HIGHLAND CAPITAL MANAGEMENT

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IMPACT OF ACA (OBAMACARE) ON THE HEALTHCARE SECTOR

Healthcare is undergoing a generational change, the likes of which we haven't seen in over 50 years. As Obamacare goes into effect, the sector will face fundamental change and winners and losers will emerge. Here we share our view of the impact on different areas of the healthcare sector.

HOSPITALS AND MEDICAL TECHNOLOGY COMPANIES

The wave of new, paying customers entering the healthcare system creates an attractive opportunity for hospitals and for medical technology companies that sell into hospitals. The Emergency Medical Treatment and Active Labor Act (EMTALA), passed in 1986, requires hospitals to provide emergency care treatment to anyone needing it regardless of citizenship, legal status or ability to pay. To put this issue in perspective, approximately 20% of hospital revenue is unpaid due to mandatory treatment for the uninsured. Once Obamacare is in effect, most of those unpaid customers will become paid customers, and hospital profit margins may materially

+ Hospitals will likely be providing the same amount of service and care but have an increase in the percentage of hospital revenue that is actually paid. A hospital operator with 10% EBITDA margin that sees expansion to 13% EBITDA margin from higher volume and higher paying customers would experience a 30% boost to EBITDA levels. Given that most hospitals are highly levered at 5x total net leverage, this could effect a 150% upward movement in equity values.

+ As hospital operating profits improve, medical technology companies will likely pivot to growth mode. Hospitals should be more comfortable in spending capital to purchase medical technology which creates a large market opportunity. In particular, medical devices and Healthcare IT are two focus areas as they facilitate growth within hospitals. In addition, hospitals will be more focused on ways to attract volumes of patients to their facilities and will look to position themselves as cutting edge with the latest and best treatments. Companies specializing in robotics, cardiovascular implants, spine and general surgery will find they are in much higher demand.

OBAMACARE, MEDICAID, AND THE EXCHANGES

The health insurance market is in a period of dynamic change. About two-thirds of the newly insured are expected to be served from expanded Medicaid programs and the remaining one-third from the Obamacare public exchanges. This will result in opportunities for some companies and a new set of challenges for others, particularly those based on the old model.

+ Medicaid health insurers are going to experience a significant inflow of new enrollees. That may sound promising, but for health insurers there may be dangers associated with revenue growth. Newly insured individuals tend to utilize extremely high levels of healthcare for a period of 12-18 months, and this can cause losses for health insurers serving new enrollees and therefore we would look to underweight these companies.

+ The Obamacare public exchanges (also an area to underweight) should pose significant risk to health insurers and are likely to create significant losses for participating health insurers in 2014 and 2015. Insurance companies can no longer underwrite risk as they are accustomed to, resulting in a number of challenges:

- lack the ability to effectively price risk
- exposed to greater risk of adverse selection
- absorb new industry taxes to pay for Obamacare
- exposed to the potential for newly insured individuals to utilize extremely high levels of healthcare for a period of 12-18 months
- forced to rebate back excess profits but suffer all of the losses from unprofitable enrollees

+ Private exchanges are poised for growth and companies building and operating these private exchanges stand to benefit. We estimate that at this time in 2012, there were only 1mm people on private exchanges. We calculate that there are currently 7mm people on the exchanges and see growth to 40-50mm people by 2018. Many employers are moving employees to private exchanges as part of a pivot from defined benefit to defined contribution. There is opportunity for companies building private exchanges, while companies that built their business around the old model are now at risk.

IMPACT OF VOLUME: PHARMACEUTICALS AND DISTRIBUTORS

Approximately 34mm Americans are expected to get health insurance due to Obamacare creating a significant expansion opportunity. There are a few areas in particular which may benefit from the expected volume increase across the healthcare system:

+ Pharmaceuticals. Uninsured individuals use few prescription drugs. With 34mm individuals coming into the healthcare system, we feel that pharmaceutical companies are well positioned to address increased demand for prescription drugs. Pharmaceutical companies with good pipelines experiencing Obamacare fueled prescription growth stand to benefit the most. Pharmaceutical companies with poor pipelines that are owned for dividend yield, as a whole may underperform in a rising interest rate environment given the relative attractiveness of a risk-free Treasury yield.

+ Distributors. These companies bulk purchase prescription drugs from pharmaceutical companies on behalf of health insurance plans and manage the logistics and shipment of drugs to pharmacy locations across the country. It is a consistent, low-margin business. Distributors should benefit from increased demand for prescription drugs, as more volume flows through the system. In addition, certain distributors are moving beyond pharmaceutical drugs, into distribution of basic

BIOTECHNOLOGY

Biotechnology is rapidly changing and we are just starting an inflection point in the pace of scientific and technological advances. Scientists' greater understanding of the biology of disease combined with human genetics has brought much greater efficiency to this area.

+ Biotech drugs used to take 12 years and $800mm spend to come to the commercial market, mostly due to a widespread inability to determine who would benefit from each drug. That is changing. Scientists know more about underlying biology and pathophysiology of disease, and know more about the biology of how drugs work. They are using diagnostics to determine what patients have a specific genetic or biologic profile. Biotechnology companies are then developing drugs in smaller, more targeted populations at a fraction of the cost and at a significantly faster pace. The age of targeted therapy is better for the patient, because the patient only receives drugs that science has proven he/she may benefit from.

+ Diagnostics allow physicians to pinpoint the cause of disease, segment disease sub-types amongst a wide population, and determine what drugs or treatment options are optimal. In this way, diagnostics are an indispensable feature of healthcare both today and in the near future.

The coming year will continue to bring new challenges and opportunities to this sector. The one thing that is certain is continued

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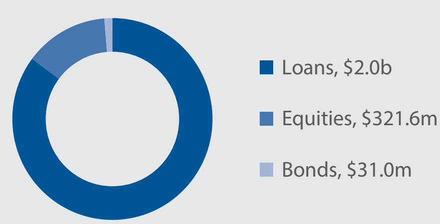
Healthcare Sector at Highland, $2.4 Billion[1]



Data as of 11/30/13

(1) As of 11/30/13, inclusive of Highland Capital Management, L.P. and affiliates, based on fee calculation AUM

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