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Tidings from Tokyo: Rising Japanese Investor Interest in US Health Care

Summary

It was an interesting time to travel abroad, a time made even more interesting by recent developments in the fight over the ACA, but before the immigration ban took hold. We thought it might be at least informative for US investors to have a window into how Japanese investors are viewing US markets, investments in health care and, to a very modest extent, their concerns about border taxes, trade and international policy issues. In the 18 months since our last trip to see Japanese investors, interest in US HC stocks has grown, broadening beyond their prior focus almost exclusively on ETFs. Individual investors too are increasingly interested in US investments beyond US mutual funds and the combination of industry size, relative underperformance in the last year and the potential for growth and yield in some cases seems to be driving the renewed interest in both HC generally and specific companies. UNH, an MSUSA Top Pick, with significant growth, sufficient liquidity and a dividend, is the one stock in this analyst's coverage that is most frequently owned by the Japanese investors we met. We reiterate our ratings and PTs on UNH and our hospital coverage.

Company	Symbol	Price (1/27)	Rating Prior	Rating Curr	PT
Community Health Systems, Inc.	CYH	$6.58	–	U-P	$3.00
CVS Health	CVS	$77.75	–	Buy	$90.00
HCA Holdings, Inc.	HCA	$79.52	–	Neutral	$78.00
LifePoint Health, Inc.	LPNT	$60.00	–	Neutral	$50.00
Quorum Health Corp	QHC	$8.72	–	Neutral	$3.00
Tenet Healthcare Corp.	THC	$18.29	–	U-P	$13.00
UnitedHealth Group Incorporated	UNH	$162.99	–	Buy	$178.00

Source: Bloomberg and Mizuho Securities USA

Key Points

The key items of interest to those Japanese investors with whom we met were:

1. ObamaCare (naturally) and what will Trump and Congress cause to happen to it - and who is affected/by how much? (Sound familiar?)

2. Border taxes and whether we think they'll be implemented and, if so, how will it affect pricing, margins and profits throughout the US health care system?

3. Are hospitals cheap or dear?

4. UNH is surprisingly well understood in Japan, even if its ownership is still limited.

We think that the search for potential return could lead to a very significant flow of institutional and individual investors' funds into US stocks and, more specifically into larger cap companies with strong growth and management like UNH and CVS (Hynes, Buy, $90PT) and are likely to continue to keep HCA on the radar screen.

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Tidings from Tokyo

It's hard enough for US generalist investors to understand our byzantine health care system: one can image how difficult it is for those outside the US to understand it, That's especially true now that the ACA is in play. But we've learned that the notion that money can be made in times of turmoil for those who understand it is a universal one - and in that, the investors we met with share common ground with our clients here. In that sense, it's a small world indeed. We think that this turmoil may well have been part of the reason that our schedule was so robust, seeing more than 30 investors from 17 firms in two days. On our last trip we saw fewer than half as many investors in the role of HC analyst (versus DoR). These investors were, in some cases, new to health care and thus required some basic exposition around the payer/provider roles and ObamaCare. In other cases, their knowledge was quite deep and broad and more subtle issues could be discussed. The key items of interest were:

1. ObamaCare (naturally) and what will Trump and Congress cause to happen to it - and who is affected/by how much? (Sound familiar?)

2. Border taxes and whether we think they'll be implemented and, if so, how will it affect pricing, margins and profits throughout the US health care system? In fact, the concern went beyond the obvious, i.e., about Japanese pharma companies' exports to the US, and we focused more on the potential impact to purchases of those goods here in the US, e.g., pharmacies, hospitals, doctors' offices, etc. As one might imagine, there was significant concern about this and other isolationist types of policies that the US may impose. The HC Services team's (Ann Hynes & Skolnick) at MSUSA work on the potential implications of tax reform was of particular interest to several Japanese investors as they grapple with the potential implications for both their US and Japanese investments.

3. Are hospitals cheap or dear? HCA is the one hospital company that is relatively well-known in Tokyo and we spent some time with a few investors delving into HCA's prospects as a leading hospital company. As a reminder, we have a Neutral rating and $78 PT on HCA and see the price as reasonably balancing risks and opportunities at this time. But we also see it as a really nice house in an increasingly troubling neighborhood as it fights the falling tide of hospital volumes across all payers and all geographies.

4. UNH is surprisingly well understood in Japan, even if its ownership is still limited: it is viewed not just as an insurance company, but also valued for its Optum opportunity. Oh that it were so easy to convince US investors and analysts of the power of Optum + UHC to create attractive investor returns. But that's what comes of the deep study and intensive work that Japanese investors put into their stock selection process.

In conclusion, we think that the search for potential return could lead to a very significant flow of institutional and individual investors' funds into US stocks and, more specifically into larger cap companies with strong growth and management like UNH and CVS (Hynes, Buy, $90PT) and are likely to continue to keep HCA on the radar screen.

Price Target Calculation and Key Risks

Community Health Systems, Inc.

Our valuation of $3 is based on 6.7x our 2016E EV/EBITDA and 7.5x our 2017E EBITDA on a guidance basis, including the assumed $1.2B in sale proceeds as cash. We now expect FCF to be negative in 2016, along with further margin compression in 2016 and 2017, which argues for a below peer multiple in our view. However, the high degree of leverage prevents the multiple from going much below 6.5x. These reflect likely volume and mix pressures, coupled with high leverage as well as the remaining CVR risk.

Risks to our rating and price target include, but are not limited to, better than expected asset sale results or the involvement of an activist investor, or the acquisition of shares by deep value investors. Factors weighing on valuation include, but are not limited to, relief of the following: pricing pressure from government and private payers, continued soft volume growth, additional labor cost pressures, further deterioration of bad debt, integration of HMA and turnaround of HMA, physician losses, competition for acquisitions, the pending spin-off and a highly levered balance sheet. However, CYH may be more successful at cost cutting and growing volume than we think and that could cause upside surprise to be reflected in the stock price. CYH has not yet finalized the value of the CVR, which could result in unexpectedly higher settlement and/or legal costs above the reserve level. ACA repeal risk, along with the risks associated with Medicaid block grants and Medicare privatization also exist.

CVS Health

Our valuation of $90 assumes the company will trade at a mixed valuation of a free cash flow yield of 7% based on 2017E adjusted FCF and its 10-year low PE of 12.5x. Risks include continued soft prescription volume due to the economy, market share shifts resulting from the introduction of health reform, loss of key client contracts, increased government regulation, industry pricing pressure and increased competition.

HCA Holdings, Inc.

Our valuation of $78 is based on 7.3x our 2016E EV/EBITDA less NCI.

Risks to valuation include, but are not limited to, repeal/replacement of the ACA, pricing pressure from government and private payors, continued soft volume growth, further deterioration of bad debt, competition for acquisitions, increasing labor costs and labor market shortages, HITECH payment risk, a levered balance sheet and the repeal of all of the provisions of the ACA and the implementation other recent legislation (MACRA and IMPACT), along with the potential for privatization of Medicare and block grants for Medicaid.

LifePoint Health, Inc.

Our valuation of $50 is based on a 6.5x multiple on our 2017E EV/EBITDA less NCI, which rises to 7.5x when we include an estimate of future capex liabilities as 'debt.' We think this multiple is appropriately reflecting likely inpatient volume pressures, the dilutive impact of acquisitions in the near term plus capex commitments associated with them and balanced by its moderately levered balance sheet and smaller, but still positive, FCF. Risks to valuation include pricing pressure from government and private payors, continued soft volume growth, further deterioration of bad debt and competition for acquisitions, excess dilution from acquisitions due to slower than expected improvement in margins and execution risk and the risk of repeal, Medicaid block grants and Medicare privatization.

Quorum Health Corp

With our below-guide $170mm EBITDA estimate and with serious total net leverage of 6.0x our corresponding $233mm LTM CA EBITDA estimate, the EV multiple explodes in our target price model. At our new target of $3, the stock would trade at 8.2x guidance-basis EBITDA. But if the assets are sold, $3 is only 6.7x our new estimate. While our PT is more than 10% from the current stock price, the low dollar price makes the stock highly volatile.

Risks to our rating and price target include, but are not limited to: repeal/replace the ACA, execution, reimbursement, litigation, regulation, investigation and other market and government-based risks. In addition, QHC, formed through a spin-off from CYH, is a very new company just having been formed on 4/29/15. Thus, it has a limited track record and has had much time to execute on its strategic plan. Our estimates, and therefore our rating and price target, are thus based on extremely limited company-specific information. We expect the shares to be very highly volatile given the small float and high degree of leverage, and the risk of repeal of the Medicaid expansion and the potential for the privatization of Medicare and Medicaid block grants.

Tenet Healthcare Corp.

Our $13.00 PT is based on 7.4x our 2017E EBITDA less NCI of $2.157B, which corresponds to 6.6x our 2016E EBITDA and 6.3x our 2017E EBITDA. Risks to our price target include, but are not limited to, repeal/replace the ACA, pricing pressure from government and private payors, continued soft volume growth, HITECH payment risk, execution risk (including closing transactions in a timely fashion) and further deterioration of bad debt. Risks associated with health policy changes, ACA repeal, Medicaid block grants, privatization of Medicare all factored into our target multiple as well.

UnitedHealth Group Incorporated

Price Target Methodology: Our $178 one-year PT is based on a 50/50 blend of our DCF model using a 2.5% long-term growth rate, of $178 and a target P/E of 18.5x our 2017E Adjusted EPS of $9.50. Blending the two equally yields our $178 1-year price target for UNH shares.

Key Risks: Among the key risks to our rating and price target are repeal/replace the ACA, execution risk; reimbursement and regulatory risks; competitive risks and market risk. Further, UNH is modestly exposed to exchange rate risk, with less than 5% of its revenue derived from its global businesses, principally in Brazil. Execution risk includes, but is not limited to, risks in both the benefits and services businesses. In the benefits business, estimation of cost trends and other actuarial calculations are critical activities as they influence pricing and reserves for the Company's insurance products. Any misstep there could result in a material and negative effect on the stock price. In addition, the Optum services business is highly innovative and technology driven. Missteps there could lead to the potential for material disappointments in results and multiple compression. Reimbursement and regulatory risk could not only affect pricing, but also members served. The timing and extent of such changes are usually out of the Company's control and therefore could represent exogenous events with negative earnings and stock price implications. Political/health policy risks could be significant and future national health policy remains highly uncertain.

Companies Mentioned (prices as of 1/27)

Community Health Systems, Inc. (CYH- Underperform $6.58)
HCA Holdings, Inc. (HCA- Neutral $79.52)
Quorum Health Corp (QHC- Neutral $8.72)
UnitedHealth Group Incorporated (UNH- Buy $162.99)
CVS Health (CVS- Buy $77.75)
LifePoint Health, Inc. (LPNT- Neutral $60.00)
Tenet Healthcare Corp. (THC- Underperform $18.29)

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Investment Risks and Valuation Methods can be located in the following section of this research report - Price Target Calculation and Key Risks.

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None

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Rating Distribution

(As of 1/27)	**% of coverage**	**IB service past 12 mo**
Buy (Buy)	45.55%	42.19%
Hold (Neutral)	51.25%	37.50%
Sell (Underperform)	3.20%	44.44%

For disclosure purposes only (NYSE and FINRA ratings distribution requirements), our Buy, Neutral and Underperform ratings are displayed as Buy, Hold and Sell, respectively.

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