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Fixed Income Group Research

Post-pandemic, what's in store for health care and pharma

February 2022

- The onset of the COVID-19 pandemic in early 2020 led to a pivot in the health care industry to accommodate the development and rollout of vaccines and therapeutic remedies; address the need for testing, detection, and care; and combat multiple variants of the disease.
- At the same time, the pandemic has sped up many secular changes that were already underway, such as telehealth, virtual visits, and online pharmacy distribution. We expect these changes to influence many companies' capital allocation and acquisition strategies as they evaluate the impact of secular changes on their core business and look for ways to participate in new growth areas.
- Our base case is that, over time, health care companies will see a return to pre-pandemic patient utilization levels while continuing to focus on research and development as well as capturing growth opportunities that will come with an aging population.
- Health care valuations have cheapened from 2021 levels amid broader market softness during the first two months of 2022. While current valuations leave some room for upside, we believe identifying and avoiding downside surprises through individual security selection in health care remain more important than sector or subsector allocations.
- "Accelerating innovation, partnerships and business development activity, cost management, and increased private equity involvement are themes we will be following closely in 2022," said Vanguard senior credit analyst Omar Sanders.

Authors: Omar Sanders, senior credit analyst | Jamie Shin, senior credit analyst | Johnny Will, credit analyst | Victoria Drecchio, senior research associate

How health care credit has fared during the pandemic

In general, companies in this sector have had to work through modest fluctuations in demand but have proven resilient throughout the course of the pandemic. Furthermore, while health care labor shortages and supply chain and inflationary pressures are real, ongoing issues, they have not resulted in material credit impacts for the sector overall.

Pharmaceutical companies have held up particularly well, even in the early days of the pandemic. While many parts of the global economy effectively shut down for a short period of time and experienced a rapid and severe contraction in demand, pharmaceutical companies were able to continue manufacturing their products to meet the largely stable demand for drugs, especially from patients already on medications.

Further, as COVID-19 spread, a number of pharmaceutical companies took the opportunity to research and develop vaccines and treatments such as remdesivir while the rest of their business remained largely unscathed. Then the emergence of variants spurred demand for boosters and new treatments, resulting in material financial benefits.

Similarly, many life sciences companies found opportunities to realize material financial benefits from the pandemic, notably from COVID-19 testing.

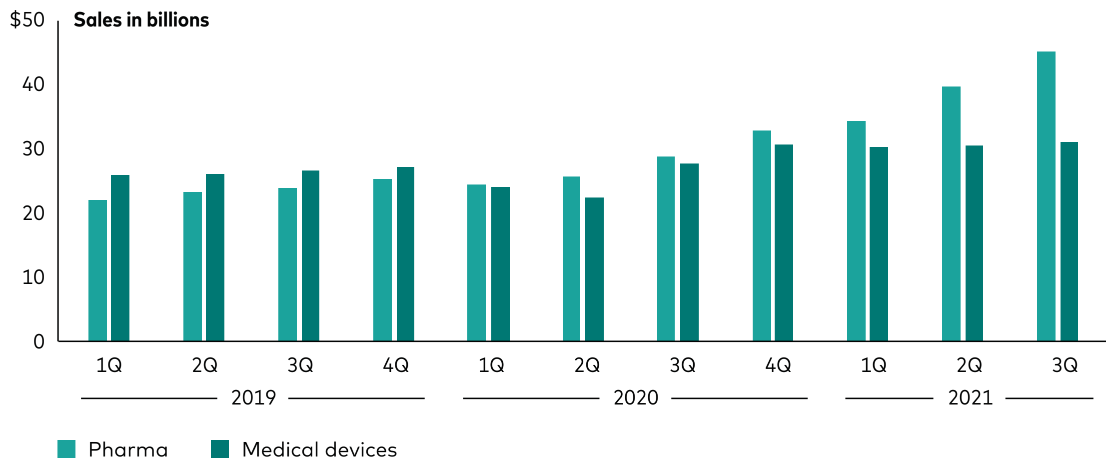
That said, uncertainty remains around the magnitude and duration of these benefits, which have not, for the most part, accrued directly to bondholders. However, the added financial flexibility provided by these tailwinds has changed our view of certain credits, particularly those that were already trading at relatively tight spreads.

Moreover, it hasn't all been rosy for the sector. At the onset of the pandemic, for example, deferred procedures resulted in an unprecedented deterioration in earnings and cash flow. Given the critical nature of the products and services provided, however, demand bounced back relatively quickly and has remained generally stable, even with the emergence of new variants. In addition, actions taken by both federal and state governments, such as keeping Medicaid beneficiaries enrolled without eligibility redeterminations and providing liquidity to health care providers via loans and grants, provided stability to the sector.

"The chart below shows that pharma sales, which tend to be fairly stable, actually increased significantly in 2021 due in large part to COVID tailwinds," said Vanguard senior research associate Victoria Drecchio. "And even sales for medical devices, a subsector which has had to navigate more headwinds such as deferred procedures, health care labor shortages, and supply chain pressures, held up well, and its sales are coming out of the pandemic stronger than they were going into it."

FIGURE 1.

Sales for pharma and medical devices proved resilient during the pandemic



Note: The sales figures shown are the sum of the largest five companies by market capitalization within our coverage as of January 19, 2022.
Sources: Bloomberg, Company Reports, and Vanguard.

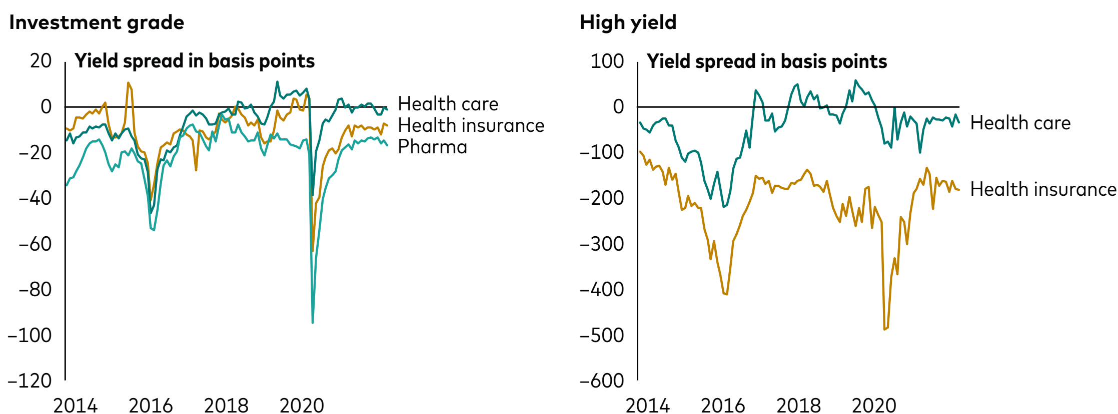
Quantifying the sector's resiliency

"As the charts below illustrate, spreads of securities issued by health care and pharma companies over the past decade have generally traded tighter than those of the broader corporate bond market as a whole, whether you're talking about investment-grade or high-yield," said Sanders. "Given the defensive nature of health care overall and the inelasticity of demand, the spread differential is most prominent during times of market stress, like that seen at the onset of the pandemic."

FIGURE 2.

In the U.S., health care spreads tend to be tighter than for corporate bonds as a whole, especially in periods of market stress

Spreads for health care segments minus the average spread for corporate bonds

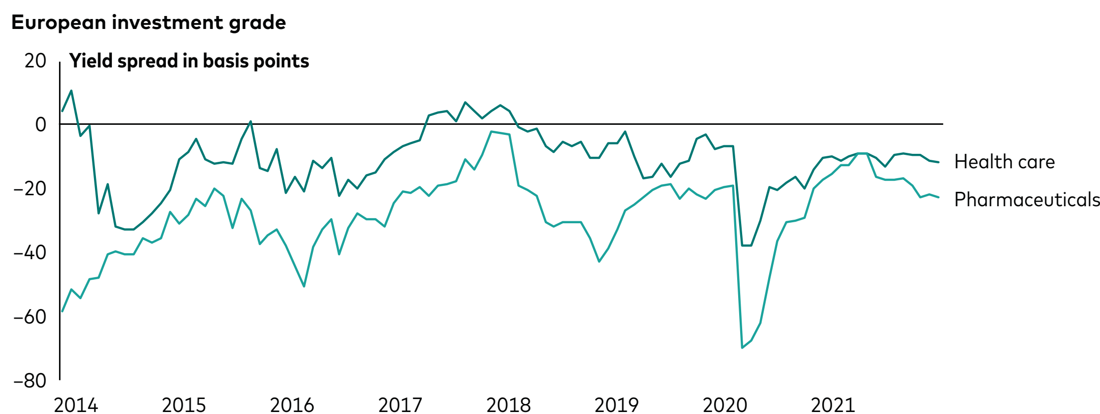


Notes: The spreads shown are all option-adjusted and as measured by the Bloomberg Corporate Bond Index for investment-grade bonds in the left-hand figure and the Bloomberg High Yield Index for high-yield bonds in the right-hand figure. A basis point is one-hundredth of a percentage point. Data are from November 29, 2013, through February 9, 2022.
Sources: Bloomberg and Vanguard.

"In Europe, the performance story is very similar," said Vanguard credit analyst Johnny Will. "The health care and pharmaceutical sectors have consistently traded inside the Pan-European corporate index, given the higher average ratings of the sector and defensive sector qualities. The same spike in outperformance is visible in the chart below at the start of the pandemic."

FIGURE 3.

In Europe, health care spreads have traced a similar path versus corporate bonds



Notes: The spreads shown are all option-adjusted and as measured by the Bloomberg Pan-European Aggregate Corporate Index. A basis point is one-hundredth of a percentage point. The data are from November 29, 2013, through January 20, 2022.

Sources: Bloomberg and Vanguard.

The road ahead for health care

"Even with the widening in bond markets to start 2022, health care continued to outperform broader bond indexes," said Vanguard senior credit analyst Jamie Shin. "We believe the industry's strong fundamentals coupled with a more benign regulatory environment across most subsectors have contributed to the relative strength. For active managers that will make security selection even more crucial going forward."

As we look for winners and losers in 2022, we will be focusing on the following themes:

- **Accelerating innovation:** Some trends that began or accelerated during the pandemic will continue to drive the direction and pace of innovation in the industry. Pharma and biotech companies will continue to invest aggressively in emerging therapy areas like cell and gene that became more mainstream due to COVID-19 research. This will create strong demand for R&D tools and support services—some provided by life sciences and medical devices companies, others provided by health care services companies. Health care providers are another subsector to watch. After seeing the rapid adoption of telehealth and decreases in ER admissions, health care providers will be looking for ways to offer care outside of the traditional hospital setting.

  We prefer companies with a track record of successfully sourcing and integrating growth assets and see some interesting opportunities in the life sciences, medical devices, and services subsectors.

- **Partnerships and smaller deals over megamergers.** While companies remain interested in finding ways to supplement organic growth and capital markets remain favorable for the sector, most management commentary from a recent industry flagship conference focused on tuck-ins and partnerships rather than transformational deals. With large M&A transactions in 2021 facing regulatory scrutiny (such as UnitedHealth's $13 billion bid for Change Healthcare, which the U.S. Department of Justice is suing to block) and examples of profitable partnerships without a huge investment up front (such as Pfizer and BioNTech partnering to develop a COVID-19 vaccine), companies are incentivized to look for smaller deals or partnerships over megadeals.

  While this is a favorable trend from a credit perspective as it reduces deal risk, we remain somewhat cautious on select pharmaceutical companies based on their historical preference for larger deals and stronger incentives to buy assets ahead of existing products' patent expirations.

- **Cost management.** The emergence and subsequent waves of COVID-19 resulted in an unprecedented level of labor shortages in addition to cost inflation. This puts larger players with negotiating leverage and/or market density at an advantage over competitors.

  Efforts to manage costs will support demand for services from health IT providers and outsourced service providers (contract research and manufacturing services for pharma and biotech, contract labor for providers). As payors also look to manage increasing costs, there will be more interest in affordable alternatives such as private label products and lower-cost-of-care settings (those outside of hospitals).

- **Greater private equity involvement.** Private equity will continue to play an important role as both buyers and sellers. In 2021, we saw a private equity consortium strike a $34 billion deal to purchase medical distributor Medline in the largest leveraged buyout since the 2008 global financial crisis. With public companies shying away from larger deals, we could see private equity doing more and bigger deals than in the past. Private equity-driven deals are likely to have higher leverage and weaker creditor protections but can be interesting opportunities to get exposure to emerging growth areas while picking up yield.

  We expect higher levels of interest in health care services, given the focus on cost management, and will be looking for opportunities there while trying to avoid idiosyncratic risks such as customer concentration and excessively aggressive financial policy.

"At Vanguard, we have a global fixed income team of analysts, portfolio managers, and traders who use a bottom-up, fundamentals-based credit research process and a disciplined, collaborative approach to risk-taking," said Sanders. "So we're well-positioned for an investment environment like this for generating alpha through identifying securities that are likely to outperform and sidestepping those that are likely to disappoint."

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* Includes funds advised by Wellington Management Company LLP.

Note: Data are as of December 31, 2021.

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