

# KING VS BURWELL

## IMPACT ON THE HEALTHCARE SECTOR

### BACKGROUND ON THE CASE

In King vs. Burwell, the plaintiff (King) challenges the legality of health insurance premium subsidies that have been made available to those who purchase health insurance on federally-run health insurance exchanges. Subsidies are available to certain individuals based on their income level, and help make the health insurance more affordable. The exact language in the Affordable Care Act (“ACA” or “Obamacare”) states that these subsidies are only available to those individuals who purchase their health insurance plan on an exchange “established by the state.” However, only 16 states operate their own exchange; the remaining 34 states rely on the federally-run exchange, Healthcare.gov. This means that the roughly 6.4 million individuals who currently receive the federal subsidy could have that subsidy taken away if the Supreme Court of the United States (SCOTUS) rules for the plaintiff and against the government (Burwell). The ruling is likely to take place before the end of June, either 6/22 or 6/29, since SCOTUS usually rules on a Monday.

### OUR TAKE

We currently believe there is a 75% chance the government prevails. Here are the three potential outcomes of how the SCOTUS could rule:

1. SCOTUS finds the law ambiguous and rules in favor of the government
2. SCOTUS finds the law unambiguous – i.e. the phrase in question, “established by the state” means just that – and rules in favor of the plaintiff
3. SCOTUS rules that denying subsidies to the states that did not establish exchanges is unconstitutional, and rules in favor of the government

The outcome of the case impacts only approximately 1/6<sup>th</sup> of the Obamacare expanded population but the ruling could impact sub sectors within healthcare.

### HERE ARE THE POTENTIAL IMPACTS:

SCOTUS Ruling	Burwell (Government)	King (Plaintiff)
Sector	Estimated Stock Impact, Ruling, and Aftermath	
Hospitals and Other Providers	Strong, Positive	Negative
Managed Care	Positive	Negative
Hospital Capital Equipment Manufacturers	Positive	Negative
Healthcare Supply Chain, Drug Retailers, Pharmacy Benefit Managers	Neutral to Positive	Neutral / Negative
Healthcare Products: Pharma, Biotech, Devices	Neutral to Positive	Neutral / Negative

## IMPACT ON THE HIGHLAND L/S HEALTHCARE FUND

We have approximately 10% of the portfolio allocated to positions that we think are tightly tied to the SCOTUS outcome:

### Hospitals

If the Court rules in favor of the plaintiffs, hospitals would likely experience a minor decline in admissions and visits by patients who rely on the subsidy for their health insurance. However, we believe the SCOTUS will likely extend the subsidy to at least the end of 2015, or perhaps longer, in order to give states time to develop a “work-around” solution so the people in those states can keep their subsidy. There will likely be significant political theater in the following months, so timing of “work-around” solutions is uncertain, but ultimately we believe they will prevail.

In the above scenario, we estimate 5-8% downside for hospital stocks on the day of the ruling, but believe this will be short-lived if “work-around” solutions can be agreed upon by the states.

If the Court rules in favor of the government, we expect hospital stocks to appreciate 5-10% on the day of the ruling, and subsequently grind 20-30% higher through year-end 2015 on favorable near-term fundamentals.

The Fund has a partial long position in hospital stocks based on our view that SCOTUS will rule in favor of the government. If we are wrong, we will be adding to our position over the subsequent weeks as we believe the downside will be short-lived and “work-around” solutions will ultimately be developed.

### Managed Care

We have owned the managed care organizations (“MCOs”) for over a year and continue to be constructive on the group, regardless of the SCOTUS decision. Our original thesis for owning the group had three points:

1. Solid underwriting and very manageable cost trends will enable the group to meet/exceed earnings expectations in 2015
2. The Medicare and Medicaid growth opportunity is underappreciated amongst investors
3. Increased regulation in all lines of business (commercial, individual, Medicare and Medicaid) dictate the dollar amount that must be spent on medical expense. Therefore, margin expansion is dependent on leveraging G&A, which requires increased scale. This will lead to M&A activity in the space.

We believe all three drivers remain intact.

### Healthcare

If the Court rules in favor of the plaintiffs, we do believe the entire healthcare sector could trade down 1-2% in sympathy. It is important to understand the ruling only impacts a fraction of the people who are newly insured under Obamacare. Most of the underlying drivers in the healthcare space, including innovation in the pharma/biotech/medical device spaces will continue. We plan to be opportunistic on both sides (long and short) if we detect any major disconnect between valuation and fundamentals.

We are not making a big bet on this outcome, but rather highlighting what could be increased volatility in the fund in the short-term. Our conviction in the names currently in the portfolio remains strong, and we have a specific plan regardless of the outcome of the King vs. Burwell case.

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