

February 12, 2016

**Dear clients and colleagues,**

2016 is an election year in the US, and in an election year health care investors typically take a deep breath and watch as politicians deliver tactics and promises on health care, which is often perceived as their most important issue. Before and after voting day, health care stocks can be volatile, especially the ones influenced by potential changes in drug pricing and channels. Historically, health care stocks on average outperform the S&P 500 six months post elections.

Total health care spending in the United States is expected to reach \$4.8 trillion in 2021, up from \$2.6 trillion in 2010 and \$75 billion in 1970. This means that health care spending will account for nearly 20% of gross domestic product (GDP), or one-fifth of the US economy, by 2021.

Curbing costs is therefore a big subject. All agree there is one notable low-hanging fruit in this area — the use of technology through health information technology (HIT). Broad adoption of HIT has been projected to save as much as \$80 billion annually, or roughly 3% of budget.

Large companies such as Siemens, Cerner and GE Healthcare have led the charge in the development of electronic health records (EHR). According to IDC Health Insights, EHR market penetration is predicted to reach 80% in 2016, up from 25% in 2009. The remaining 20% of the market is mostly in small medical practices.

We therefore look at new markets that can benefit from this EHR install base. Predictive medicine and big data are popular areas which we follow. Global Alpha is positioned in EHR connectivity through WebMD, the number one health information site.

As well, EHR will have a profound effect on operations such as supply management, an area that represents up to 25% of total hospital spending. One of the most complex areas of the supply chain is drug dispensing; the point of transfer between pharmacies and drug administrations. The largest opportunities lie in augmenting compliance and removing errors. Non-compliance represents approximately 30%-40% of treatment failures and re-admissions; it is the estimated cause of 125,000 deaths in the United States every year (errors cause 7,000 deaths per year). Medical errors lead to roughly \$2 billion in hospitalization costs annually.

The trend in the adoption of EHR in the US is supported by stringent government regulation towards patient safety and wellness, such as The Patient Protection and Affordable Care Act and The Health Care and Education Reconciliation Act (2010).

Very few companies address the physical handling of medication, which is where most errors occur. Today, we focus on the initial innovator of automated drug dispensing, Omnicell, a recent addition to the Global Alpha portfolio.

The automated dispensing industry started in the early 1990s. At that time, automated drug dispensing systems were used primarily to help nurses batch patients' drugs into individual blister packs. Over time and with the integration of EHR, it has evolved into a key system for optimizing nurses' time, improving drug administration and reducing errors.

This growing market was confirmed by Becton Dickinson's acquisition of Carefusion late in 2014 for \$12B. Becton Dickinson clearly stated its motivation for this acquisition was their wish to enter the automated dispensing sector space.

### **Omnicell (OMCL) Business Description**

Headquartered in Mountain View, California, OMCL is one of the leaders in automated dispensing cabinets. Their products are appliances which have a high degree of software content (80%). Their products help track, store, acquire, dispense and administer medications and supplies in a hospital setting.

### **Investment Theme**

- Demographics

### **Target Market Size**

- TAM \$10-\$12B, ~60% penetrated for the industry in the US
- Market opportunity is \$2-\$3B a year with a 5-year renewal cycle (20% of the market refreshes)
- Outside the US there is almost no penetration
- BCC Research estimates worldwide in-patient pharmacy automation growth to be 8.5% per year until 2018

### **Growth Strategy**

- Product innovation

### **SWOT**

#### **Strengths**

- Robust product portfolio. Products are fully integrated with the top EHR providers
- Modular systems enables quick parts replacement and software upgrades

#### **Weakness**

- Dependence on the US market increases concentration risk
- Longer implementation time for larger deals and integration risk from acquisitions

### **Opportunities**

- Aging US population increases opportunities to generate higher revenues
- Hospitals are becoming more cost conscious
- International expansion

### **Threats**

- Reforms in the health care environment
- Data breach
- Pharmacy and/or hospital consolidation

### **Management**

- Insiders own 3.23% of the company
- CEO, Randall Lipps, is the founder of the company

Have a good weekend.

The Global Alpha Team