Current Market News

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Much ado about health care

As a demonstration of a commitment to make good on a number of campaign promises related to health care reform, the White House recently released "American Patients First, The Trump Administration Blueprint to Lower Drug Prices & Reduce Out of Pocket Costs" (https://www.hhs.gov/sites/default/files/AmericanPatientsFirst.pdf). While the document took a less aggressive approach than many expected, it did identify high drug list prices, lack of government negotiation, high and rising out of pocket costs, and foreign free-riding as four primary challenges to be addressed. To remedy the situation, the Blueprint offers four strategies: improved competition, better negotiation, incentives to lower list prices, and the lowering of out of pocket expenses. The document was short on action points, but did detail a number of activities that can be taken – many of which would require an Act of Congress. From citizens to providers and payers, there clearly is a desire to solve the health care issues facing Americans.

What's in the Blueprint and what does it mean?

President Donald Trump's drug pricing speech promised lower drug prices for the American people and an attack on the "middle men" in the drug pricing chain. The list of items referenced in the Blueprint do not deviate from the White House budget and in fact double-down on the issue of drug pricing, a major talking point of the president. A big part of achieving the goals set out by the administration could involve reforming Medicare Part B (covers medical services and supplies) and Medicare Part D (helps cover prescription drugs). Here is a look at each of the strategies considered in more detail.

Promoting increased competition

- Steps to prevent manufacturers from undermining the regulatory processes, such as when a generic manufacturer "parks" their application with the FDA to prevent competition, are already on the congressional docket with legislation called the CREATES Act.
- The FDA has been implementing measures to promote innovation like bringing more generics to market, including biosimilars and more complex generics.
- Proposals are being developed to stop Medicaid and Affordable Care Act (ACA) programs from raising prices in the private market. If this were to happen it would likely involve eliminating the ACA provision that caps Medicaid supplemental rebates. As a side note, this would require Congressional action, so it is unlikely to happen in 2018.

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Better negotiation

- Experimenting with value-based purchasing in federal programs. This is a wise way to approach the issue given that all participants (on both sides of the argument) generally think it is a good idea.
- Allowing more substitution in Medicare Part D to address price increases for single source generics by reforming the program to give plan sponsors more power when negotiating with manufacturers.

Incentives for lower list prices

- The FDA is evaluating a requirement that would force manufacturers to include list prices in advertising.
- Updating Medicare's drug-pricing dashboard to improve transparency around price increases and generic competition.

Lowering out-of-pocket costs

- Part D contracts currently prevent pharmacists from proactively telling patients when they can pay less out of pocket by not using insurance. The proposed regulation prohibits this restriction.
- Improving the usefulness of the Part D Explanation of Benefits statement by including information about drug price increases and lower cost alternatives.

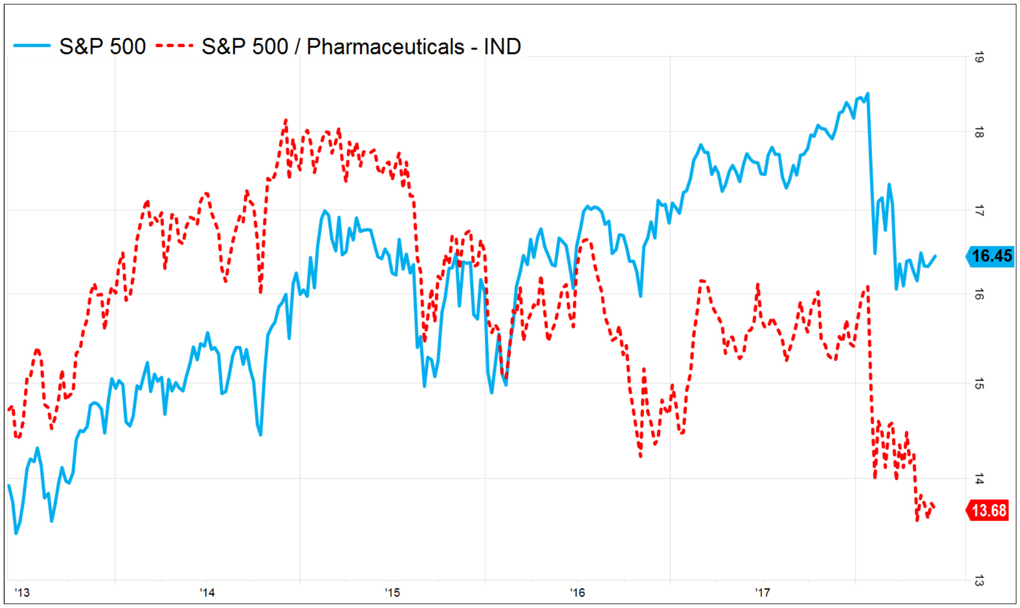
Drug pricing & pharmaceutical sector impact

The Blueprint targets high list prices and growing out-of-pocket costs for branded drugs. While the policy proposals are unlikely to have a meaningful impact on pharma realized net prices in the near term the changes could create greater pricing transparency and/or remove some of the recurring headline risk for the pharmaceutical sector overall. A key focus of the plan is to narrow the growing gap between the list and net realized drug prices in an effort to lower patients' out-of-pocket costs. It is unclear if the proposals laid out will meaningfully impact this dynamic, but with a growing number of patients exposed to high drug list prices for at least a portion of the year, any progress on this front could actually be a positive for the pharmaceutical sector.

The Blueprint also proposes using private market solutions rather than direct government negotiation on price, but does not call for a repeal of the non-interference clause on Medicare Part D. More broadly, most paths to meaningful drug pricing reform would likely require Congressional support and there is only a limited amount the administration can do without involving the House/Senate. The Blueprint envisions an expanded role for value-based pricing over time, which seeks to more fully incorporate the value of new treatments including both system-wide healthcare and societal benefits through reduced primary care costs, increased quality of life, higher workforce participation, and increased productivity.

While investor concern surrounding government drug price reform is understandable considering U.S. government payers represent ~20-25% of major pharma group sales, the pricing overhang that has impacted sector performance for the past several years is likely overdone with most of these issues either already reflected in earnings estimates, or unlikely to come to fruition for the near future. Exhibit 1 shows the degree to which forward-looking P/E valuations for the sector have lagged the broader market in recent years. With the major pharma names having underperformed over the past 18 months, despite relatively healthy fundamentals, the Blueprint announcement may provide an opportunity to revisit an out of favor sector that offers a mix of new launch-driven sales and earnings upside.

Exhibit 1: 5-Year S&P 500 vs. S&P Pharmaceuticals Industry Forward P/E



Source: FactSet, BMO Wealth Management

Healthcare facilities and managed care company impact

There also appears to be little near-term impact on healthcare facilities and managed care companies. First, their exposure is limited. For example, a large publicly traded managed care company might have an external Pharmacy Benefits Manager that contributes less than 5% of total earnings. In addition, the intensity and pacing of policy proposals seems limited at this point. In healthcare you basically rob Peter to pay Paul - lowering out-of-pocket spending is the easy part because it will just result in higher premiums.

In short, the fact that the Trump administration is moving forward with any sort of proposal to help curtail the rising cost of drugs is welcome. We are, however, left with many more questions than answers regarding how a full-scale implementation might look. As investments, pharmaceutical stock valuations over the past two years have been compressed due to fears that unknown federal laws and regulations could derail the pharma-pricing gravy train. Further clarity in this matter may reverse some of the discount currently applied to pharma stocks. However, this is a monumental challenge and it will be up to those in Washington, D.C. to move it along.

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