Opportune Entry Point for Quality Healthcare Names

Varied immediate impacts from COVID-19 crisis but sector resilient in the medium term.

Morningstar Equity Research
20 March 2020

Contents

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Executive Summary

While usually reliably defensive, we expect the healthcare companies to behave distinctly differently in this crisis as it's rooted in healthcare, and not merely a typical economic cycle. Widespread deferral of elective surgeries is slowing more discretionary treatments, such as cochlear implants, and case mix at hospitals. We expect companies exposed to elective surgery to be hardest hit and take until fiscal 2022 to recover to normal activity levels. Conversely, those providing life-saving treatments or products, such as CSL and Fisher and Paykel, will likely prove most resilient in the short term. Given Fisher & Paykel's 80% global market share in hospital ventilators and humidifiers, it is the only clear beneficiary from COVID-19. To a lesser extent we expect the Australian domestic pharma distributors, EBOS, API and Sigma, to benefit from increased volumes as people self-medicate to boost their immune systems. This also underpins demand for Blackmores, which boasts the largest market share in the vitamin and dietary supplement category.

Currently we expect the direct COVID-19 pressures on the healthcare system to play out in the next nine months. For the sector as a whole we forecast slowing, but positive, growth into fiscal 2021. Our five-year outlook for the sector is largely unchanged and we expect that should the current health crisis translate into a sustained economic downturn, the healthcare stocks should prove defensive.

Key Takeaways

- We expect companies treating life-threatening illnesses, such as CSL and Fisher & Paykel, to be the most defensive, and the latter a clear direct beneficiary given its hospital respiratory devices business. In addition, those distributing pharmacy products stand to benefit from increased volumes, this includes the pharmaceutical distributors EBOS, API and Sigma.
- Deferral of elective procedures is impacting certain device companies and hospitals, with Cochlear and Ramsay Healthcare expected to be the hardest hit.
- Beyond short-term COVID-19 impacts, the sector is expected to uphold its reputation for defensiveness. Our top picks are the pharma distributors, EBOS, API and Sigma; vitamin company Blackmores; and CSL as we believe it is an opportune time to gain exposure to this high-quality company.

Companies Mentioned

Name/Ticker	Economic Moat	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Morningstar Rating	Market Cap(Bil)
CSL [CSL]	Narrow	AUD	282.00	283.91	High	★★★	123.2
Fisher & Paykel [FPH]	Narrow	AUD	17.00	27.00	Medium	★	14.9

Name/Ticker	Economic Moat	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Morningstar Rating	Market Cap(Bil)
Sonic Healthcare [SHL]	Narrow	AUD	27.00	24.78	Medium	★★★	12.6
Ramsay Health Care [RHC]	Narrow	AUD	63.00	54.83	Medium	★★★★	11.0
Cochlear [COH]	Wide	AUD	129.00	171.33	Medium	★★	9.9
ResMed [RMD]	Narrow	AUD	17.00	24.82	Medium	★	9.7
EBOS [EBO]	Narrow	AUD	20.50	21.00	Medium	★★★	3.5
Ansell [ANN]	Narrow	AUD	34.00	22.50	Low	★★★★★	3.1
Healius [HLS]	None	AUD	3.36	2.47	High	★★★★	1.6
Blackmores [BKL]	Narrow	AUD	81.00	65.72	High	★★★★	1.2
Avita Medical [AVH]	None	AUD	0.95	0.34	Very High	★★★★★	0.7
Sigma Healthcare [SIG]	None	AUD	0.69	0.70	High	★★★	0.7
API [API]	None	AUD	1.60	1.14	Low	★★★★★	0.6
Mayne Pharma [MYX]	None	AUD	0.41	0.20	High	★★★★★	0.4

This Time It's Different As Healthcare Is at the Heart of the Coronavirus Crisis

The healthcare sector is known for its defensiveness. However, the current COVID-19 crisis is rooted in healthcare and impacts operations directly and we expect varied outcomes across the sector. Should the COVID-19 pandemic trigger a more sustained economic downturn, we expect the majority of our coverage in the sector to prove resilient over the longer term once the epicentre shifts away from healthcare. Based on recent commentary from companies, we anticipate the first round of COVID-19 impacts to be change in prioritization of hospital space, deferral of elective surgeries and diagnoses, and possible supply chain disruption. Through the 2009 global financial crisis, or GFC, revenue of the stocks covered in this report grew a median 2.4% per year, including regulatory changes impacting the domestic pharmaceutical distributors. Our outlook for fiscal 2020 is median revenue growth of 7.5%, slowing to 5.9% in fiscal 2021, as we are only three months away from most companies' fiscal 2020 year end. Beyond fiscal 2021 we expect both revenue and profit in the sector as a whole to prove defensive as we anticipate the focus to shift to the economic cycle and away from the healthcare system directly.

The COVID-19 impacts vary significantly across the sector, depending on the nature of the product or service. The most defensive stocks are likely to be those that treat life-threatening illnesses, like CSL and Fisher & Paykel. CSL primarily manufactures plasma derived products for the treatment of immune deficiency diseases and Fisher & Paykel is the largest manufacturer of hospital ventilators and humidifiers. In addition, companies exposed to self-medication as people scramble to boost their immune systems should benefit moderately from the health crisis. These include both vitamin company Blackmores and the pharmaceutical distributors through their retail and hospital pharmacy exposures. Based on our current outlook for the COVID-19 impacts on healthcare companies and changes in market exchange rates, we have made the following recent changes to our fair value estimates:

Exhibit 1 Recent Fair Value Changes

Company	Fair Value Current (AUD)	Fair Value Previously (AUD)	Date Changed
CSL	282.00	236.00	19-Mar-20
Fisher & Paykel [FPH]	17.00	16.40	23-Feb-20
Cochlear [COH]	129.00	135.00	17-Mar-20

Source: Morningstar Advisor Research Centre. Data as of 20 March 2020.

The table below ranks our coverage universe by anticipated near-term (fiscal years 2020 and 2021) impact from COVID-19 from most positive to most negative. In addition, we note the direction of risk on our medium term outlook, which assumes that the COVID-19 health crisis evolves into a more sustained economic downturn, and five-year forecast adjusted EPS growth off a fiscal 2019 base year.

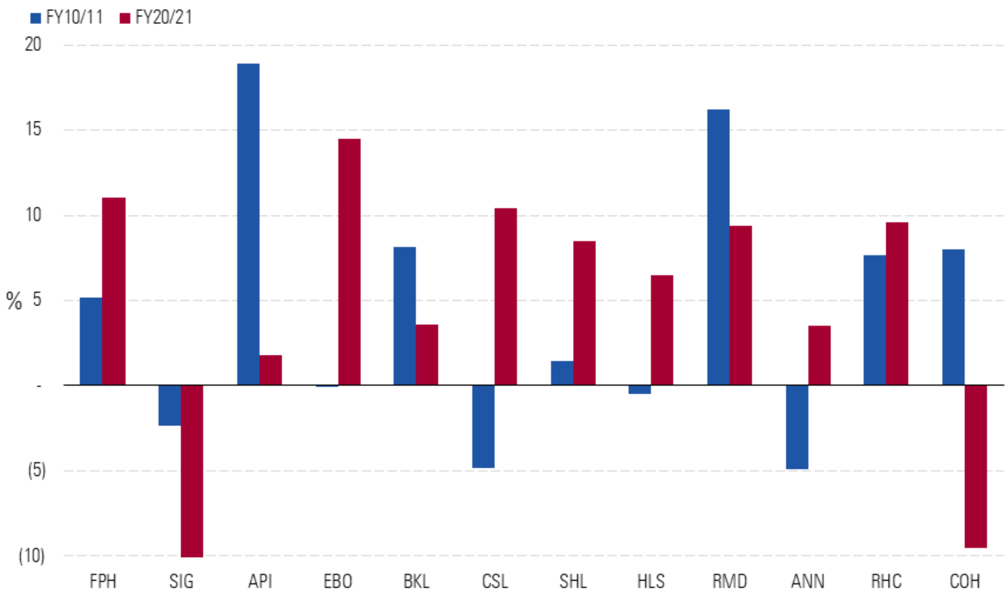
Exhibit 2 Healthcare Stocks Ranked From Most Positive to Most Negative Short-Term Impacts From COVID-19

Company	Star Rating	P/FV	Fair Value Uncertainty	Medium Term (3-5 year) Direction of Risk to Fair Value as a Result of COVID-19	5 Year Compound Adjusted EPS Forecast
Fisher & Paykel (FPH)	★	1.59	Medium	Positive	11.6%
Sigma Healthcare (SIG)	★★★	1.01	High	Slightly Positive	4.3%
API	★★★★★	0.71	Low	Slightly Positive	7.9%
EBOS (EBO)	★★★	1.02	Medium	Slightly Positive	5.1%
Blackmores (BKL)	★★★★	0.81	High	Slightly Positive	14.2%
CSL	★★★	1.01	High	Neutral	11.5%
Avita (AVH)	★★★★★	0.36	Very High	Neutral	>100%
Sonic Healthcare (SHL)	★★★	0.92	Medium	Neutral	8.1%
Healius (HLS)	★★★★	0.74	High	Neutral	5.9%
Mayne Pharma (MYX)	★★★★★	1.00	High	Neutral	not material
ResMed (RMD)	★	1.46	Medium	Neutral	10.0%
Ansell (ANN)	★★★★★	0.66	Low	Negative	7.2%
Ramsay Health Care (RHC)	★★★★	0.87	Medium	Slightly Negative	4.2%
Cochlear (COH)	★★	1.33	Medium	Slightly Negative	7.1%

Source: Morningstar Advisor Research Centre, Morningstar Analyst Estimates. Data as of 20 March 2020.

We don't expect history to repeat itself exactly and the charts below plot year on year changes in revenue and core NPAT for the two years post the GFC and our forecast for fiscal years 2020 and 2021. In addition to the direct links to healthcare in the current crisis, there are a number of company and sub-industry specific items in both the history and our forecasts. Most notably, Ramsay Healthcare and Sonic Healthcare's fiscal 2020 revenue growth rates in this chart are fueled by acquisitions and fiscal 2021 growth represents a more sustainable outlook for those two. In addition, the revenue and profits of the pharma distributors were severely impacted by Pharmaceutical Benefit Scheme price reform in fiscal 2010 and 2011, which overshadowed the resilient underlying volume trends in the sub-sector. The forward view for these companies includes a major contract shift to EBOS from Sigma.

Exhibit 3 We Anticipate Reasonable Revenue Growth From Healthcare Stocks
Revenue change year on year--two years post GFC versus next two years' forecasts.



Source: Company Reports, Morningstar Analyst Estimates. Data as of 20 March 2020.

Exhibit 4 Core NPAT Change Year on Year--Two Years Post GFC versus Next Two Years Forecasts

Source: Company Reports, Morningstar Analyst Estimates. Data as of 20 March 2020.

Avita and Mayne Pharma are excluded from these charts as the companies are currently loss-making and comparison is not meaningful.

CSL Expected to Emerge Unscathed by COVID-19

We expect CSL's operations to be largely unscathed by the COVID-19 pandemic. CSL's revenue declines post the GFC can be attributed to excess supply of plasma in the market leading to price weakness. Approximately 80% of global plasma donations take place in the U.S. and due to donors being compensated for the time it takes in making the donation, supply has typically increased when unemployment goes up. However, we expect the encouragement of social distancing and possible travel restrictions from neighbouring countries will provide some headwinds and consequently we do not expect excess plasma supply in the near term. In addition, there is far higher demand for plasma products currently than a decade ago, stemming from the new products and increased indications for its usage.

We do not expect plasma products to play a significant role in the treatment of COVID-19. While the company's vaccine division, Seqirus, is engaged with the University of Queensland in researching a COVID-19 vaccine, we do expect it to make a significant financial contribution in the foreseeable future. The fiscal 2020 revenue growth forecast of 8.1% is impacted approximately 420 basis points by the change in distribution model in China, with a comparable bounce-back in the subsequent year. Our AUD 282 fair value estimate factors in five-year revenue growth averaging 9.4% and EPS growth of 11.5%.

Deferral of Elective Surgeries a Headwind for Ramsay and Cochlear

We view Ramsay Healthcare and Cochlear as the most vulnerable stocks in our local coverage to COVID-19 financial impacts. We expect the deferral of elective surgeries, which impacts both companies, will take at least nine months to revert to normalised levels. In Ramsay's case, despite a high likelihood that coronavirus cases fill up hospital beds, these lower acuity cases come at the expense of more profitable elective surgeries. Ramsay began its global expansion in fiscal 2010, acquiring its U.K. operations not long before the GFC, and has added major French and Nordic hospital groups subsequently. In fiscal 2019, the company earned 45% of revenues in Australia, down from 80% in fiscal 2009. We believe the evolution in geography adds more risk, not less, to Ramsay's business, due to the reliance on government funding of healthcare, lower operating margins and financial leverage linked to the acquisitions.

In the near term we expect Ramsay to report lower margins as a result of the COVID-19 pandemic, over and above the structurally lower margins from the Capio acquisition. At this stage, we expect it to take until the end of calendar 2020 for normal activity levels to resume. The company recently withdrew its fiscal 2020 profit guidance, and, excluding the impacts on reported profit from the new lease accounting standard, we forecast low- to mid-single-digit profit growth extending beyond the COVID-19 pandemic. Our AUD 63 fair value estimate is based on forecast five-year compounded revenue and adjusted EPS growth of 5.8% and 4.2% respectively.

Cochlear confirmed that it expects major declines in cochlear implant surgeries for the foreseeable future and also withdrew its fiscal 2020 guidance. Currently we expect that cochlear implant surgeries for children, where it is an established standard of care, to resume toward the end of the calendar year and the backlog to take approximately two years to catch up. However, the outlook is different for adults where the surgery is highly discretionary and the target market is over 65 years old, the demographic most susceptible to COVID-19 mortality. We expect 20% of the surgeries deferred the next nine months will in fact get cancelled and the backlog take longer to clear. A key unknown is the rate at which deferred cochlear implant surgeries can be caught up and it will ultimately be dependent on operating theatre capacities and financial constraints, particularly in government funded health systems. As such, we expect children to be prioritised over adults.

In the near term we've reduced our earnings expectations for Cochlear for fiscal 2020 and 2021 significantly, but expect the COVID-19 effects to have worked fully through the system by fiscal 2024 and leave our five-year outlook largely unchanged. Our AUD 129 fair value estimate, down from AUD 135 previously, includes five-year compound revenue growth and adjusted EPS growth of 7.8% and 7.1% respectively. The COVID-19 impacts on Cochlear's cash flow are compounded by the company recently losing its appeal on a long-outstanding litigation case and we have raised the likelihood to 100% from 50% that the company will be liable for the USD 391 million, approximately AUD 600 million, in penalties and interest. Consequently, we expect the second half fiscal 2020 dividend to be suspended and believe the 70% dividend payout policy is at risk as the company directs cash towards deleveraging.

A Perfect Storm for Fisher & Paykel, but ResMed's Sleep Diagnosis Pipeline Suffers

Fisher & Paykel is the most direct beneficiary from COVID-19. We were already bullish on the growth trajectory for its hospital business, which has an estimated 80% market share in its 120 geographies in hospital ventilators and humidifiers, and now we expect upside risk to our forecasted revenues in fiscal 2020 and 2021. This division contributes 60% of revenues and the vast majority of this is for single-use masks and other consumables. The company has increased manufacturing volumes to meet demand and upgraded fiscal 2020 (March year end) guidance twice on the back of COVID-19. Aside from the near-term tailwinds, which we expect to carry through well into the fiscal 2021 year, our longer term growth forecasts are underpinned by the increasing adoption of its nasal high flow therapy as a standard of care both in the ICU and non-emergency care. Our AUD 17, or NZD 17.90 fair value estimate, includes a forecast five-year revenue and adjusted EPS growth of 10.5% and 11.6% respectively.

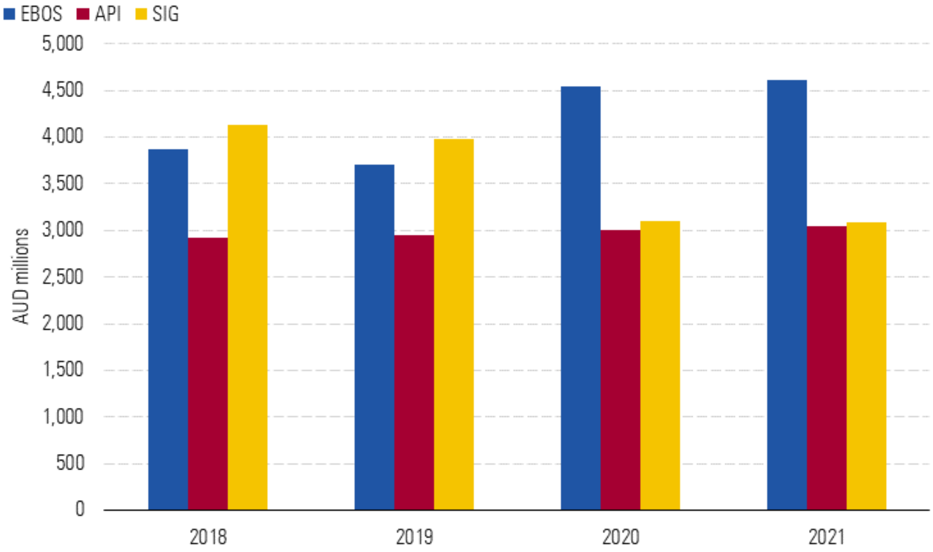
ResMed is almost entirely focused on the home treatment of sleep apnoea and doesn't have a comparable hospital respiratory device business to Fisher & Paykel. We expect ResMed's existing customers will continue to resupply with masks and other consumables through COVID-19, however the company has highlighted that the diagnoses of sleep apnoea, and consequently device sales, have trailed off. We expect the impacts to be very short-term in nature and normalised sales activities to resume within six to nine months. COVID-19 does not impact the prevalence or treatment of sleep apnoea in any way. We make no change to our AUD 17 or USD 114 fair value estimate at this time. We forecast five-year compound revenue growth of 8.6% and adjusted EPS growth of 10.0%.

Demand for Vitamins and Pharmacy Products a Boost for Blackmores and Pharma Distributors

As people world-wide rush to self-medicate on immune boosting products, we expect an increase in pharmacy sales, including vitamins. We expect retail pharmacies to benefit from the increased volume of sales. Despite EBOS having the largest community pharmacy business, the company is more diversified than peers API and Sigma, and thus the impact of the increased volume on group profits may be diluted. Sigma has the largest contribution from community pharmacy at over 90% of revenue and as a result we expect the effects of the volume uplift to be greatest for Sigma. Importantly, the largest uplift is expected in over-the-counter, not prescription, medications which are not subject to a regulated margin. This will likely alleviate the downward margin pressure from the Pharmaceutical Benefit Scheme price cuts on prescription medicines.

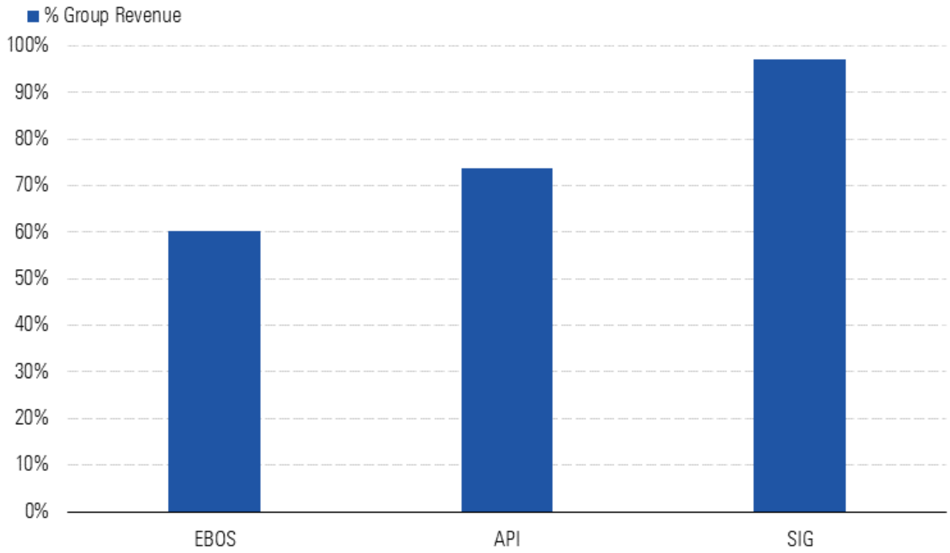
The industry has excess distribution capacity; however, the sharp uplift will likely strain supply chain capacity and is dependent on underlying suppliers' product availability. We think that the COVID-19 sales are net additional sales to the system and not just forward purchasing, consequently, we anticipate revising near-term revenue forecasts modestly, but do not expect much change to our fair value estimates as our five year view of sales and profits for the industry is unchanged.

Exhibit 5 EBOS' Superior Scale and Cost Advantage in its Pharmacy Business Earns it a Narrow Moat
Relative size of community pharmacy businesses.



Source: Company Reports, Morningstar Analyst Estimates. Data as of 20 March 2020.

Exhibit 6 However, Sigma Provides a Pharmacy Pure Play
Comparison of community pharmacy contribution to group revenue.



Source: Company Reports, Morningstar Analyst Estimates. Data as of 20 March 2020.

Based on observed consumer behavior, vitamin and dietary supplement company, Blackmores, is likely experiencing unprecedented demand for its immune boosting products. Blackmores has a brand renowned for quality and the largest market share in the category in Australia.
We believe COVID-19 is adding net additional sales in the domestic Australian market, however, the financial impact will be muted by the loss of cross-border sales and current operational turnaround situation the company is faced with. After profit halved from fiscal 2016 to 2019, the newly appointed management team has set a new strategic agenda for Blackmores, which we expect to take up to three years to deliver. Management recently guided to effectively a break-even second half of fiscal 2020 and we expect the operational challenges to mask some of the immediate COVID-19 upside. We forecast travel restrictions between China and Australia for the second half of fiscal 2020 to result in the loss of between 2% and 5% of group sales for the full fiscal year. An estimated 5% to 10% of ongoing sales are products purchased in Australia and carried cross-border into China. This is already included in our forecasts and AUD 81 fair value estimate. Longer-term, we expect the health crisis to underpin demand for Blackmores products and the company to emerge from a two to three year turnaround in better shape. We forecast five-year compound revenue growth of 6.4% and EPS growth of 14.2% forward to fiscal 2024.

Ansell's Industrial Exposure Potentially a Medium Term Drag on Earnings

Despite Ansell's exposure to medical gloves and protective wear, we expect the industrial exposure, approximately 50% of revenue, to weigh on results if the downturn is sustained. Global industrial demand is a reasonable indicator of the top line for this segment and we anticipate revising our near-term forecasts for fiscal years 2021 and 2022 downwards. However, the capital stewardship in Ansell is Exemplary and it is the only company in this list which commenced buying back shares on the market pull-back. Ansell's net debt/EBITDA was 0.8 at the end of fiscal 2020 and we estimate the company generates around AUD 100 million in free cash flow each year. On this basis, and assuming the current dividend payout ratio of 45% is maintained, Ansell will be net cash positive by fiscal 2023. Given the low borrowing rates, we expect the buybacks to enhance EPS and currently forecast five-year core EPS growth of 7.2%, in the middle of management's guided long term range of 5% to 10%.

No Significant Impacts Expected for Pathology Players Sonic and Healius, nor for Avita and Mayne Pharma

While Sonic and Healius are actively participating in COVID-19 testing, we expect these additional pathology volumes will only offset other volumes lost from deferred doctor visits and elective treatments. Consequently, we do not anticipate this contributing materially to earnings. We make no changes to our fair value estimates or forecasts at this stage. Our AUD 27 fair value estimate for Sonic includes five-year revenue growth of 6.8%, which includes an approximately 2% contribution from acquisitions given the company's strategy, and EPS growth of 8.1% forward to fiscal 2024.

Healius is in a more precarious position because of very high gearing and investments required to turn around the business. Although the company raised equity in August 2018 to fund the operational investments required, the pace of the turnaround has lagged management's targets. Healius recently announced an intention to divest its medical centre business in order to invest in other divisions and, given the current environment, we see this opportunity as limited. Financial leverage is high at net debt/EBITDA of 3.6 in fiscal 2019 and should it not find a buyer, a dilutive equity raise is possible.

We see the rejected bid proposal made for Healius and the company attempting to sell its medical centres division as overshadowing any share price impacts from COVID-19. Our AUD 3.36 fair value estimate assumes the company is largely successful in its bid to improve margins in its pathology and imaging businesses and experiences modest growth in medical centres. We would have supported the take-out at a proposed cash offer of AUD 3.40 per share as it crystallises our turnaround estimates. Our forecasts include 6% compounded revenue growth over five years and core EPS growth of 13.1% over that period. However, we expect reported EPS growth to outpace that at 25%, as the significant strategic project expenses, excluded from core profits, trail off over the period.

Avita and Mayne Pharma are both wholly exposed to the U.S. healthcare market. We do not expect significant impacts to Avita's roll-out in burn centres as a result of COVID-19 as treatments of burns is critical, not elective, and burn centres function separately to general hospital admissions. Should the roll-out experience short-term setbacks due to travel restrictions within the U.S. it would not alter our five-year view on potential market share for the company, nor the AUD 0.95 fair value estimate. Avita is currently loss making and we expect it to be profitable from fiscal 2022. Likewise, we expect no change in demand for Mayne's products and make no changes to our outlook or AUD 0.41 fair value for the company. We expect the company to post losses in fiscal 2020 and 2021 and point to our high uncertainty rating for the stock as AUD 0.25 of our fair value estimate is dependent on the successful launch of a novel oral contraceptive licensed under a deal with Mithra in October 2019.

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