

Healthcare: Change presents great investment opportunities

Healthcare spending has increased dramatically over the past 50 years, both in absolute terms and as a share of GDP. Total healthcare spending is estimated to have reached \$2.8 trillion or roughly 18% of GDP in 2012, up significantly from just under 6% of GDP in 1965, the year Medicare was created. Healthcare spending is expected to reach almost 20% of GDP in 2022.

Although there has been a dramatic increase in healthcare spending over the past 50 years, the rate of increase has been notably slower in the past four years. In the years 2009-2012, annual healthcare spending has grown slightly below 4%, significantly below the average annual growth of 6.9% experienced during the 2000-2009 period. The federal government projects national healthcare spending growth in 2013 will remain below 4 percent. The slowdown is partially attributable to the recession in which job losses caused losses of insurance coverage, which in turn caused lower utilization of healthcare services. In addition, structural changes have contributed to the recent slowdown in healthcare spending:

- Employers have been shifting more of the healthcare cost burden to employees, resulting in higher out-of-pocket expenses for employees, also causing lower utilization of healthcare services.
- Payers have been successful driving greater utilization of lower cost generic drugs instead of more expensive branded drugs.
- Providers have been more focused on reducing preventable health complications during hospitalizations and reducing hospital readmission rates in response to reimbursement rule changes.
- Consolidation among providers has resulted in greater operational efficiencies and increased bargaining power with suppliers.
- There is a shift in reimbursement away from fee-for-service payments and toward greater care coordination and risk-based payments.
- Comparative effectiveness studies may be starting to have an impact on the use of existing technologies and the development and marketing of new technologies that are unable to show cost effectiveness versus less expensive alternatives.
- Companies have introduced tools and services that provide

consumers with more pricing transparency and quality data to help manage their own healthcare choices.

The crux of the Affordable Care Act (the "ACA"), the most significant legislation impacting the U.S. healthcare system since the passage of Medicare and Medicaid in 1965, is expected to go into effect in January 2014.

The ACA is expected to increase the number of people with health insurance coverage by 11 million people in 2014 and by 27 million people in 2022. The ACA expands health insurance coverage through three provisions:

- The expansion of Medicaid to cover the poorest Americans.
- The creation of health insurance exchanges with subsidies provided for low-to-middle income families who lack employer-sponsored insurance or do not qualify for Medicaid.
- A mandate for the uninsured to obtain coverage.

The Supreme Court ruling on the ACA allowed states to opt out of the law's Medicaid expansion. As of September 17th, 29 states are moving toward participating in Medicaid expansion, while other states are either considering participating through alternative expansion models, leaning against participating or not participating. We think over time, more states will participate in Medicaid expansion. Enrollment in health insurance exchanges began October 1, 2013, with coverage beginning in January 2014. Also effective January 1, 2014, insurers will be prohibited from discriminating against or charging higher rates for any individual based on gender or pre-existing medical conditions.

The increase in insurance coverage is expected to drive greater demand for healthcare products and services.

Growth in national healthcare spending is expected to reaccelerate to 6.1% in 2014, 1.6 percentage points faster than would be expected in the absence of the ACA. While expectations for the pace of insurance coverage expansion have moderated over the past year, and the full extent of the expected benefits



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to healthcare providers could be delayed, we believe that the ACA represents a tailwind for healthcare providers over the next several years and presents significant opportunities for some of the companies in which we are invested.

Several large employers have recently announced significant changes related to their employer-sponsored health benefits. We think these announcements are unlikely to impact companies in which we are invested, and we are actively evaluating investment opportunities related to these developments.

We seek companies that can benefit directly from change in healthcare and that can reduce costs and enhance efficiency while improving patient outcomes. We invest in companies that we believe have open-ended growth opportunities, attractive revenue models, competitive advantages, and talented management teams.

We think hospitals will benefit from increased patient volumes and lower bad debt expense under the ACA. Our investments include Community Health Systems, Inc., one of the nation's largest publicly traded hospital companies and a leading operator of general acute care facilities in non-urban and mid-sized markets; and Universal Health Services, Inc., a leading operator of acute care hospitals and freestanding behavioral health inpatient facilities in the U.S. We believe these companies are also likely to benefit from the consolidation trend among healthcare providers, driven by continued reimbursement pressures, higher regulatory requirements and the need for more sophisticated IT systems to manage population health. We expect the pace of hospital consolidation will intensify as they seek to bulk up to gain better leverage with payors and extract greater cost savings from vendors while spreading clinical efficiencies and best practices over broader platforms.

Healthcare exchanges, whether run by individual states, the federal government or in partnerships, will require consumer outreach, eligibility, enrollment services and call centers, among other services, which in many cases will be outsourced to commercial providers. We are participating in the expansion of Medicaid and health insurance exchanges through our investment in MAXIMUS, Inc.,

which is the leading enrollment broker for government health plans and outsourced administrator of social welfare programs in the U.S. and internationally.

By 2030, one in five Americans will be over age 65, compared with only one in eight today. We believe many of our investments will benefit from additional healthcare services required by an older population. We highlight our investments in Brookdale Senior Living, Inc., the largest operator of senior living communities offering its residents a full continuum of services, including independent and assisted living and skilled nursing; and Emeritus Corp. a national provider of assisted living, Alzheimer's, and related dementia care services. Both have significant embedded organic growth through improved rates and occupancy over the next several years, driven by favorable demographics with tightening supply on low senior housing unit starts. With 1.9 million total units, serving a current population of 12 million seniors, the \$70 billion industry's penetration rate is only about 15% and estimated to grow by approximately 35% through 2015. The industry is highly fragmented, with the top 10 providers controlling only about 35% of the U.S.'s senior housing units; both companies have demonstrated an ability to improve operations and generate attractive returns at acquired properties. We believe both companies are trading below the net asset value of their owned assets.

An aging population and a greater number of insured will also increase demand for physician services. We are investors in IPC, the Hospitalist Co., Inc., the nation's largest dedicated hospitalist company, and an industry consolidator with over 1,200 healthcare professionals providing hospitalist services at about 1,000 hospitals and post-acute facilities in the U.S. IPC is the market leader in the highly fragmented and underpenetrated hospitalist sector, but has only a 3% share of the U.S.'s fastest growing medical subspecialty. The company is well aligned with healthcare reform, as hospitalists provide higher quality care and better patient outcomes at lower cost. IPC's expanding sub-acute presence enhances its potential for a meaningful role under bundled reimbursement or in Accountable Care

Organizations.

We think companies that help people manage diabetes will benefit from an increase in the prevalence of diabetes. Diabetes affects an estimated 25.8 million people in the U.S., 8.3% of the U.S. population, up from less than 1% in 1958. The total estimated cost of diagnosed diabetes is \$245 billion. If current trends continue, the number of Americans with diabetes will exceed 20% by 2050. We have investments in two companies, Insulet Corp. and DexCom, Inc., which sell medical devices for insulin-dependent diabetics. Insulet sells a unique tubeless insulin pump which delivers a constant stream of insulin and helps insulin-dependent diabetics maintain better blood glucose control than multiple daily injections. DexCom sells a unique continuous glucose monitoring device which helps insulin-dependent diabetics monitor their blood glucose levels in real-time and avoid life-threatening and costly hypoglycemic events. Both DexCom and Insulet help insulin-dependent diabetics keep their blood glucose levels as close to normal as possible, which lowers the risk of long-term complications. In doing so, DexCom and Insulet are helping to reduce overall healthcare costs.

We have investments in companies that sell innovative products that make surgery less invasive and shorten hospital stays. For example, Edwards Lifesciences Corp. is the market leader in transcatheter aortic valve replacement, a new procedure in which a heart valve is inserted through a catheter and implanted within the diseased aortic valve. The procedure is significantly less invasive than surgical aortic valve replacements, which require open heart surgery, a procedure in which the surgeon cuts through the breastbone, stops the heart, removes the valve, and replaces it. Transcatheter valve replacement is a shorter procedure and the patient recovers much faster than with surgery and leaves the hospital sooner. We think over time, transcatheter valve replacement will become the dominant form of therapy for aortic valve disease and Edwards will benefit. Edwards is also working on transcatheter mitral valve technology, which, if successful, could expand the size of the company's market opportunity.

Another exciting area of healthcare, is the field of genetic analysis. We have an investment in Illumina, Inc., the recognized leader in next-generation DNA sequencing, a fast growing market with enormous potential. Until recently, DNA sequencing has been used primarily for research purposes. In the research market, Illumina's technology is the gold standard with roughly 90% of the world's sequencing output produced on Illumina's instruments. Due to rapid advances in technology, the cost of sequencing a whole human genome has declined from \$1 billion, when the Human Genome Project began 23 years ago, to a few thousand dollars per human genome today. The result is that new applications for DNA sequencing are emerging in cancer diagnosis and treatment, as well as reproductive health. It is becoming common medical practice for a physician treating a cancer patient to have the patient's cancer tumor sequenced and then to prescribe drugs that target mutations specific to the patient's cancer. In reproductive health, several companies (including one that Illumina recently acquired) have developed simple blood tests that can identify chromosomal abnormalities early during pregnancy. These tests use Illumina's DNA sequencing technology. In the future, it may become common practice to sequence infants at birth and to use their genetic profile to manage their health throughout their lifetime.

Molecular diagnostics is also an exciting space, as proper medical testing can lead to better medical care and costs relatively little. According to the Mayo Clinic, an estimated 60% to 70% of all decisions regarding a patient's diagnosis and treatment, hospital admission, and discharge are based on laboratory test results. Our investments in the diagnostics space include Cepheid, which manufactures molecular diagnostics equipment and related assays, and Masimo Corporation, which provides ultra-accurate patient monitoring for vital signs, blood loss and other parameters. We believe Cepheid is well positioned to help hospitals bring testing closer to the patient by enabling them to set up profitable, in-facility labs with fast, accurate and easy to use equipment. Masimo is poised for significant growth now that the two largest manufacturers of

pulse-oximetry equipment are nearly ready to launch products that contain Masimo's unique Rainbow parameters, which can help hospitals dramatically reduce the volume of costly and potentially dangerous blood transfusions used during surgeries.

In an environment where healthcare payors and consumers are focused on cost reduction, we look for companies that will benefit from the shift towards low cost, generic prescription drugs and store brand over-the-counter (OTC) drugs. For example, we have an investment in Perrigo, Co., the leading manufacturer of store-brand OTC drugs. Store-brand OTC drugs are gaining market, because they generate higher gross profit dollars for retailers and significant savings for consumers. Perrigo estimates its business model saves consumers roughly \$1.5 billion annually in their healthcare spending. Perrigo holds a dominant position in the store-brand OTC market and benefits from low cost manufacturing. The company also has unique logistics capabilities and expertise in customer service and consumer marketing. We think the company will benefit from new product introductions as more prescription-only products move to OTC status. We also think the company has an opportunity to expand into adjacent categories and geographically.

We have investments in companies with exposure to fast growing emerging markets. China is making significant investments in life sciences research and infrastructure. We think Mettler-Toledo International, Inc., which generates roughly one-third of company sales from emerging markets and 18% of sales from China, will benefit from this trend. We expect CFR Pharmaceuticals SA, a Latin American branded generics pharmaceutical company, to benefit from rising GDP, an aging population, improved life expectancy and the growth of the middle-class in Latin America.

We have investments in companies that provide products and services to biotech and pharma companies. We think Pall Corp. and West Pharmaceutical Services, Inc., which sell products used in biotech drug manufacturing (in the case of Pall) and injectable drug packaging (in the case of West), will benefit from growth in biologics. We also like Covance, Inc., Quintiles

Transnational Holdings, Inc. and ICON plc, leading contract research organizations (CROs) that provide outsourced drug development services to pharmaceutical and biotech companies. CRO fundamentals are improving as the pharmaceutical industry moves beyond patent cliffs; R & D spending is expected to accelerate from 3% in 2012 to 8% in 2015. Biotech funding is up, and FDA new drug approvals hit a 15-year high in 2012, all of which should drive the need for CRO services. We also believe the outsourcing theme

The Baron healthcare team is focused on identifying businesses that solve problems in healthcare, whether by reducing costs, enhancing efficiency or improving patient outcomes.

We believe the rapidly evolving healthcare landscape currently offers many exciting investment opportunities.

has plenty of runway driven by biopharma's need for a lower, more variable cost structure and inherent lack of biotech infrastructure. As R & D budgets tighten and clinical trials become increasingly more complex and globalized, biopharmaceutical companies are recognizing that drug development is not a core competency and are increasing their use of outsourcing with the largest CROs, often in the form of strategic relationships, gaining share from smaller and niche providers.

Healthcare IT is another attractive investment area within healthcare. In 2009 as part of the economic stimulus, the U.S. passed legislation designed to increase adoption of electronic medical record technology to improve healthcare quality and lower healthcare costs. The ACA also encourages healthcare providers to form Accountable Care Organizations in which providers agree to be accountable for the quality, cost and overall care of a population. We think the trend towards greater care coordination and the shift towards risk-based payment models will drive healthcare providers to invest more in population health and other data and analytics tools, which should benefit Cerner Corp. and The Advisory Board Company.

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* % of Long Positions.

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