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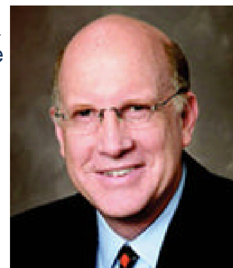
Will Medtech Remain a Safe Port in the Current Financial Storm?

Medtech has generally benefited from the widely held perception that the industry is relatively recession resistant. In times of previous economic downturn, investors have often fled to the safety of the medtech sector with the realization that as people grow older, get sick, and have accidents, they continue to seek medical care and continue to generate demand for medical devices, supplies, and equipment—regardless of the current state of the economy.

But can the current financial morass be considered part of the normal business cycle, or are we dealing with more profound and structural changes to the underlying economy that will affect all industries—including medtech?



Gunderson: Living with pain.

Thomas Gunderson, managing director and senior medtech analyst with Piper Jaffray & Co. (Minneapolis), says that large-cap firms with strong balance sheets will obviously be in a better position to ride out the storm. "Yet, while we have typically cited the nondiscretionary aspects of spending in the healthcare sector, that was already being challenged to some degree in recent months . . . and we're likely to see further erosion depending upon the length and depth of the current upheaval." Gunderson notes that elective procedures such as Lasik eye surgery and cosmetic procedures took an early and expected hit, but he wonders how far the category of so-called elective medical care will expand as a function of deepening economic woes.

"Some of my analyst colleagues are hearing from orthopedic surgeons who are reporting fewer requests for procedures," says Gunderson. "They thought they would see a pick-up, but it's not happening. Some of the major pharmaceutical retailers are noting a decline in prescription refills.

"It all comes down to a question of what can be deferred. And with patients experiencing higher copays and deductibles, that may be an expanding category, as the confluence of greater out-of-pocket costs and a sour economy take their toll.

"Maybe you've had chronic pain for some time. Given the current economic environment, you may have to decide to buck up and live with for another year or so," Gunderson adds.

From an investment perspective, Gunderson says to look to those medtech companies that manufacture products related to medical care that cannot be deferred, such as routine emergency room visits, trauma care, heart failure, cancer, aneurisms, and many others.

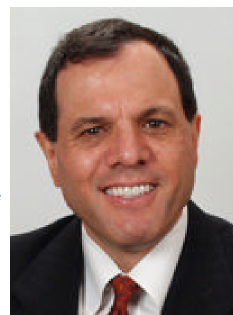
Simpson: A large-cap oportunity.

Gregory Simpson, principal and medtech analyst with Stifel, Nicolaus & Co., Inc. (St. Louis), notes that medtech enjoys an "obvious safe-haven element" and has been holding up well over the past few months. Simpson sees a potential opportunity for large-cap companies that are much better positioned to deal with the disruptions in the credit markets, but says the current environment will be a little trickier for small- and mid-cap companies.

"For those companies—especially emerging companies with a near-term need for capital—the current situation in the credit markets can be a significant issue and a huge obstacle," says Simpson. "The interesting thing to watch will be how long the current situation persists, and whether the large-cap, well-funded companies move to take advantage of this situation by buying or providing capital to these emerging companies. These large-cap companies have been lacking in aggressiveness in recent years, but the current environment could provide them with a golden opportunity."

Richard S. Cohen, president of the Walden Group Inc. (Tarrytown, NY), a strategic healthcare investment banking and private capital firm, says the demand for healthcare is largely nondiscretionary. Apart from slowing demand in discretionary procedures, there will be continuing need for medical technologies that effectively diagnose and treat medical problems.

However, Cohen cautions about "the broad economic dislocations and widening budget deficits that can be expected to restrain government reimbursement—and, by


Cohen: Pricing pressures.

extension, private insurance and managed-care coverage. Budget constraints cannot choke off care, but medtech companies should prepare for pricing pressures by continuing to reduce costs of production by improving efficiencies, increasing automation, improving their supply chains, and carefully monitoring expenses."

"The unrelenting need and demand for healthcare by a growing population of aging adults, their desire to remain more active later in life, and increased sensitivity to care in emerging markets, can be expected to support the medtech industry for the foreseeable future," says Cohen. "Yet, the current crisis will cause companies to sharpen their strategies and lead undercapitalized ones to fail. All this puts a premium on innovation, product quality, efficient production, and above all skillful management."

Cohen sees innovation and product differentiators as not only driving company growth and beating the competition, but also as a means of justifying higher-paying reimbursement codes. He also sees geographic diversification as an additional strength. "Companies that have developed market presences in emerging countries will benefit from low-cost sourcing and new customer markets as these areas develop—a strategy that can help to balance out currency fluctuations and issues that affect particular regions."

Rick Wise, medical technology analyst with the New York office of Leerink Swann LLC (Boston), says, " Healthcare is traditionally viewed as a safe haven for equity investors. However, we think it's essential to be selective during these volatile times. Companies which require acquisitions and/or external funding to grow may lag companies with stronger finances."

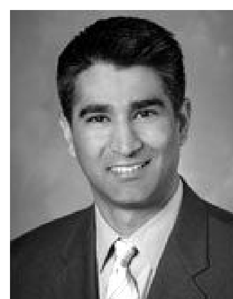
Wise says medtech balance sheets are generally in good shape. " Debt levels for most companies in our universe are relatively modest. Most of the companies have plenty of capacity remaining on credit lines."

"Overall, we believe investors may continue to gravitate toward medtech stocks given the recent turmoil in the financial sector and turbulent economic cross-currents." Wise notes that considering the group's solid year-to-date performance relative other benchmarks (+5.4% versus – 18.8% for the S&P 500, for instance), "a 'flight-to-defensive' investor mindset could well prolong this outperformance."

Rajan: Aversion to risk.

Venkat Rajan, a research analyst at Frost & Sullivan (San Antonio, TX), specializing in the medtech sector, sees the current financial crisis as adversely affecting smaller, emerging companies with innovative technologies. "It wasn't that long ago that an emerging medtech company could present a groundbreaking product and investors would clamor on board. Not now. There's a real aversion to risk out there and a resulting tough investment climate."

Rajan says that venture capitalists are increasingly asking serious and sobering questions. "They want to know about your FDA approval strategy and how you plan to get a reimbursement code. Questions about training increasingly come into play as investors know that hospitals are reluctant to bring on new devices or equipment that will require additional physician and staff training and drive up their operational costs. Similarly, devices and technologies that are seen as reducing costs—such as home healthcare products—are likely to get a better reception."


Denhoy: Strategic buyers.

Raj Denhoy, director of equity research for medtech at Thomas Weisel Partners Group Inc. (San Francisco), says, "No one is sure how this will play out as the current financial situation is very different from what we've seen in the past. Healthcare spending has remained largely nonelective since payments generally did not come directly from patients. However, with steadily increasing out-of-pocket patient costs—even for those with good insurance—what is considered to be elective or discretionary healthcare spending may be an expanding category, which would adversely affect sales of certain medtech devices and equipment going forward."

Like other industry analysts, Denhoy says that large-cap medtech companies are generally in a better position to weather the storm. "But if credit really slows, it could crimp business, regardless of the size of the company. Small, emerging medtech firms with new technologies will find the public markets essentially closed—and they won't be alone, as just about every sector will be similarly affected."

Denhoy sees large, diversified hospital supply companies as likely to suffer the least. Firms with products tied to one sector could be hit the hardest, as they attempt to weather the storm with very little maneuverability.

While Denhoy says there's little appetite for risk right now, current market conditions could present an opportunity for companies with strong balance sheets to expand by acquiring companies that complement their existing product line. As an example, he noted that Medtronic Inc. (Minneapolis) announced plans earlier this month to acquire CryoCath Technologies Inc. (Montreal), a manufacturer of products to treat cardiac arrhythmias, for $380 million.

"In spite of the current climate, strategic buyers are still out there," says Denhoy.

Industry analysts continue to assert medtech's position as a safe port in the storm. But if the storm becomes a tsunami, all bets may be off.

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