Simplifying the Small-Cap Healthcare Maze

Seeking "Healthy" Returns

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Introduction

Everyone routinely experiences health care through dental, medical, or mental health care services, thus classifying this as an extremely relatable industry. However, investing in the healthcare sector can be considered complex as it requires understanding numerous revenue sources and accounting nuances. For example, in many cases, the consumer receiving health services is not actually paying the invoice or bill.

Screening for Opportunities in the Small-Cap Healthcare Universe

There are approximately 482 U.S.-domiciled healthcare companies that are publicly traded and have equity market capitalizations between $100 million and $2.5 billion.[i] Within this group, only 38 companies fit North Star's screening parameters for attractively valued micro-cap stocks, and just 1 company populates when screening for attractively valued small-cap dividend paying stocks (as of 06/30/2022). The quantitative screen North Star uses for its micro-cap value strategy is market capitalizations below $1 billion and price-to-earnings ratios less than 12. North Star's small-cap dividend strategy screens for companies with market capitalizations below $2.5 billion, price-to-earnings ratios less than 20, and dividend yields above 3%. In general, healthcare company dividend yields tend to lag yields in other sectors because there is a conflict if companies that receive significant payments from federal and state governments then enrich shareholders with profits from those government sources.

The Healthcare universe of small-cap stocks is commonly divided into two buckets: (1) Healthcare Services and (2) Life Sciences.

The small-cap Healthcare Services universe consists of companies providing health care to patients through inpatient hospital management and residential senior living management companies, as well as outpatient specialty providers such as laboratories, diagnostic centers offering magnetic resonance imaging (MRI) and computed tomography (CT) scan services, therapy treatment centers for diseases such as cancer and diabetes, and business management companies that market to physicians.

Small-cap Life Sciences companies make up much of the universe with 436 equities populating when searching for healthcare names that have market capitalizations between $100 million and $2.5 billion (as of 06/30/2022).[i] As the subsector name suggests, these are science-backed businesses that develop products for diagnosing and treating various conditions. These include medical equipment companies, such as diagnostic and therapeutic equipment, consumable healthcare products, and biology-based medicines in the pharmaceutical and biotechnology fields. Within this group value-oriented opportunities tend to be rare because micro-cap and small-cap Life Sciences companies typically have highly speculative valuations that often rely on positive clinical trial outcomes rather than steady earnings and cash flows.

Cumulative and Annualized Returns as of 06/30/2022

	1H 2022	1 Year	5 Year	10 Year
Russell 2000 Healthcare (RGUSHS)	-31.00%	-44.80%	11.54%	141.13%
S&P 500 Healthcare (S5HLTH)	-8.33%	3.37%	77.47%	303.55%
Russell 2000 Index (RTY)	-23.45%	-25.24%	28.47%	144.15%
S&P 500 Index (SPX)	-19.97%	-10.64%	70.74%	237.74%

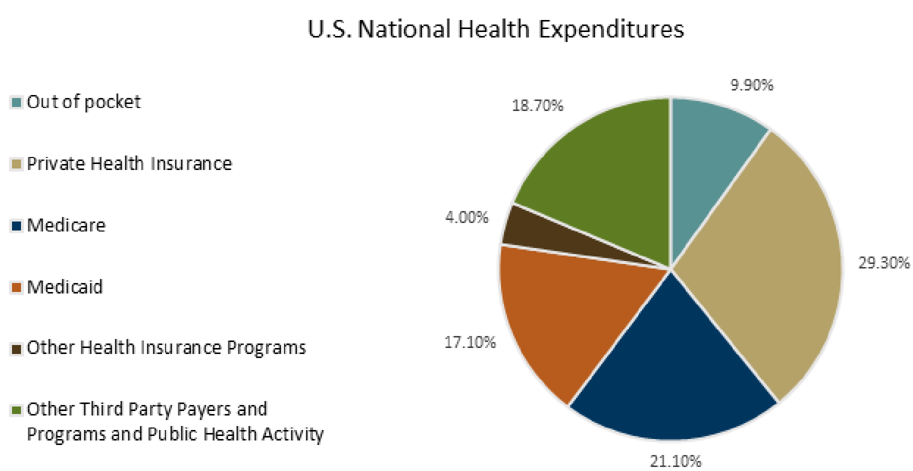
Source: Bloomberg LP | Investors cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses, or sales charges.

Whereas over the last decade the small-cap healthcare sector has performed in line with the Russell 2000 Index, the most recent five years (2017-2022) it has underperformed after outperforming the previous five years (2012-2017); however, during both periods, the small-cap healthcare sector had dramatically underperformed large-cap peers. Furthermore, according to the above chart, the healthcare indices have had a very low correlation to broader indices. This is likely due to the event-driven nature of companies in the Life Sciences sub-industry where stock price performance is typically volatile around events such as clinical trials and product approvals by regulatory agencies; such events – whether positive or negative for the earnings outlook of these Life Sciences companies – result in stock price movements that may not be necessarily correlated to the broader market.

Key Drivers Vary

The key factors to successful investments in the Healthcare Services subsector can be quite different from the Life Sciences subsector. Healthcare Services is mostly a domestic U.S., slow growth area likely expanding in units with general population growth (around 1%-2% annually).[ii] However, companies serving this market frequently grow at 2.0-3.0 times the underlying population growth rates because of market share gains through organic sales growth and/or acquisition growth.[iii]

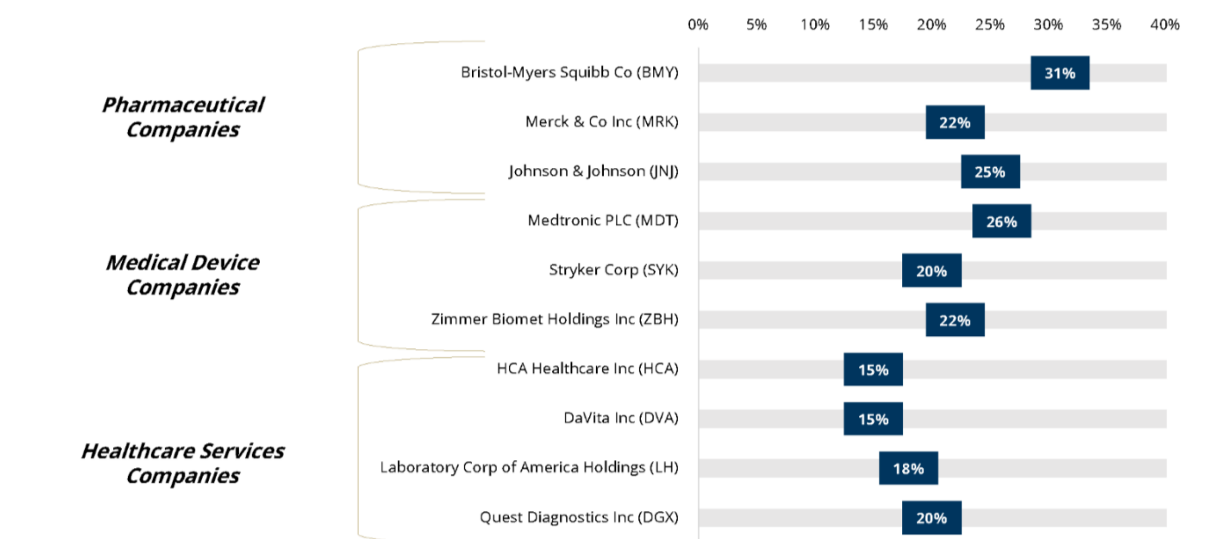
Modifications to reimbursement pattern or process is another possible catalyst for earnings growth that has been a highly predictable source of Healthcare Services investment returns. The United States healthcare economy is approximately 20% of annual Gross Domestic Product (GDP), or approximately $4 trillion annually. As can be seen in the chart below, the two large government payor systems of Medicare and Medicaid account for 38.2% of all payments made in the U.S.A. Thus, when a government agency, such as the Veteran's Administration or Medicare, changes reimbursement systems and levels, there is a significant impact on business prospects for relevant providers.



Source: Centers for Medicare and Medicaid Services

In contrast to Healthcare Services, the Life Sciences subsector is much more global, and in some ways more competitive. Thus, this subsector is viewed as much simpler to dissect. The key drivers in Life Sciences are innovation and efficiency. Healthcare innovation demands clear superiority of products because the risk of recommending or using a new diagnostic or treatment technique is too great. Given the need for clearly superior innovation, the research and development (R&D) stakes are much higher than those of Healthcare Services, as are the potential returns. While mature Healthcare Services businesses tend to generate mid- to high-teens operating margins, mature Life Sciences companies, in many instances, generate operating margins well above 20%.

Comparison of Healthcare Sub-Sector Operating Margins (2019-2021)[iv]



Healthcare Services

This opportunity set can be analyzed as two primary sub-sectors: (1) inpatient facility operators; and (2) specialty providers of outpatient services, logistics and technology. Inpatient facility operators include hospital management companies, inpatient rehabilitation companies, and senior housing companies, as well as staffing and services companies that serve these verticals. Specialty outpatient services businesses include outpatient surgery center operators, dialysis center operators and similar specialized care providers. While some healthcare services analysis includes real estate investment trusts (REITs) and healthcare information technology companies, those companies are valued more like REITs than like healthcare providers.

One of the best indicators of the earnings outlook for Healthcare Services companies is the trend and outlook for reimbursement payment levels in the relevant verticals. Cost-plus payment processes have generally led to low-profitability and oversupply in some verticals such as home nursing; however, over a decade ago, when home nursing reimbursement from Medicare adjusted to case rates per diagnosis, profitability improved significantly. A similar change from per-treatment reimbursement to per-diagnosis reimbursement is scheduled in radiation oncology Medicare payments for January 2023 and may create investment opportunities. In contrast, there are many examples of earnings disruptions due to unfavorable reimbursement dynamics as has occurred in the hospice vertical[v], the inpatient rehabilitation vertical[vi], and the home oxygen services vertical.[vii] It is critical to avoid investments where unfavorable reimbursement changes are likely; ultimately, we believe such negative changes may drive industry consolidation, but earnings visibility is greatly reduced in the near-term.

Considering the major dependence on reimbursement stability and visibility, interesting opportunities may be more likely exist in less capital intense Healthcare Services verticals. Highly capital intense verticals, such as hospitals and nursing homes, require may major facility improvements and ongoing maintenance. Such investments are made over several quarters or even years. Overall, disruptive reimbursement revenue changes can be devastating to earnings visibility due to high fixed costs.

Life Sciences

The Medical Technology vertical can be seen as fertile ground for value opportunities. This vertical has fairly regular waves of innovation that improve patient outcomes. These product cycles drive down the share prices of the legacy MedTech companies and can drive temporary attractive valuations. In general, when medical technology companies with strong product prospects get valued near 1.0x enterprise value to sales (EV/Sales), attractive entry points can emerge. These discounted stocks rarely remain so because of the significant opportunities for cost savings in mergers between medical technology companies, including manufacturing efficiency improvements and sales force synergies.

In contrast to the small-cap Medical Technology vertical, where fundamental value opportunities can often arise, the Pharmaceutical and Biotechnology verticals may be difficult subsectors for small-cap value Investors. These enterprises can be unprofitable and capital-consuming in the early years of drug discoveries, thus value investors may have little earnings visibility and therefore may not be able to apply discounted-cash-flow valuation processes.

Stocks of Interest

The following companies are illustrative of North Star's past and present healthcare sector investments.

Accuray Inc (ARAY)[viii]
Accuray, a medical device company, is a solid representation of the global B-to-B model as the company sells to healthcare institutions and physician group entities around the world. ARAY has developed integrated hardware and software machines that utilize radiation therapy for reducing or eliminating cancerous tumors. The company generates sales and earnings from its medical equipment products and from annual service contracts that support the medical professionals who use the equipment. Two primary catalysts drive our interest in Accuray: (1) a new management team that is improving operational execution such that they expect recent gross margins in the 40% range to gradually expand, and (2) the new Medicare payment system scheduled to take effect in January 2023 creates incentives to use Accuray medical equipment that can complete radiation treatments more quickly and more economically versus traditional equipment.

Sharps Compliance Corp (SMED)[ix]
While Stericycle Inc (SRCL)[x] dominates hazardous disposal and treatment for extremely large commercial businesses and "mom and pop" shops handle small-scale waste services, Sharps Compliance is a specialized waste management operator for the underserved middle-market of waste generators. In addition to its compelling market share, Sharps Compliance has also built out (organically and transactionally) a sophisticated route system to transport hazardous waste and unused medication. Through stable partnerships with retail pharmacies like CVS Health Corp (CVS)[xi], SMED's opportunity has been identified in the growing volume of unused prescription medication and health care materials like needles that need to be disposed of using compliant methods. Recently, niche healthcare companies have been popular consolidation targets particularly due to the tremendous inflow of private equity dollars. Sharps Compliance Corp's sticky customer relationships, gross margins historically in the high 30's/low 40's, and advantageous market position ultimately attracted Aurora Capital Partners to take over the company in an all-cash deal at a 20x EBITDA multiple.[xii]

Summary

In conclusion, healthcare stock valuations can be challenging for value investors. Such investors are therefore more likely to invest in out-of-favor, but well-capitalized yet under-earning businesses. To avoid value traps, it is crucial to study the various subindustries, differentiated business models, and positive or negative regulatory catalysts.

Contact Information

Please contact us at info@nsinvest.com if you would like to discuss the North Star funds, strategies, and investment research.

Investors should carefully consider the investment objectives, risks, charges, and expenses of the North Star Funds. This and other important information about each of the Funds are contained in the prospectus, which can be obtained at www.nsinvestfunds.com or by calling (855) 580-0900. The prospectus should be read carefully before investing. The North Star Funds are distributed by Northern Lights Distributors, LLC member FINRA/SIPC. Northern Lights Distributors, LLC and North Star Investment Management are not affiliated. 4055-NLD-09152022

Important Risk Information

Mutual funds have investment risks including loss of principal. There is no guarantee either fund will meet its objective. No-load mutual funds are sold without sales charge; however, they have ongoing expenses, such as management fees. There is no guarantee that any investment strategy will achieve its objectives, generate profits or avoid losses.

About North Star Investment Management

North Star is an employee-owned boutique asset management firm. The North Star Funds, managed by North Star Investment Management Corporation, are part of the North Star Family of Financial Services. North Star is a Chicago-based investment management firm serving individual investors since 2003.

The North Star Funds actively invest in undervalued and often overlooked small and micro capitalization companies where our macroeconomic and primary research and analysis indicate a catalyst for growth. We believe in the businesses we own—we have "high conviction" in the securities we select, and typically only hold 40 to 50 names in each portfolio.

Portfolio Selection – High Conviction, Low Turnover, Risk Management

- Each fund has a concentrated portfolio of 40 to 50 high conviction names with low turnover averaging 11%
- For risk management, each position is limited to approximately 3.0% of a portfolio
- We overweight the best stocks, but no more than 5% in any one position
- For both SMAs and funds we will nibble and bunt our way into positions by buying a little at a time
- We talk to company management in addition to doing our own primary research
- We have a bullpen of potential stocks to add to our portfolios
- Sell discipline results from a dramatic change in firm strategy, or failure to perform according to business goals.

Appendix

Russell 2000 Index: The Russell 2000® Index measures the performance of the small-cap segment of the US equity universe. The Russell 2000® Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership.

S&P 500 Index: The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities and serves as the foundation for a wide range of investment products. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

Dividend: A dividend is a distribution of some of a company's earnings to a class of its shareholders, as determined by the company's board of directors. Common shareholders of dividend-paying companies are typically eligible as long as they own the stock before the ex-dividend date. Dividends may be paid out as cash or in the form of additional stock.

Gross Margin: Gross margin represents the percent of total sales revenue that the company retains after incurring the direct costs associated with producing the goods and services sold by a company.

Operating (Cash Flow) Margin: Operating margin is a cash flow ratio which measures cash from operating activities as a percentage of sales revenue in a period.

EBITDA: EBITDA, or earnings before interest, taxes, depreciation, and amortization, is an alternate measure of profitability to net income. By stripping out the non-cash depreciation and amortization expense, as well as taxes and debt costs dependent on the capital structure, EBITDA attempts to represent cash profit generated by the company's operations. EBITDA is not a metric recognized under generally accepted account principles (GAAP).

Definitions provided by Bloomberg LP

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[i] Global Industry Classification Standard and Bloomberg Equity Screening
[ii] https://web.archive.org/web/20220307190343/https://www.un.org/development/desa/pd/sites/www.un.org.development.desa.pd/files/files/documents/2020/Jan/un_2017_world_population_prospects-2017_revision_databooklet.pdf
[iii] https://www.statista.com/statistics/1117974/healthcare-industry-profit-growth-by-sector/#:~:text=The%20total%20U.S.%20healthcare%20industry's,billion%20U.S.%20dollars%20in%202024.
[iv] Company Filings via the US Securities and Exchange Commission Filings https://www.sec.gov/edgar/searchedgar/companysearch
[v] https://www.thefiscaltimes.com/Articles/2013/01/18/Medicare-Cracks-Down-on-14B-Hospice-Industry
[vi] https://gibbinsadvisors.com/inpatient-rehabilitation-facilities-irfs-at-risk/
[vii] https://www.gao.gov/products/gao-11-56
[viii] 0.6% position in the North Star Micro Cap Fund (NSMVX) as of 06/30/2022
[ix] 0.2% position in the North Star Micro Cap Fund (NSMVX) as of 06/30/2022
[x] 0.0% position in the North Star Funds as of 06/30/2022
[xi] 3.1% position in the North Star Opportunity Fund (NSOIX) as of 06/30/2022
[xii] Sharp's Compliance Corp. (2022). August 22, 2022 8-K https://www.sec.gov/ix?doc=/Archives/edgar/data/0000898770/000114036122030856/brhc10041236_8k.htm