



The Shifting Healthcare System:

William Blair Healthcare Research Team

William Blair & Company®

Ben Andrew
Ryan Daniels, CFA
John Kreger
Amanda Murphy
John Sonnier
Corey Tobin
Brian Weinstein, CFA

Kristina Blaschek
Liping Cai, CFA
Roberto Fatta
Natalie Nadler, CFA
Karen Jay
David Kittle
Jeremy Lopez, CFA
Timothy Lugo
Matthew O'Brien

Table of Contents

- ◆ The looming healthcare crisis in the United States
- ◆ The new administration's impact on healthcare
- ◆ Implications for healthcare as an industry and an investment

The Looming Healthcare Crisis in the United States

The Looming Healthcare Crisis in the United States

- ◆ In our view, *exorbitant health care spending will be the largest issue facing the U.S. economy over the next several decades.*
- ◆ Let's start with some expert opinions on the topic:
 - **“Rapidly rising healthcare costs are not simply a federal budget problem, they are our nation’s number one fiscal challenge.”**
 - David Walker, Comptroller General of the United States
 - **“Medicare”** – Alan Greenspan’s one-word response to a recent question regarding what, in his view, represents the biggest long-term risk to our nation.
 - **Healthcare spending in the United States is “the single most important factor determining the nation’s long-term fiscal condition.”**
 - Special report from the Congressional Budget Office
 - **“Medicare is drifting towards disaster.”**
 - Michael Leavitt , Former Head of Health and Human Services
 - **“If you don't fix healthcare, healthcare expenses are going to make this banking bailout deal look like a rounding error.”**
 - Senator Ron Wyden (D-Ore.)

The Looming Healthcare Crisis in the United States

“At the fiscal summit that we held here last week, the one thing on which everyone agreed was that the greatest threat to America's fiscal health is not Social Security, though that's a significant challenge. It's not the investments that we've made to rescue our economy during this crisis. **By a wide margin, the biggest threat to our nation's balance sheet is the skyrocketing cost of health care. It's not even close.**”

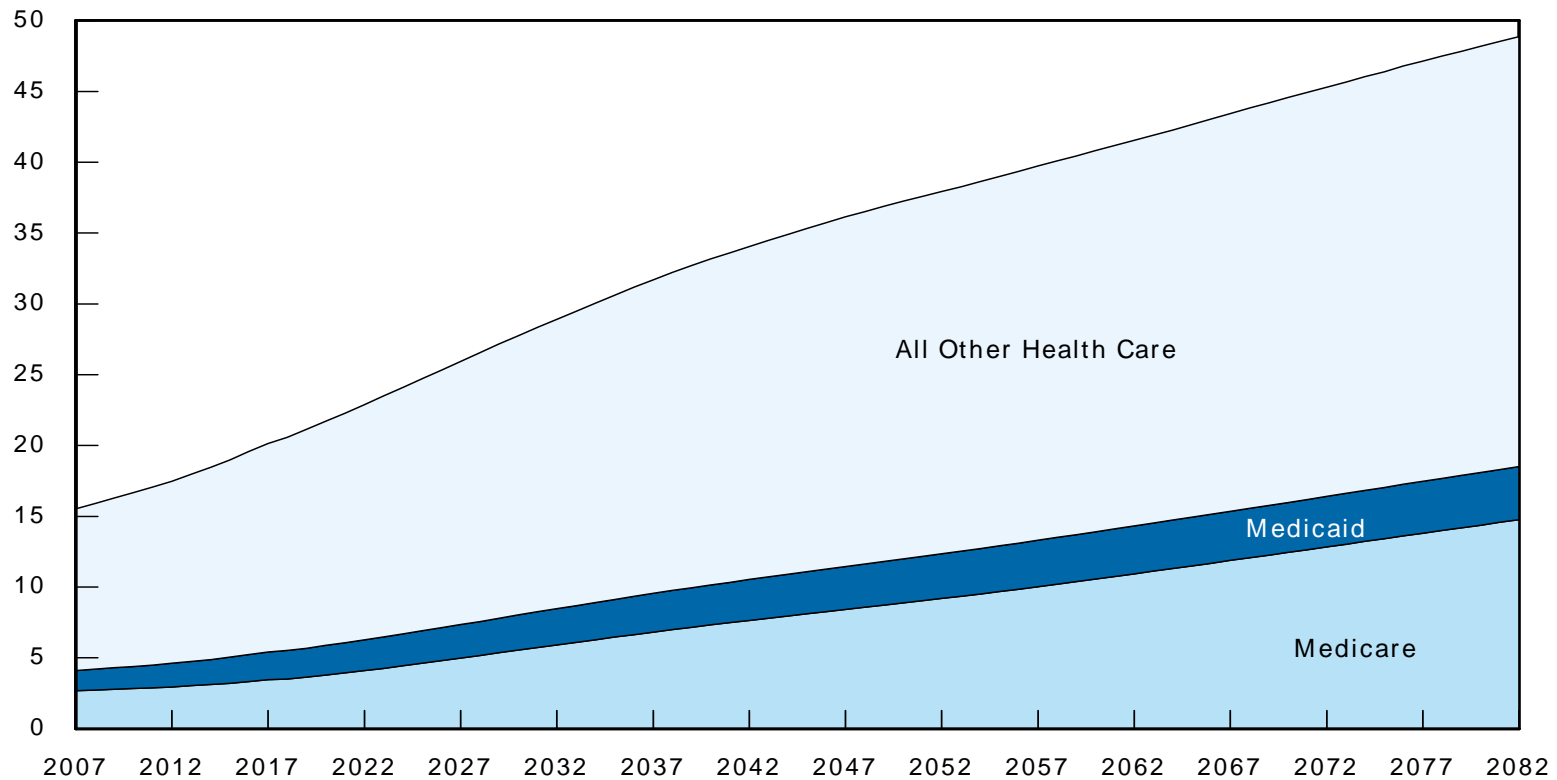
-- President Barack Obama, March 5, 2009

The Looming Healthcare Crisis in the United States

◆ *Why are these U. S. leaders so worried?*

- Because, if nothing is done, healthcare will consume 50% of the country's GDP by 2082.
- Also, the Medicare Trust Fund will be bankrupt in less than 10 years (right as most of the baby boomers enter Medicare).

Percentage of U.S. GDP Consumed By Healthcare Expenditures



Source: Congressional Budget Office

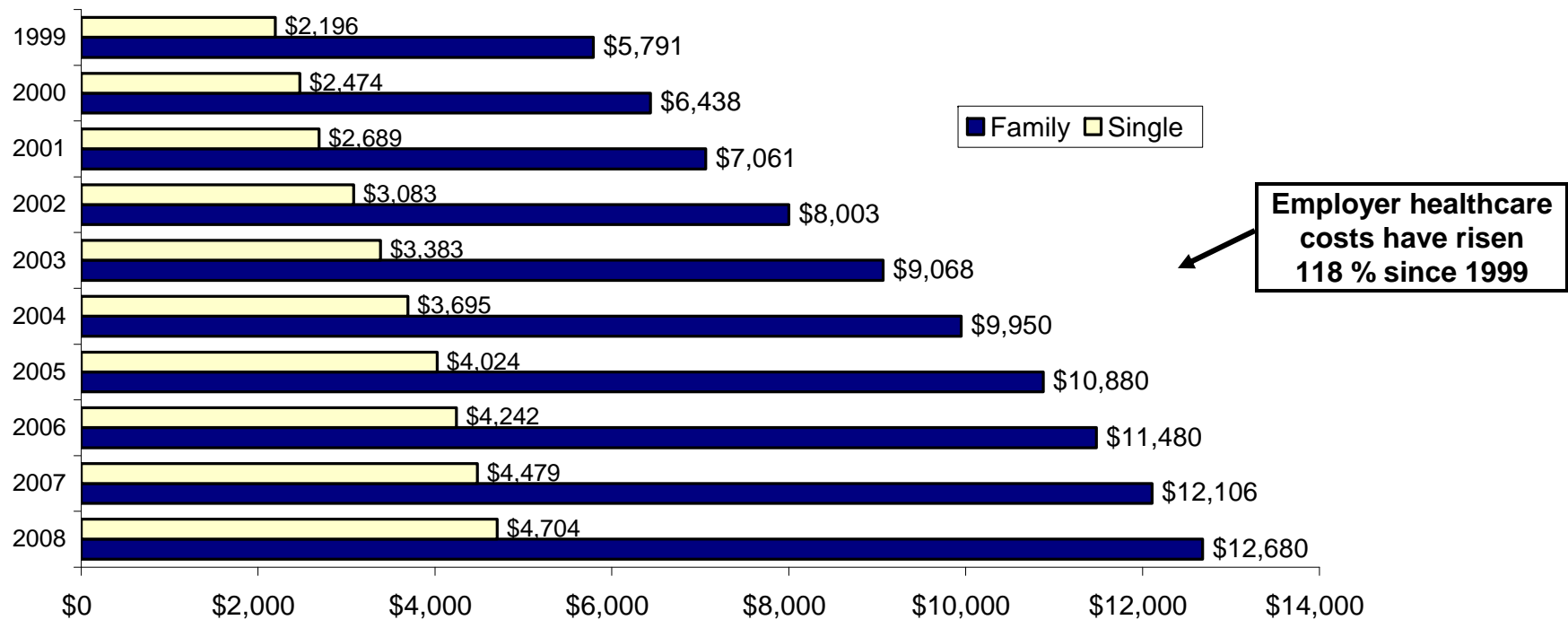
The Looming Healthcare Crisis in the United States

- ◆ Let's put some numbers behind the problem: At the start of 2008, the net present value of our unfunded, future Medicare, Medicaid, and Social Security liabilities is approximately **\$50 trillion**.
- ◆ Total U.S. Government Debt just broke through **\$10 trillion** in October 2008 (equal to only 20% of the healthcare/pension liabilities of the U.S. government).
- ◆ So what are the most viable solutions?
 1. **Invest today to save the future.** To sustain these programs, the United States would need to invest approximately \$455,000 per American household—or approximately \$175,000 for every man, woman, and child in the United States.
 2. **Grow out of this mess.** A second option is to grow our way out of this mess. To do so would only require real GDP growth of more than 15% for each of the next 75 years. Unfortunately, real GDP growth over the last 15 years (a fairly robust period of growth) has averaged roughly 3%.
 3. **Systemic reform.** *Obviously, the only real way to address this issue is to drive systemic healthcare reform.* It is not an issue of if, but an issue of how soon, this will happen.

The Looming Healthcare Crisis in the United States

◆ *Why are business leaders and consumers worried?*

Average Annual Premiums for Single and Family Coverage



Source: Kaiser/HRET Survey of Employer-Sponsored Health Benefits, 1999-2008.

The Looming Healthcare Crisis in the United States

- ◆ *The cost of healthcare is only one of the issues...the other is poor quality of care.*
- ◆ As Business Roundtable report published March 12, 2009 indicates that Americans in 2006 spent \$1,928 per capita on health care, at least two-and-a-half times more per person than any other advanced country.
- ◆ Despite this, the United States also reported:
 - Below-average life expectancy;
 - The largest percentage of uninsured individuals of any industrialized nation;
 - Infant mortality rates that are higher than most European countries and three times the rate of countries such as Japan;
 - One of the lowest utilization rates of preventive healthcare services in the world; and
 - A growing obesity epidemic that threatens to make the life expectancy of the next generation—for the first time in U.S. history—lower than that of their parents.

*The New Administration's Impact
on Healthcare*

The New Administration's Impact on Healthcare

- ◆ At its roots, President Obama's healthcare reform agenda is quite simple:
 1. Expanded healthcare coverage
 2. Make healthcare more affordable
 3. Increase the quality of healthcare in the U.S.
- ◆ However, achieving this objective will be a monumental challenge, and--in our view--the reform timeframe appears very aggressive.
- ◆ President Obama recently stated, "Our goal will be to enact comprehensive health care reform by the end of this year. That is our commitment. That is our goal."
- ◆ Key Members of the House and Senate also announced their commitment to enacting "comprehensive healthcare reform" before their August recess.
- ◆ Our skepticism lies in the fact that the last major healthcare reform took place 45 years ago, with the establishment of Medicare. *The government now hopes to reshape our entire healthcare system in less than five months...*

The New Administration's Impact on Healthcare

- ◆ President Obama has outlined eight guiding principles for healthcare reform:
 1. Protect families' financial health
 2. Make health coverage affordable
 3. Aim for universality
 4. Provide portability of coverage
 5. Guarantee choice
 6. Invest in prevention and wellness
 7. Improve patient safety and quality care
 8. Maintain long-term fiscal sustainability

The New Administration's Impact on Healthcare

- ◆ President Obama has outlined eight guiding principles for healthcare reform:

1. **Protect families' financial health**
2. Make health coverage affordable
3. Aim for universality
4. Provide portability of coverage
5. Guarantee choice
6. Invest in prevention and wellness
7. Improve patient safety and quality care
8. Maintain long-term fiscal sustainability

What this means:

The reform plan must reduce healthcare premiums, limit individual's ultimate exposure, and provide government subsidies to help pay for insurance premiums.

The New Administration's Impact on Healthcare

- ◆ President Obama has outlined eight guiding principles for healthcare reform:
 1. Protect families' financial health
 2. **Make health coverage affordable**
 3. Aim for universality
 4. Provide portability of coverage
 5. Guarantee choice
 6. Invest in prevention and wellness
 7. Improve patient safety and quality care
 8. Maintain long-term fiscal sustainability

What this means:

Health plan administrative costs must be reduced; unnecessary tests and services must be eliminated.

The New Administration's Impact on Healthcare

- ◆ President Obama has outlined eight guiding principles for healthcare reform:
 1. Protect families' financial health
 2. Make health coverage affordable
 - 3. *Aim for universality***
 4. Provide portability of coverage
 5. Guarantee choice
 6. Invest in prevention and wellness
 7. Improve patient safety and quality care
 8. Maintain long-term fiscal sustainability

What this means:

There must be a path toward universal coverage; this will likely be the longest and trickiest part of the healthcare reform debate.

The New Administration's Impact on Healthcare

- ◆ President Obama has outlined eight guiding principles for healthcare reform:
 1. Protect families' financial health
 2. Make health coverage affordable
 3. Aim for universality
 - 4. Provide portability of coverage**
 5. Guarantee choice
 6. Invest in prevention and wellness
 7. Improve patient safety and quality care
 8. Maintain long-term fiscal sustainability

What this means:

Allow employees to carry their healthcare coverage with them; create a government exchange to compete with private plans (*another controversial reform initiative*).

The New Administration's Impact on Healthcare

- ◆ President Obama has outlined eight guiding principles for healthcare reform:
 1. Protect families' financial health
 2. Make health coverage affordable
 3. Aim for universality
 4. Provide portability of coverage
 5. **Guarantee choice**
 6. Invest in prevention and wellness
 7. Improve patient safety and quality care
 8. Maintain long-term fiscal sustainability

What this means:

The existing employer-based system will remain intact; explicit indication of trends toward socialized medicine would derail all hopes of reform.

The New Administration's Impact on Healthcare

- ◆ President Obama has outlined eight guiding principles for healthcare reform:
 1. Protect families' financial health
 2. Make health coverage affordable
 3. Aim for universality
 4. Provide portability of coverage
 5. Guarantee choice
 - 6. Invest in prevention and wellness**
 7. Improve patient safety and quality care
 8. Maintain long-term fiscal sustainability

What this means:

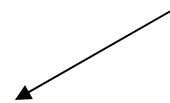
The system must move from sick-care to preventive healthcare. Reimbursements must change to drive this behavior.

The New Administration's Impact on Healthcare

- ◆ President Obama has outlined eight guiding principles for healthcare reform:
 1. Protect families' financial health
 2. Make health coverage affordable
 3. Aim for universality
 4. Provide portability of coverage
 5. Guarantee choice
 6. Invest in prevention and wellness
 7. **Improve patient safety and quality care**
 8. Maintain long-term fiscal sustainability

What this means:

HCIT investments will be key; pay-for-performance (rather than paying for consumption) will become the new reimbursement standard.

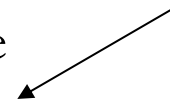


The New Administration's Impact on Healthcare

- ◆ President Obama has outlined eight guiding principles for healthcare reform:
 1. Protect families' financial health
 2. Make health coverage affordable
 3. Aim for universality
 4. Provide portability of coverage
 5. Guarantee choice
 6. Invest in prevention and wellness
 7. Improve patient safety and quality care
 8. **Maintain long-term fiscal sustainability**

What this means:

We must find ways to pay for the plan. Taxpayers and healthcare companies will fund this reform.



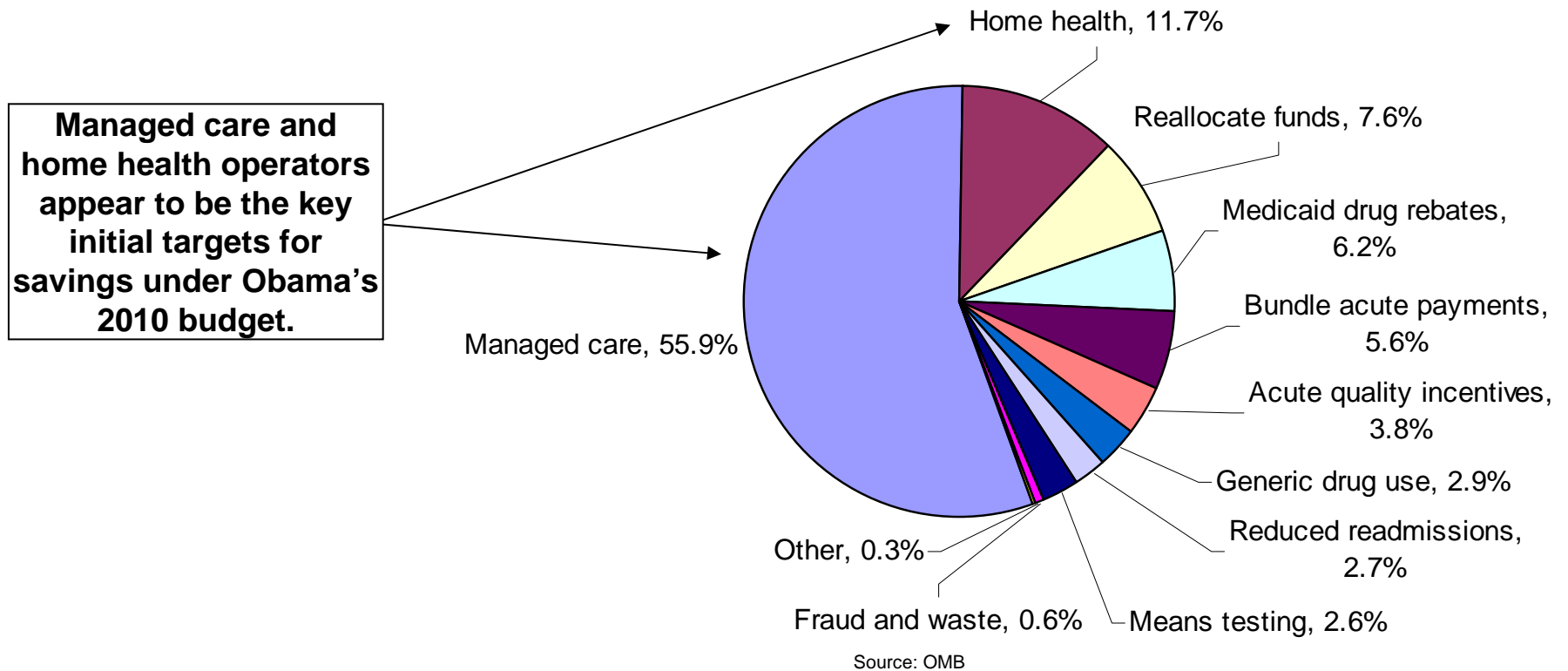
The New Administration's Impact on Healthcare

- ◆ The move toward expanded coverage (and some would argue more government control) is already moving forward:
 - SCHIP Bill expanded government coverage to four million incremental children
 - Stimulus package funds more government support of individuals in Medicaid
 - Debate surround a Medicare-type option to compete with private insurers appears to be part of the healthcare reform agenda

- ◆ Interestingly, many of the guiding principles also have already been put to work:
 - Stimulus package included more than \$1 billion for comparative effectiveness research; \$20 billion to invest in healthcare IT (HCIT)
 - Obama's fiscal 2010 budget calls for reimbursement updates that will dramatically cut provider payments by penalizing lower-quality operators
 - The budget contains initial cuts for home-healthcare providers and Medicare Advantage plans, greater rebates from drug manufacturers (Medicaid only), and utilization reviews for diagnostic imaging services
 - Budget also encourages means-testing of Medicare beneficiaries

The New Administration's Impact on Healthcare

- ◆ The President's "Healthcare Reform Reserve Fund" shows the initial areas of focus for spending reductions. The budget assumes \$316 billion in "reform funds" from savings initiatives and reimbursement cuts, with the remaining \$318 billion coming from increased tax dollars.
- ◆ Importantly, even the President admits this \$634 billion is only a *starting point* to pay for healthcare reform. *That means that additional rate reductions and savings opportunities will still need to be found...*



*Implications for Healthcare as an
Industry and an Investment*

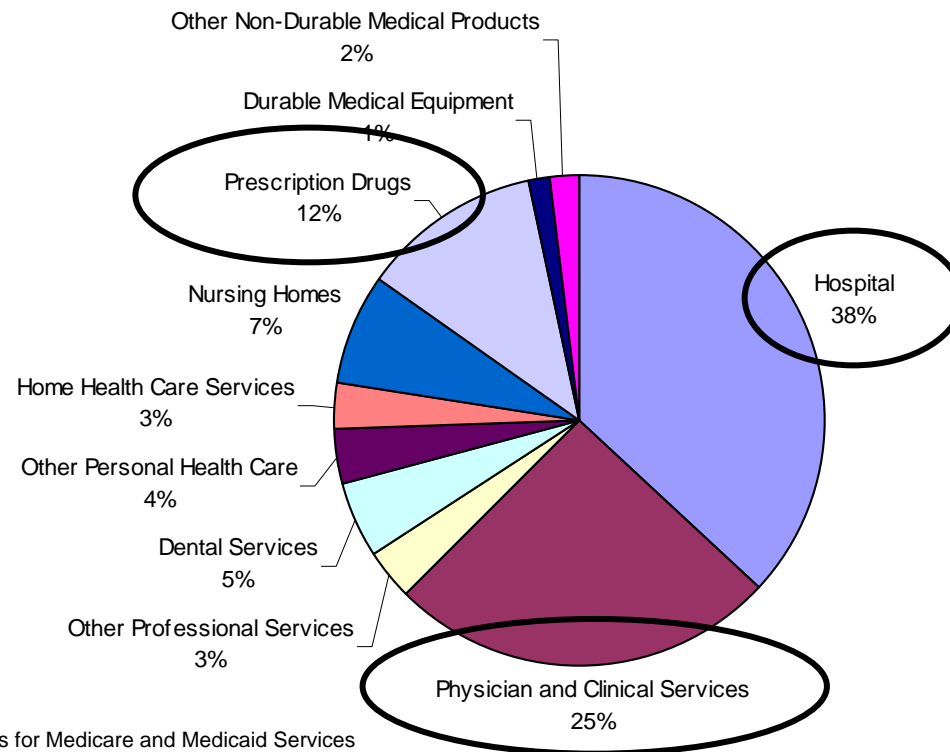
Implications for Healthcare as an Industry and an Investment

- ◆ President Obama has been clear that *all entities involved in healthcare must share the burden of healthcare reform.*
- ◆ This rhetoric, alone, has been enough to pressure healthcare stocks over the last several weeks.
- ◆ That stated, this transformation is an epic undertaking, and reform discussions and gradual changes will persist for many years.
- ◆ In our view, the key areas of focus will remain on acute-care hospitals, pharmaceuticals, and physicians. These three areas consume nearly *\$0.75 of every dollar Medicare spends on healthcare* – so if reform requires long-term savings, it must focus on these three areas.
- ◆ Managed care companies also remain a key government target; first via rate reductions to Medicare Advantage plans and later via direct competition with the government and its potential insurance exchange.

The New Administration's Impact on Healthcare

- ◆ Again--to really move the healthcare spending needle--the focus will eventually have to center around hospitals, pharmaceuticals, and physician/clinical services.
- ◆ In general, we believe reimbursement cuts (hospitals) and Medicare rebates (pharma) may eventually occur; for physicians, it will likely revolve around a redistribution of payments and a focus on increased quality (pay-for-performance) and care coordination (the medical home).

U.S. Health Care Spending by Type of Service 2007



Implications for Healthcare as an Industry and an Investment

- ◆ Over the long-term, our healthcare team focuses on investment ideas we believe will drive superior relative returns:
 - Consumer-based healthcare providers with limited government reimbursement risk (veterinary healthcare, dental, aesthetics, and outsourcing providers)
 - Higher-quality, lower-cost healthcare deliver sources (surgery centers, PBMs, and diagnostics providers)
 - Innovative products and services companies (medical technology, biotechnology, and specialty pharmaceuticals)
 - Preventive healthcare companies and enablers (HCIT, laboratories, and disease management providers)

Disclosures

*Percentage of companies in each rating category that are investment banking clients, defined as companies for which William Blair has received compensation for investment banking services within the past 12 months.

Ryan Daniels & Ben Andrew attests that 1) all of the views expressed in this research report accurately reflect his/her personal views about any and all of the securities and companies covered by this report, and 2) no part of his/her compensation was, is, or will be related, directly or indirectly, to the specific recommendations or views expressed by him/her in this report.

Stock Rating: William Blair & Company, L.L.C. uses a three-point system to rate stocks. Individual ratings reflect the expected performance of the stock relative to the broader market over the next 12 months. The assessment of expected performance is a function of near-term company fundamentals, industry outlook, confidence in earnings estimates, valuation, and other factors. Outperform (O) – stock expected to outperform the broader market over the next 12 months; Market Perform (M) – stock expected to perform approximately in line with the broader market over the next 12 months; Underperform (U) – stock expected to underperform the broader market over the next 12 months; Not Rated (NR) – the stock is currently not rated.

Prior to September 3, 2002, William Blair & Company, L.L.C. used a four-point numerical system to rate stocks. Investment ratings reflect the expected performance of the stock relative to the market over the next 12 to 18 months: 1 – Strong Buy (Significant Outperformance); 2 – Long-term Buy (Outperformance); 3 – Hold (Market Average Performance); 4 – Sell (Underperformance).

Company Profile: The William Blair research philosophy is focused on quality growth companies. Growth companies by their nature tend to be more volatile than the overall stock market. Company profile is a fundamental assessment, over a longer-term horizon, of the business risk of the company relative to the broader William Blair universe. Factors assessed include: 1) durability and strength of franchise (management strength and track record, market leadership, distinctive capabilities); 2) financial profile (earnings growth rate/consistency, cash flow generation, return on investment, balance sheet, accounting); 3) Other factors such as sector or industry conditions, economic environment, confidence in long-term growth prospects, etc. Established Growth (E) – Fundamental risk is lower relative to the broader William Blair universe; Core Growth (C) – Fundamental risk is approximately in line with the broader William Blair universe; Aggressive Growth (A) – Fundamental risk is higher relative to the broader William Blair universe.

The ratings and company profile assessments reflect the opinion of the individual analyst and are subject to change at any time.

The compensation of the research analyst is based on a variety of factors, including performance of his or her stock recommendations; contributions to all of the firm's departments, including asset management, corporate finance, institutional sales, and retail brokerage; firm profitability; and competitive factors.

THIS IS NOT IN ANY SENSE A SOLICITATION OR OFFER OF THE PURCHASE OR SALE OF SECURITIES. THE FACTUAL STATEMENTS HEREIN HAVE BEEN TAKEN FROM SOURCES WE BELIEVE TO BE RELIABLE, BUT SUCH STATEMENTS ARE MADE WITHOUT ANY REPRESENTATION AS TO ACCURACY OR COMPLETENESS OR OTHERWISE. OPINIONS EXPRESSED ARE OUR OWN UNLESS OTHERWISE STATED. FROM TIME TO TIME, WILLIAM BLAIR & COMPANY, L.L.C. OR ITS AFFILIATES MAY BUY AND SELL THE SECURITIES REFERRED TO HEREIN, MAY MAKE A MARKET THEREIN AND MAY HAVE A LONG OR SHORT POSITION THEREIN. PRICES SHOWN ARE APPROXIMATE. THIS MATERIAL HAS BEEN APPROVED FOR DISTRIBUTION IN THE UNITED KINGDOM BY WILLIAM BLAIR INTERNATIONAL, LIMITED, REGULATED BY THE FINANCIAL SERVICES AUTHORITY (FSA), AND IS DIRECTED AT, AND IS ONLY MADE AVAILABLE TO, AUTHORIZED PERSONS AND OTHER PERSONS FALLING WITHIN COB 3.2.5(1)(b) OF THE FSA HANDBOOK, AND MAY NOT BE PASSED ON TO PRIVATE CUSTOMERS IN THE UNITED KINGDOM. ANY UNAUTHORIZED USE IS PROHIBITED. "WILLIAM BLAIR & COMPANY" AND "WILLIAM BLAIR & COMPANY (SCRIPT)" ARE REGISTERED TRADEMARKS OF WILLIAM BLAIR & COMPANY, L.L.C. Copyright 2009, William Blair & Company, L.L.C.