Health Insurance Changes Create Investment Opportunities

We, like many people, embrace the adage that “change brings opportunity.” In the spirit of this philosophy, we think the changes brought on by the Patient Protection and Affordable Care Act, commonly called the ACA or Obamacare, may create significant investment opportunities for corporations and, in turn, for investors. Whether you support or oppose the new regulations, they are already re-shaping the investment landscape and it is essential that your portfolio be well-positioned for the changes ahead.

Caution Slowly Gives Way to Opportunity

In recent years, US-focused investment managers have been leery of how government legislation might affect health care-related companies. Health care remains an extremely important component of growth, value, large cap, and small cap market segments, but we have consistently seen managers insulate portfolios from stocks that could be meaningfully affected by health care reform, including hospital systems, insurers, and companies that are more domestically than internationally focused.

Instead, managers have generally focused more on medical supply companies, manufacturers of medical and diagnostic equipment, and companies with decidedly more global footprints. These companies were considered less vulnerable or better able to weather changes brought on by US health care reform.

Interestingly, now that the ACA has passed and some unknowns have slowly become “knowns,” not much has changed. Of the managers we use at Pitcairn, this has been a universal response. One manager commented, “There will be opportunities within health care, but so far we have only shifted from unknown details to unknown effects, and we tend not to invest in unknowns.”

Managers Eye Peripheral Players & Technology

One of our small cap managers suggested that the “real” opportunities may be “second and third derivative opportunities, and companies that don’t even exist yet, or if they do exist today, will soon evolve into something very different.” These second and third derivative opportunities would include companies outside the traditional health care sector, for example, technology or financial companies that benefit indirectly from new health care regulations or have products that serve health care providers. Health care, technology, and financials – the three sectors considered most likely to benefit from health care reform – account for nearly 50% of the S&P 500 Index as shown in Table 1.

Technology companies, for example, could significantly affect the opportunity set. At the end of July, eHealth, a web-based insurance provider, inked a deal with the Centers for Medicare and Medicaid Services to provide insurance in 36 states and its stock immediately shot up 25% to $28/share, approximately where it trades today. What had been a micro-cap company and a virtual unknown in the insurance industry saw its market cap grow to $500 million on the reaction to this news.

Private Equity Investors Poised to Benefit

Two of Pitcairn’s small cap-focused managers shared a belief that private
equity investors might be able to benefit more substantially – and more directly – from the ACA than those investing in public markets. One commented, “We feel the greatest opportunities exist in private equity and venture capital, particularly due to the inherent ability these companies have to take risks and explore uncharted territory. They do not have to answer to shareholders the way publicly-traded companies do.”

According to PricewaterhouseCoopers, in 2012, the life sciences, including health care technologies, accounted for 25% of all venture capital dollars invested. The total commitment that year was $1.2 billion invested in 163 companies, doubling the $480 million invested in 2011 and six times the $211 million that was invested in 2010.

Within the private equity universe, small companies in niche market segments appear particularly promising. (This is probably true in the public markets as well.) Examples include companies such as HealthEdge and PatientSafe Solutions that are helping to shape the health care evolution. HealthEdge provides an integrated financial, administrative, and clinical platform for health care payers. The PatientSafe Solutions system integrates patient identification workflows with electronic health records on a hand-held Apple iOS-based device, allowing medical personnel to verify a patient’s treatment orders, procedures, or services. Both companies are late stage venture capital opportunities, meaning they are well-established companies whose next step may be an initial public offering (IPO).

### Larger Insured Pool Demands Improved Quality & Efficiency

It is estimated the ACA will add 30 to 35 million members to insurance plans nationwide. The sheer volume supports the belief that health information technology will be a core investment opportunity. Meanwhile, consensus suggests that instead of being reactive, health care will become more proactive. Consumers will demand better diagnostics, targeted therapies with fewer side effects, and more personalized medicine.

It looks like we may see the Six Sigma concept popularized by Japanese carmakers being applied much more assertively to health care, with a goal of improving quality and reducing waste and inefficiency. Some examples of opportunities created by this trend include:

- **Private health exchanges.** Health care reform makes exchanges feasible for a wide array of employers and could lead to significant cost savings. That’s because the ACA will create guaranteed-issue health care markets where no one can be denied insurance, regardless of pre-existing conditions. Employers do not have to offer group plans for employees. Instead, they can give employees a pre-determined amount to purchase their own health care plan through public/private exchanges. Private health care exchanges will be attractive because they are likely to offer more decision-support tools and personalized help for customers (employees). Extend Health, an example of a private exchange platform, is another late stage venture capital-backed company.

- **Software and services.** As private insurance exchanges grow, there will be significant investment in software and services, such as call center technologies and back-end administrative systems.

- **21st century technology.** Many payers and providers are using antiquated systems to tackle a brand new business model (exchanges) and provide customized benefits. Technology startups that focus on quality of patient care rather than patient volume are likely to flourish under the ACA.

- **Waste and inefficiency** is estimated to drive one-third of all health care costs. Hospitals and large provider systems account for the majority of this waste. Investment opportunities may be found in companies that can contribute to improved efficiency and cost reduction through:
  - Data and analytical tools for benchmarking, cost management, and value-added initiatives
  - Tools that increase the adoption and use of electronic health records
  - Purchasing systems that leverage buying power to lower costs
  - Technological interfaces between physicians and health care facilities for enhanced patient care management
  - Redesigns of medical facilities and workflow patterns to increase efficiency

Many investment managers also believe the ACA will drive industry consolidation.
in areas such as hospitals, dental providers, vision clinics, and physician practices. For example, private equity firm Cerberus Capital Management is financing Steward Health Care Systems, which is creating a national chain of hospitals that offer low-cost, high-quality patient care. Steward is using advanced electronic health management capabilities to focus on preventive care and to standardize everything from billing to best care practices.

For our clients who include private equity investments in their portfolios, Pitcairn continues to search for private equity managers, such as Cerberus Capital Management, that are constantly uncovering leading-edge investments. These days, health care seems to be on the radar of many private equity managers. As we said above, companies financed through private equity are often more nimble and able to take more risks, allowing them to capitalize on timely opportunities like those created by health care reform.

If you are interested in accessing health care investments via private equity vehicles or in adding a broader private equity component to your portfolio, talk to your relationship manager. Private equity gives you exposure to promising companies not available in the public markets.

**Health Care Reform & Your Portfolio**

New regulations and a changing health care landscape continue to drive opportunities across a wide range of companies in the traditional health care sector, but also within technology, financial, and other areas. As always, the active managers of your portfolio are aggressively searching for companies that will benefit from secular changes like health care reform while striving to avoid companies that may suffer from new regulations. Pitcairn’s goal is to ensure that your portfolio, while always positioned for the long term, also takes full advantage of current opportunities.
About Pitcairn

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