With the passage of the Health Care Reform bill, we thought that some of our clients and friends would like to understand the legislation a little better, and gain some insight into how various health care businesses might be affected by the new legislation.

Here is an extract from one of the research reports we receive from Standard & Poors.

HEALTH CARE REFORM PASSES, NOW THE PROCESS BEGINS

On Sunday night, the House of Representatives passed the Senate's version of health care reform along with a separate bill of amendments known as the reconciliation bill. The House passage makes health care reform a reality after a year's worth of contentious debates. President Obama will sign the bill into law today. The reconciliation bill now goes to the Senate for another vote. Although Senate Republicans can employ various delaying tactics and challenge the reconciliation bill (even potentially sending the bill back to the House for another vote), Standard & Poor's Equity Research thinks such an action would just delay the inevitable, as the Democrats likely have enough votes to pass the reconciliation bill.

If the reconciliation bill passes as currently structured, what does this all mean for health care investors? What are the key elements and when should investors expect the impact? Well, the most immediate impact we see is that the uncertainty created by the reform legislation is now gone. Investors can now focus on the potential impact of reform on various industries within the health care sector. S&P Equity Research believes, with the overhang of reform lifted, investors will return to concentrate on fundamentals.

Certain elements of the bill will become effective within six months of passage, including barring insurance companies from denying coverage to children with pre-existing conditions; prohibiting the cancellation of policies of people who get sick; permitting children to stay on their parent's insurance policies until their 26th birthday; and payment of a $250 rebate to seniors reaching the Medicare coverage gap (the donut hole). However, most of the more sweeping features of the legislation with far greater impact on the sector do not become effective until 2014. These include the establishment of subsidies for the currently uninsured to purchase insurance; state health insurance exchanges where individuals and small businesses can buy insurance; and the mandate that individuals lacking insurance purchase it or face a penalty.

So, which industries will see the greatest impact?

Managed Care

S&P Equity Research views long-term prospects of the health reform package as positive for the managed health care industry, on balance.

There are, however, some negatives we see. Managed care organizations (MCOs) will face restrictions that can pressure margins, including the ban on revoking coverage, a ban on lifetime caps on coverage, an end to denying coverage to people with pre-existing conditions, and being required to spend a minimum level of benefit costs as a percentage of premiums received. Also, Medicare Advantage (MA) plans will be receiving sharply lower premium rate increases to bring them on par with traditional Medicare Fee-for-Service. Lastly, the managed care group, as a whole, will pay fees of $67 billion, starting in 2014, to the federal government to help finance health care reform.

On the plus side, in our view, the bill could increase the coverage of an additional 32 million previously uninsured Americans. S&P Equity Research thinks the MCOs will benefit from better economies of scale

and improved negotiating clout with providers. We expect MCOs with Medicaid health plans to gain members from the expansion of Medicaid eligibility requirements. While we believe MCOs with MA plans will match the pending reduction in rate increases by offering fewer add-on benefits, we do not expect benefit cuts to be enough to encourage a significant number of members to leave and believe many may still see meaningful enrollment gains from the aging baby-boomer population. MCOs can also receive risk adjustment payments for caring for sicker populations.

S&P Equity Research also believes many MCOs will be able to more closely meet the minimum benefit expenditure requirements by transforming medical-related general & administrative (G&A) expenses (such as those for wellness programs, disease management, etc.) to benefit expenses, as WellPoint recently did, thereby reducing the level of potential operating margin pressure we previously envisioned. We note the fees MCOs must pay will start in 2014, not immediately, and think these fees will be outweighed by the improved G&A cost leverage we see and incentives to further control G&A spending. Finally, we believe MCOs that are better able to manage under health reform may well benefit by acquiring less successful ones, thus further building membership and negotiating clout.

BWFA does not currently have any MCO companies on our "Buy" list.

Pharmaceuticals-Branded Drugs

The new health care reform legislation is likely to have little effect on major pharma players, in the view of S&P Equity Research, with a projected 2%-3% increase in revenues stemming from extending health insurance coverage to 32 million presently uninsured Americans roughly offsetting the already-agreed-to Medicare Part D price discounts, higher Medicaid rebates, and new fees. The new bill also left out a ban on payments by branded drugmakers to generic firms to delay the launch of generics. However, S&P Equity Research thinks that proposal, which was included in President Obama's late February plan, may possibly be resurrected as standalone legislation at some future point, given strong Federal Trade Commission support for that issue.

The health bill also calls for closing of the present gap in coverage under the Medicare Part D prescription drug benefit, often referred to as the "donut hole," by 2020. The donut hole comprises expenditures made by seniors between $2,830 and $4,550 (in 2010). The bill plans to accomplish this through the drug industry's concession to reduce prices on brand-name drugs purchased in the doughnut hole by 50%, amounting to a savings of some $20 billion over the next ten years.

The drug industry also agreed to an increase in the Medicaid rebate - paid by drug manufacturers to state Medicaid funds for drugs purchased -- to 23%, from 15%, and other concessions totaling an estimated $38 billion over ten years, according to the Congressional Budget Office (CBO). Additional fees based on pharmaceutical sales used in other government health programs are expected to add another $28 billion, bringing big pharma health care reform bill fees to about $85 billion over the next 10 years.

S&P Equity Research believes the new legislation will have an initial modest 2%-3% negative impact on industry sales and profits, as the price discounting takes effect before new health insurance and drug prescribing patterns are completely phased in. However, over the long-term, S&P Equity Research expects health care reform to be neutral or modestly positive to the industry's top and bottom lines. We believe drug makers are also likely to offset the new fee through price increases.

Our view reflects that a number of industry-opposed initiatives contained within earlier versions of health care reform were notably absent. These included a mandate for the government to engage in direct negotiations with drug manufacturers on Medicare drug pricing; a proposal to extend Medicaid rebates to the much larger Medicare Part D program; and re-importation of cheaper versions of branded drugs from foreign countries.

BWFA currently holds the following investments in the Branded Drugs category: Bristrol Myers Squibb (BMY), Johnson & Johnson (JNJ), and Bayer AG (BAYRY).

Generic Drug Manufacturers

S&P Equity Research also views the new health care reform bill as a net positive for generics manufacturers. Representing the first choice in drug therapy, inexpensive generics should be prime beneficiaries of new pharmaceutical business resulting from the extension of new health coverage for the 32 million presently uninsured. Wider pharmaceutical usage should also result from the planned closing of the donut hole.

However, the generic industry got less than what it expected in biogenerics. The new health reform legislation grants branded producers 12 years of marketing exclusivity, as compared to the five years generic drugmakers had hoped for. However, S&P Equity Research still sees biogenerics, often referred to as biosimilars, as a potentially very lucrative opportunity for major generic firms who have strong capabilities in this developing industry.

BWFA currently holds Mylan, Inc. (MYL) in the generic drug category.

Biotechnology

S&P Equity Research views the health care reform legislation as positive for the biotech industry. A key feature of the legislation as it pertains to the biotech industry is the inclusion of a provision to create a regulatory pathway for the approval of biogeneric drugs. As noted above, we view the 12 years of market exclusivity granted to branded drugmakers before biogenerics as a victory for the biotech industry, given attempts by the White House to reduce the exclusivity period. Nevertheless, we continue to expect biotech drugmakers to retain a sizable market share upon the entry of biogenerics, as we see required clinical testing and manufacturing considerations limiting the number of market entrants.

The increase in insured patients should also be viewed as a positive for biotech companies, according to S&P Equity Research, since many biotech companies have seen profits limited by their establishment of patient access programs for the uninsured and those who could not afford treatments. Over the long-term, S&P Equity Research expects drug pricing to come under increased regulatory pressure, particularly for those treatments that provide marginal benefit. However, we see the increase in patients with health coverage under the new legislation offsetting such pricing limits.

BWFA currently holds Amgen (AMGN) and Cephelon (CEPH) in the biotechnology category.

Medical Devices

S&P Equity Research sees health care reform as being neutral for medical device stocks. The scaling back of the so-called medical device tax, which seeks to raise a total of $20 billion compared with $40 billion as originally proposed, when combined with the delay in implementation to 2013, should help the industry to align its cost structure to partially offset the impact of the planned tax, in our view. In addition, while all medical device companies will bear additional expense to fund the tax, given that it is now designed as an excise tax of 2.3% of sales per year, as opposed to a fee, the cost of the tax will now be deductible by the device companies for income tax purposes, thereby lowering the after-tax impact and overall effect. S&P Equity Research continues to view the impact as manageable and expects the industry to offset any increased costs with gains from coverage of an additional 32 million previously uninsured individuals, and cost optimization activities. We also continue to see the impact being greatest on the emerging device companies, as they likely have the least flexibility to afford a tax based on revenues.

BWFA currently holds Stryker (SYK), St. Jude Medical (STJ), and Johnson & Johnson (JNJ) in the medical devices category.

Acute Care Hospitals

While S&P Equity Research believes the passage of health care reform will be positive for hospitals in the longer term as coverage is expanded to many of the currently uninsured, we continue to believe that in the near term, health care facilities will face cost pressures given the $155 billion in industry reimbursement concessions over 10 years. Our view reflects that the majority of the estimated 32 million uninsured who will gain coverage will not obtain benefits until approximately 2014, but cutbacks in the rate of Medicare reimbursement will begin almost immediately. In addition, given the potential for cost overruns and the already spiraling costs of health care as a proportion of the federal budget, we believe there is the potential that industries which depend most heavily on government reimbursement, such as health care facilities, could see further rate cuts down the road as the costs of implementing reform become clearer. Although health care reform has shifted investor psychology on the group, near term we believe that challenging fundamentals from weak admissions and rising bad debt will prevail. In addition, most facilities have been able to offset weak admissions and rising bad debt via strict expense controls including a number of one-time items (eliminating 401K contributions, salary increases and merit raises, etc) and thus see operating expense leverage as limited. Lastly, while bad debt is likely to be lessened by coverage of a majority of the uninsured, we see the potential that bad debt experience for those remaining uninsured after health care reform could be worse than expected.

BWFA does not hold any investments in the hospitals group, but we do own a small software company, Eclipsys (ECLP), which hospitals and healthcare providers purchase to run their businesses.

Distributors and Prescription Benefit Managers

S&P Equity Research sees drug distributors and pharmacy benefit managers (PBMs) clearly benefiting from the expected addition of 32 million previously uninsured Americans. In addition, provisions, which start in 2010, to close the Medicare prescription coverage gap (the donut hole) should also help yield higher volumes of drugs handled by both the distributors and PBMs. We also expect the newly insured and seniors to prefer generic drugs owing to lower out-of-pocket costs required to purchase such drugs, compared to branded drugs, a trend that should benefit the margins of both industries.

BWFA recently added Express Scripts (ESRX) in the PBM area, and has owned Express Scripts previously.

Clinical Laboratories

Clinical Laboratories and related diagnostic tests manufacturers should also be a beneficiary of the large influx of the newly insured, according to S&P Equity Research. In spite of the expected decline in Medicare and Medicaid reimbursement rates, we believe the significant volume increase will more than offset lower rates.

One last thought: S&P Equity Research thinks one aspect of reform that has not received sufficient attention is the potential strain on health care facilities, doctors, and other medical professionals. With an estimated additional 32 million people gaining coverage, how could the current system of doctors and facilities handle the tremendous influx? We believe this issue will be particularly acute in terms of primary care doctors, where there is already a shortage. Under the new system, it is primary care doctors who will largely handle initial diagnosis and treatment. While some of the system overflow may be handled by physician's assistants and licensed practicing nurses doing patient intake, the wait times to see a doctor or receive procedures like non-emergency surgery will surely increase, in our view. Although the health care reform bill provides additional funding for medical education and training, S&P Equity Research sees the amount of funding as insufficient. We also expect it will be some time before any new practitioners

come to the market. On the positive side, in order to help ensure that there are a sufficient number of doctors willing to care for the large influx of new Medicaid patients, where rates have traditionally have been about 20% lower than those paid by Medicare, reimbursement rates will rise to the level of Medicare rates in 2013 and 2014. As a result, the available pool of physicians willing to treat these newly insured patients is likely to increase, in the view of S&P Equity Research, helping to reduce some of this strain on the system. Nevertheless, we do see this as on ongoing issue for both the government and the medical profession going forward.

BWFA currently owns Laboratory Corp (LH) in the Lab and testing area.

Research report prepared by -JEFFREY LOO, JEFFREY ENGLANDER, HERMAN SAFTLAS, PHILLIP SELIGMAN, and STEVEN SILVER, S&P Equity Analysts