-leading

franchises with a particularly strong position in its medical device business, which focuses in key strategic areas such as diabetes, structural heart solutions and diagnostics. Continued investment and innovation in these areas should help drive a wider moat and ultimately lead to revenue growth and margin expansion.

A Mixed Bag

Although some companies were direct beneficiaries of the pandemic, others have experienced a more nuanced impact, particularly companies that are exposed to elective procedures, like medical device companies. Early in the pandemic, these companies suffered from surgical facility shutdowns and volumes declined suddenly, which led to sharp declines in margins and some companies even becoming unprofitable for a quarter or two. Areas that are less discretionary, like heart procedures, fared relatively better, whereas more discretionary areas, like neuromodulation, saw steep double-digit declines.

2021 was a year for these companies to rebuild, with surgical volumes nearing their pre-pandemic peak. But with each subsequent COVID flare up, such as the recent Omicron wave, the industry sees volumes slow again. As we are hopefully entering the endemic phase, these companies can now start planning for more steady growth, which will help them achieve volume leverage and margin expansion.

Integer is a contract manufacturer for large global medical device companies, including Abbott and Medtronic. The company was challenged during the pandemic with lower volumes and being a high fixed-cost manufacturer, its profitability declined sharply, faster than the decline in volumes. Integer is a share leader in the industry with a strong management team that is making smart, long-term decisions to drive topline growth and margin expansion. The company also has a long-term partnership mentality with customers — they are not just a vendor but a key integrated stakeholder in the success of their products.

Due to the regulated nature of the medical device space, highly specific manufacturing and very sticky customer relationships, Integer is poised for success as elective surgeries increase, and device volumes recover. Despite the challenges the company has seen during the pandemic, Integer has continued to invest in R&D and innovative M&A activity, which has improved product offerings and further strengthened its long-term position.

Some cross currents in medical supplies have provided opportunities for patient investors. Becton Dickinson, a diversified medical supplies company, experienced both headwinds and tailwinds during the pandemic. The company is a leader in syringes and diagnostics and benefited from increased sales in both areas, but this benefit was offset by lower hospital volumes that negatively impacted the rest of its businesses. If we look beyond the noise of COVID, we see a growing global medical supplies company with a good management team, significant free cash flow generation and a clear strategy for capital allocation. The company has significant economies of scale and diversified product offerings with market-leading brands. Like Abbott and Pfizer, Becton Dickinson is using profits from COVID sales on strategic acquisitions to fortify its product portfolio.

Investing in an Endemic World

At Diamond Hill, our investment approach is agnostic to black swan market events like the COVID pandemic. While some segments of health care flourished, others experienced nuanced outcomes or struggled. However, with our focus on companies with wide, sustainable moats, free cash flow growth and strategic capital allocation, we believe these companies will not only withstand short-term fluctuations but often emerge from periods of volatility in a superior position than peers, providing returns for patient shareholders.

As of 30 April 2022, Diamond Hill owned shares of Abbott Laboratories, Becton, Dickinson and Co., Integer Holdings Corp., Medtronic PLC and Pfizer, Inc.

The views expressed are those of the author as of May 2022 and are subject to change without notice. These opinions are not intended to be a forecast of future events, a guarantee of future results or investment advice. Investing involves risk, including the possible loss of principal. Past performance is not a guarantee of future results.