COMMENTARY

November 8, 2019

Dear Clients and Colleagues:

Hospitals are the heart of our healthcare universe as most sub-sectors, from insurance, to pharmaceuticals, to devices, are integral to a hospital's operations. Hospital trends and capex cycles are important inputs Global Alpha considers when forming its opinion on the sector.

In a recent weekly commentary, we covered Raffles Medical Group (RFMD SP), a Global Alpha holding. Singapore-based Raffles benefits from positive trends in Asian demographics, medical tourism and a 3.4 million hospital bed shortage in Asia. The situation in North America and Europe is quite different.

Nearly two-thirds of the 104 healthcare systems operating in the US saw deteriorating operating margins from fiscal year 2015 to fiscal year 2018. For hospitals reporting declines, the total loss came in at $6.8 billion, a 44% decrease. Why? Healthcare costs have simply exploded, and payers, such as governments and private insurance companies, are trying to push back, leaving hospitals stuck in the middle.

In 1965, healthcare consumed just 5% of the US Gross Domestic Product (GDP). Today, that number is 18%. To try and control their expense line, the government (Medicare) is pressuring the growth rate of medical procedure reimbursement levels, making it more and more difficult for hospitals to make money. The average hospital profit margin on procedures covered by Medicare is -10%.

For a long time, insurance companies and governments never questioned the price they paid for procedures performed at hospitals, so there was no incentive for hospitals to keep costs down. Hospitals have contributed to the increase in healthcare costs in recent decades by: (1) purchasing redundant, expensive medical equipment and generating excess demand, (2) hiring highly paid specialists to perform ever-more complex procedures with diminishing value rather than right-sizing their workforces, and (3) tolerating massive inefficiencies in delivery of care.

We would describe investing in US hospitals as a negative thematic. However, as hospitals struggle to remain viable, opportunities are being created in other healthcare sub-sectors. Companies that provide cost cutting or efficiency solutions are benefiting from strong secular trends. Global Alpha holds many of these companies in our portfolios, including Omnicell (OMCL US).

Omnicell is the uncontested leader in dispensing automation systems that manage drug logistics in hospitals. The company has developed multiple drug dispensing system that are used worldwide. Its new automated pharmacy system is designed to link hospital departments to a central nervous system to control drug dispensing and to better manage inefficiencies between departments.

The completely automated pharmacy concept has been validated by leading hospitals in the US, including the Mercy hospital system, a large 45-hospital network that recently signed a long-term partnership agreement with Omnicell.

Managing interdepartmental activities can certainly lead to increased efficiencies. In most hospitals, the various departments don't use a universal coding system for medical procedures and payments. Having a system that provides some standardization is a first step. Global Alpha recently established a holding in Craneware plc (CRW LN), a company that can help hospitals in this area.

Based in Edinburgh, Scotland, Craneware's software solutions focus on improving how hospitals deal with patient payment responsibility, enabling healthcare providers to better managed cash flow, reduce bad debt and improve collection rates while keeping administration costs low. The company's software is being used in 1,600 of the 5,500 hospitals in the US (30% penetrated). Craneware continues to innovate with new software—pricing analyzers, claims informatics, etc. Its new software suites are sold at a much high price point. Cross-selling opportunities also exist as only 450 clients currently employ the full platform suite.

Hospitals are under pressure and are looking to streamline and reorganize. In addition, outside competition in profitable segments, such as orthopedic surgeries, continues to intensify as these types of surgeries are faster and less invasive and have quicker recovery times. More clinics are opening and competing with hospitals.

Outpatient activity is here to stay and continues to chip away at hospitals' profits. As such, hospitals have had no choice but to join the outpatient trend. It sounds counterintuitive, but for outpatient clinics to thrive, patient volume is critical, and hospitals have that volume. If a small, competing specialty organization has low patient volumes and much lower costs, there is synergy in a partnership.

This is what RadNet (RDNT US) is achieving with good success. This Global Alpha holding operates the largest network of radiology clinics in the US with 340 imaging centres. With a 17% EBITDA ratio, it enjoys best-in-class operational margins.

Radiology is a core activity for hospitals, and reimbursements for these procedures have been stable for the last few years. If reimbursements for radiology procedures were reduced, lower tier hospital operators would go bankrupt; therefore, payers are reluctant to reduce reimbursement rates. This helps protect RadNet's margins and ensures it remains a leading operator.

Savvy hospitals have found that profitability can be improved by partnering with experts who can manage large patient volumes at best-in-class margins. Currently, RadNet has joint ventures with health care provides Cedars-Sinai (CA), Dignity Health (CA), RJWBarnabas (NJ), University of Maryland Medical System (MD), MedStar Health (MD) and LifeBridge Health (MD).

Have a great weekend.

The Global Alpha team