

POST ELECTION PLAYBOOK

IMPACT ON THE HEALTHCARE SECTOR

There has been a great deal of speculation leading up to the elections, but now that the voting is in — let's take a look and see what the impact really is. Specifically, what did the November elections mean for the healthcare sector?

ELECTIONS SIGNIFICANCE

As expected, Republicans have won the Senate giving them greater legislative authority. Here, we will highlight the impact to the healthcare sector overall and within different pockets.

- You cannot look at Republican House/Senate as the opportunity for full-scale implementation of the entire Republican legislative slate because: a) President Obama still has the veto, b) Senate Republicans will not have the 60 votes necessary for cloture supermajority.
- Very important to note — Republican sweep does not kill the Affordable Care Act ("ACA"), it only opens up the potential for very minor tweaks.
- For Healthcare, the Governor's races are actually more important than Senate. Most talking heads have been focused on the Senate race, but we have been focused on both.

KEY GUBERNATORIAL ELECTIONS

There are five key states where the gubernatorial elections had a big impact. Why do Governors matter? Well, state governors determine Medicaid expansion, the mechanism used to address approximately 2/3 of the 35mm Americans who receive health insurance under the ACA. There are a number of Healthcare companies that benefit from Medicaid expansion including Hospitals, Medicaid Managed Care, Cost Containment service businesses and other Healthcare Service companies.

Only 27 of 50 States originally expanded Medicaid, largely for political reasons of not wanting to be aligned with President Obama. Governors balance the economic incentive of high Federal cost subsidy against political considerations.

A Republican governor win means the state is less likely to expand Medicaid, which takes some wind out of the sails of companies that benefit from Medicaid expansion. Here were the key outcomes:

Republicans cleaned up in the larger states.

Texas	<i>Greg Abbott (R)</i>
Florida	<i>Rick Scott (R)</i>
Georgia	<i>Nathan Deal (R)</i>
Tennessee	<i>Bob Haslam (R)</i>
Virginia	<i>Terry McAuliffe (D)</i>

REPUBLICAN SENATE

The outcome is a clear positive for medical device companies. Republicans will push for legislative repeal of the medical device tax:

- This tax was implemented as part of the ACA on January 1, 2013 and applies a 2.3% tax on the sale of medical devices.
- A repeal of the medical device tax may boost margins and earnings power of medical device companies.
- Advamed, an industry organization, has spent \$150mm lobbying Congress since 2008 for repeal of the tax.
- There seems to be bipartisan support to repeal the medical device tax.

The outcome is also a positive for Medicare Advantage ("MA") health insurers. Republicans are less likely to implement reimbursement cuts, which protect operating margins and earnings visibility:

- This is a program that came from the Medicare Modernization Act of 2003, implemented under the Bush administration and now accounts for 30% of all Medicare recipients in the US. (cont.)

- MA has endured persistent reimbursement cuts over the past decade.
- Republicans are more supportive of the MA program and less likely to push for more reimbursement cuts.

HEALTHCARE

Our view of Healthcare is that the sector is fairly-valued and we do not expect relative outperformance above the S&P 500. This is mostly based upon valuation, but partly influenced by the Republican election victories.

- Valuation tells us that Healthcare fundamentals are strong, but increasingly priced in. Healthcare trades 17.7x NTM P/E, slightly up from 17.3x NTM P/E, now 2 full turns higher than S&P500 and well above 10-yr average P/E multiple.
- Republican control may slow down the expansion of the Healthcare sector through legislation and by de-funding certain Healthcare programs.
- Mitch McConnell, Senate majority leader, will use Reconciliation, a legislative process, to impact the budget and starve the Healthcare sector of funds necessary for ACA related expansion.

Keep in mind, it is very important to distinguish between our views of a long/short healthcare strategy and that of the Healthcare sector as a whole. Because a long/short healthcare strategy seeks to generate alpha and profit from both winners and losers, it is not necessary for the Healthcare sector or equity markets to do well in order to produce returns for clients.

Therefore, we do not think the best approach is to invest long-only in the sector. There are already \$140 billion of long-only assets. A long/short strategy allows investors to participate in Healthcare without taking on high market exposure.

Our view of a long/short healthcare strategy over the next several years is very bullish, specifically the opportunity to meet client needs by seeking high absolute returns with low beta exposure and low correlation to equity markets, with a focus on downside protection and capital preservation.

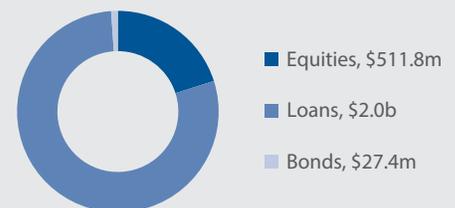
Healthcare Sector at Highland



Michael Gregory
Head of Healthcare Equity and Credit
Portfolio Manager, Highland Long/Short Healthcare Fund

Sub Specialty: Healthcare Generalist
Background: Cummings Bay Capital, Sands Point Partners
Education: Yale School of Management, MBA;
The Wharton School of University of Pennsylvania, BS in Economics

Healthcare Sector at Highland, \$2.5 Billion¹



1. As of 3/31/14, inclusive of Highland Capital Management, L.P. and affiliates, based on fee calculation AUM

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