ESG Industry Report Card: Health Care

May 21, 2019

Key Takeaways

- Social factors are prevalent considerations in our analysis of health care companies because they often play a crucial role for the communities they serve and derive a portion of their revenue from the government.

- For this reason, they are often in the public debate on how to tackle the rising cost of health care, how to address the lack of transparency around prices, and how to improve access to quality care; furthermore, safety risks can affect credit quality.

- While several of these risks are increasing, we believe that over the next five years efforts to reform health care reimbursement, prices, and access will be incremental rather than dramatic.

- Generally, we consider innovative companies with thoughtful pricing strategies or that adapt to the changing landscape as having stronger businesses.

The ESG Risk Atlas

To calibrate the relative ranking of sectors, we use our environmental, social, and governance (ESG) Risk Atlas (see "The ESG Risk Atlas: Sector And Regional Rationales And Scores," published May 13, 2019). The Risk Atlas provides a relative ranking of industries in terms of exposure to environmental and social risks (and opportunities). The sector risk atlas charts (shown below) combine each sector's exposure to environmental and social risks, scoring it on a scale of 1 to 6. A score closer to 1 represents a relatively low exposure, while 6 indicates a high sectorwide exposure to environmental and social risk factors (for details see the Appendix). This report card expands further on the Risk Atlas sector analysis by focusing on the credit-specific impacts, which in turn forms the basis for analyzing the exposures and opportunities of individual companies in the sector.
Environmental Exposure (Risk Atlas: 2)

Environmental factors have infrequently affected health care companies’ credit quality. Extreme weather or supply disruptions can affect some manufacturers, but to date this has rarely caused credit deterioration. Pharmaceutical product, medical device, and life science product manufacturing involve hazardous substances and can produce byproducts that could harm the environment. Environmental remediation and failure to comply with regulations can be costly or cause plant shutdowns, which could affect product supply.

Social Exposure (Risk Atlas: 3)

Social factors are prevalent in our credit analysis on health care companies because most health care companies are either providing a service to the community or a product to treat a human ailment. While many of these treatments, products, and drugs can benefit society, they can also be costly to the government or taxpayers, payers, and consumers.

In developed countries, aging populations put cost pressure on health care systems. Improving health outcomes while raising the cost effectiveness of therapies are increasingly becoming twin goals for health care companies. In some markets, including the U.S., public debate focuses on the accessibility and affordability of medicines and quality care and relatedly the transparency of prices. Increasingly, payers are advocating that health care providers and manufactures be compensated for the value they bring, to better align incentives.

In the U.S., given health care’s importance to the economy and society, we believe potential changes to reimbursement and access will likely be mostly incremental, rather than dramatic, over the next five years. We view the potentially seismic downside risk that would likely occur from proposals such as Medicare for all as highly unlikely. In addition, we expect any potential drug pricing reform in the U.S. would only moderately burden EBITDA margins for pharmaceutical companies, because we believe the significant social benefits from the industry will lead to a balanced approach that supports continued investment in research and development (R&D) and attractive levels of returns and profitability. (For more information, see "Health Care Washington Watch: Which Government Proposals May Affect Ratings?," published April 18, 2019; and “Which Pharma Company Ratings Could Be At Risk If U.S. Drug Pricing Reforms Become Law?,” published Oct. 31, 2018).

Social risks around drug pricing and affordability in Western Europe are less controversial due to high levels of regulatory involvement, and often the nationwide setting of drug formularies and price lists. That said, tight government pricing, regulation, and inflexible policy choices might result in disincentives and misallocation of resources in new drug and therapy development in these markets.

We believe pharmaceutical companies that are highly innovative, invest in R&D, meaningfully improve disease treatment, are thoughtful of public opinion in developing their pricing strategies, and have a reputation for clinical excellence and regulatory compliance have more sustainable business models. In contrast, those that have a limited pipeline and rely on acquisitions, primarily develop and manufacture lifestyle drugs or raise prices significantly may face greater challenges.

For many U.S. health care companies, efforts to reduce system costs will likely require many companies to evolve. This will also contribute to reimbursement risk, which already constrains ratings on providers, particularly hospitals, which deliver the most expensive of health care services. Reimbursement cuts, lower rate increases, efforts to move more volume to the
lowest-cost sites of care, a greater uninsured population, and adverse shifts in payer mix can diminish the financial profile of these companies. We view adapting companies as having stronger business risks. In Western Europe, health care service providers, such as hospitals, face similar risks to those in the U.S. Those risks center around reimbursement and its impact on volume and mix of services offered.

Medical device manufacturers face less direct reimbursement risk, but cost stress facing hospitals can lead to indirect pressure on these companies. Similarly, life science companies also only face indirect reimbursement risk (their growth can correlate to the growth of lab testing and R&D spending of other health care companies), although some life science companies have some exposure to government funding levels.

Medical device manufacturers and pharmaceutical manufacturers must ensure the quality and safety of their products because safety issues could be life-threatening or debilitating. The risk of litigation related to safety matters could impair credit quality. For example, pelvic mesh-related legal settlements have affected device manufacturers' credit quality, although this is starting to subside. Currently, the proliferation of opioids has become a public health issue in the U.S. and could hurt the credit quality of some pharmaceutical manufacturers and distributors (for more information, see "The Opioid Crisis: Growing Litigation Concerns For The Health Care Industry," published Oct. 2, 2018).

Data protection has become a notable social risk in light of emerging data privacy and protection laws. This risk is more near term and more quantifiable in terms of mitigation than other social risks in the sector. This means that it's likely to be already priced into health care companies' cost structures.

**Governance**

Governance is company-specific and is often influenced by a company's culture and ownership structure. At the sector level, the health care industry is highly regulated; the government is an important payer for health care services and products. There are also regulations involving safeguarding patient information, safety testing, monitoring and manufacturing quality, and marketing compliance. Noncompliance with these regulations, improper billing for services and products, aggressive marketing tactics, pricing manipulation, and failure to protect patient privacy have surfaced within the sector and can affect ratings.
ABBVIE PROVIDES SOCIETAL BENEFITS BY PRODUCING LIFE-EXTENDING DRUGS IN DIFFICULT-TO-TREAT THERAPEUTIC AREAS SUCH AS ONCOLOGY, IMMUNOLOGY, VIROLOGY, AND ENDOCRINOLOGY, RATHER THAN THE LIFESTYLE DRUGS THAT SOME PEERS ARE INVESTING IN. THE COMPANY SPENT ABOUT $5 BILLION ON R&D IN 2018. ITS R&D INVESTMENT HAS HELPED IT OBTAIN MARKET LEADERSHIP IN CERTAIN AREAS, ENABLED IT TO MAINTAIN HIGH PROFITABILITY, AND SUPPORTS ITS BUSINESS RISK. HOWEVER, INCREASED PUBLIC SCRUTINY ON DRUG PRICES ARE INCREASING SOCIAL RISKS THAT COULD HAMPER ABBVIE’S AND THE WIDER INDUSTRY’S PROFITABILITY AND GROWTH. THE COMPANY COMMITTED TO RAISING PRICES ONLY ONCE A YEAR AND BELOW A DOUBLE-DIGIT PERCENT. IN 2019, IT EXPECTS NET PRICE INCREASES IN THE U.S. IN THE LOW-SINGLE-DIGITS, IN LINE WITH INFLATION. THE DEBATE ON REBATES ALSO COULD AFFECT ABBVIE’S CREDIT QUALITY. ALCON IS A LEADING COMPANY IN EYE CARE PRODUCTS AND SURGICAL EQUIPMENT, OFFERING A VARIETY OF PRODUCTS TO COVER ALL PRICE RANGES, WHICH ALSO ENABLES ACCESSIBILITY IN LESS DEVELOPED COUNTRIES. ITS INVESTMENT INTO INNOVATION FOCUSES ON HIGHER PERFORMANCE LENSES, ROBOTICS, AND CONNECTIVITY TO ADDRESS THE TRENDS IN HEALTHCARE MARKETS—HIGH PERFORMANCE, PRECISION, DATA ANALYTICS, AND SAFETY. DESPITE ITS EFFORTS, IT’S NOT IMMUNE. IN 2018 IT VOLUNTARILY WITHDREW CYPASS, MICRO-STENTS FOR SURGICAL GLAUCOMA. THE WITHDRAWAL OF CYPASS WAS NOT RELATED TO A MANUFACTURING OR QUALITY ISSUE, BUT BASED ON AN ANALYSIS OF A LONG-TERM SAFETY STUDY THAT SHOWED POTENTIAL ENDOTHELIAL CELL LOSS POST-SURGERY. WE DON’T ANTICIPATE THAT THE RECALL WILL AFFECT THE RATING, BUT IT’S IMPORTANT THE COMPANY MAINTAIN A GOOD PRODUCT SAFETY PROFILE.

ALLERGAN PROVIDES SOCIAL BENEFITS BY DEVELOPING SAFE AND EFFECTIVE LIFE-ENHANCING DRUGS IN AREAS SUCH AS EYE CARE, CENTRAL NERVOUS SYSTEM, AND GASTROENTEROLOGY, ALTHOUGH A SIGNIFICANT PORTION OF REVENUE RELATES TO AESTHETICS, WHICH WE BELIEVE PROVIDES LESS OF A SOCIAL BENEFIT. AESTHETICS PRODUCTS ARE CASH PAY AND MORE DISCRETIONARY, AND MUCH LESS EXPOSED TO SOCIAL PRESSURE ON PRICES AND REIMBURSEMENT. IN 2018, THE COMPANY INVESTED $2.3 BILLION IN R&D, OR ABOUT 14% OF REVENUES. HOWEVER, INCREASING SCRUTINY OF PHARMACEUTICAL PRICES IN THE U.S., WHICH ARE MUCH HIGHER THAN IN OTHER AREAS AND PERsistently RISE MORE QUICKLY THAN INFLATION, HAVE INCREASED SOCIAL RISKS THAT COULD HAMPER ALLERGAN’S PROFITABILITY AND GROWTH. IN ADDITION, IT HAS BEEN NAMED IN LAWSUITS RELATED TO THE MARKETING OF OPIOID PRODUCTS.

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We believe Amgen provides significant social benefits by investing in the development of safe and effective life-extending and life-enhancing drugs in therapeutic areas such as immunology, oncology, and cardiovascular disease. In 2018, the company invested $3.7 billion in R&D, or about 16% of revenues. However, increasing scrutiny of pharmaceutical prices in the U.S., which are much higher than in other areas and persistently rise more quickly than inflation, have increased social risks that could hamper Amgen’s profitability and growth.

AstraZeneca PLC  (BBB+/Stable/A-2)  

From a sustainability point of view, supplying new and innovative medicine is key to credit quality. AstraZeneca is recognized as one of the most innovative companies in the industry. It spent almost $6 billion in R&D in 2018. The group manages about 130 projects in its clinical pipeline, of which about 20 are in phase III and five are pending regulatory approval. It has been recognized as a leader in applying artificial intelligence (AI) in early clinical trials, which should help improve the efficiency of developing of new drugs. Recently launched drugs are posting strong revenue growth, helping offset older drugs’ pricing pressure. Pricing strategy and medicine accessibility are also important in managing reputation. AstraZeneca, via its access health care program, offers assistance to help with medicine costs. It also promotes awareness of noncommunicable diseases, among other initiatives. However, increasing scrutiny around pharmaceutical prices in the U.S., the largest market for medicine, could hamper AstraZeneca profitability and growth prospects, if not managed wisely.

Bausch Health Cos. Inc.  (B/Stable/--/-)  

Under previous management, Bausch had focused on acquiring products, cutting costs, and at times raising prices, but the company has shifted to focusing on internal R&D. We believe Bausch Health provides social benefits and is increasing its investment in developing safe and effective life-prolonging and life-enhancing drugs and medical devices. In 2018, the company invested $431 million in R&D, or about 5% of revenues. While this is still relatively low compared to other pharmaceutical and biotech companies, the company is planning to steadily increase its R&D. However, increasing scrutiny of pharmaceutical prices in the U.S., which are much higher than in other areas and persistently rise more quickly than inflation, have increased social risks that could hamper Bausch’s profitability and growth. The company has been embroiled in the debate regarding relying on pricing increases, rather than innovation and new products, for growth. Bausch has increased its R&D spending, relied less on pricing increases in recent years, and has employed a more balanced approach to growth.

Bayer AG  (BBB/Stable/A-2)  

The steadily growing and aging global population presents fundamental challenges in health care and nutrition. Bayer, which deals with health care and agriculture products, will have to keep investing in new technologies to provide safe and effective solutions and react to the changing environment. Innovation is key for both segments. In 2018, Bayer invested about €5.2 billion (16% of revenues) in R&D. In health care, its focus will be on external innovation and collaborations, but it will have also to maintain internal capabilities to become a preferred partner for drug development. We believe that investments into improving patient compliance and efficiency in R&D are important to maintain margins as payers increasingly scrutinize drug prices. In crop science, product innovation in seeds and crop protection should continue to drive more stable and potentially higher agriculture yields in an environment affected by climate change. Development of customized digital solutions for farmers, like advanced seed scripting tools, should provide a significant competitive advantage. While focusing on future products’ safety and efficacy, Bayer also needs to manage risks from its legacy products to maintain credit quality. In pharma, the company recently settled a lawsuit in the U.S. on its bestselling drug Xarelto. It also faces litigation in the U.S. over glyphosate, an active ingredient contained in herbicide product Roundup (originally a Monsanto product). We believe how the company will manage its reputation and potential cash outflows resulting from court judgements or potential settlements will be an important credit factor.

Bristol-Myers Squibb Co.  (A-/Watch Neg/A-1+)  

Increased public scrutiny of high drug prices and the transparency of drug prices are increasing risks that could hamper Bristol-Myers and the wider industry's profitability and growth. Against this backdrop, we believe Bristol-Myers operates sustainably. The company’s R&D spending is relatively high, even compared with that of larger peers, at about 28% of revenue. Furthermore, the company focuses its efforts on developing life-extending drugs, rather than lifestyle ones, in difficult-to-treat areas such as oncology, immunology, and cardiology, and was a pioneer in a breakthrough in immune-oncology. We believe that this focus on life-extending, innovative therapies somewhat
mitigates Bristol-Myers’ exposure to broader industry criticism that pharmaceutical prices are too high. The company did not increase net prices in 2018 and does not expect to in 2019. Bristol-Myers is positioned well if the industry moves to value-based reimbursement. The company uses two of its oncology drugs, Opdivo and Yervoy, for combination therapy, which it could bundle, and its pending acquisition of Celgene might provide opportunities for further bundled therapies.

Cardinal Health Inc. (BBB+/Stable/A-2)  U.S.  Tulip Lim

The aging population and growth of lower-cost generic drugs, which are more profitable for Cardinal, are tailwinds for the industry. Increased public scrutiny on drug pricing and price transparency could be risks to profitability. We believe branded drug pricing pressure will not cause absolute EBITDA to decline in the next two years, we expect generic deflation to be a modest headwind, and we do not incorporate the risks of rebate removal into our base-case projections. In addition, the company is a defendant in various lawsuits. We have adjusted debt upward for product liability lawsuits for which Cardinal has already accrued expenses, such as those for the Cordis IVC filter. Regarding opioid lawsuits, given the uncertainties surrounding the size and timing of a settlement, we have not incorporated a settlement in our base-case scenario, although it could be material for distributors. For now, the company has limited capacity because of elevated leverage following the acquisition of the patient recovery business from Medtronic PLC. However, we believe that a near-term settlement is unlikely and Cardinal could build capacity with its sizable discretionary cash flow generation.

Community Health Systems Inc. (CCC+/Negative/--)  U.S.  David P. Peknay

We believe social factors are more material for the rating on Community than environmental ones. Hospital companies must adapt to the changing landscape to meet the challenges of health care reform. This entails strong, sophisticated management to understand the issues, and follow the appropriate strategy. Although Community is one of the largest for-profit hospital companies in the U.S., it did not adapt as well as its peers over the past several years, leaving it with significant debt leverage, weak patient volumes, and deteriorating financial performance. Coupled with significant debt maturities in the next few years and an identifiable risk of default, we downgraded it to ‘CCC+'. The company has had to make some strategic changes, including selling a large number of hospitals and implementing a new business strategy. These efforts could help Community better manage reimbursement risk, defend market share in its key markets, and improve margins. However, we think the company’s governance practices are in line with industry standards, mitigating this risk.

CSL Ltd. (A-/Stable/A-2)  Australia  Sam Playfair

As one of the world’s leading providers of biotherapeutics, social factors are an integral part of our analysis of CSL. The company continues to develop innovative biotherapies that address unmet medical needs or enhance current treatments. The CSL’s R&D activities support innovation in new products and technology, improving products, and manufacturing expertise. We believe this has helped the company obtain market leadership and enabled it to maintain high profitability, which supports its business risk. In our view, the major industry risks come from contamination, which could have a sizable impact on businesses within the plasma industry. That said, there is strict regulatory oversight of the industry and CSL maintains strong operational capabilities and risk management expertise.

CVS Health Corp. (BBB/ Stable/A-2)  U.S.  Andy Sookram

There are ongoing public debates around the role of PBMs, price transparency, spiralling health care costs, and the opioid crisis. CVS’ recent acquisition of Aetna creates opportunities to address some of these concerns. Quality and safety of products and services, data privacy, and cybersecurity breaches are also areas of focus. We believe the company has ample financial resources to address moderate issues if they occur, or proactively invest in its systems and labor workforce.

Danaher Corp. (A/Watch Neg/A-1)  U.S.  Arthur C. Wong

For Danaher, we believe ESG factors have a limited impact on the rating. But, we believe the company provides solutions to address environmental and social issues. Danaher’s main divisions are environmental and applied solutions, life sciences, and diagnostics. The company’s products are used mainly in the R&D and production of life-extending pharmaceuticals and diagnostics for improving patient health. Danaher’s products are also used to analyze, treat, manage, and improve water supplies, such as municipal water sources, lakes, streams and oceans—a major worldwide initiative. We see increasing emphasis on air and water safety testing and purification in both industrialized and emerging economies.

DaVita Inc. (BB/ Stable/--)  U.S.  Ji Liu, CFA

Social factors are an integral part of our credit analysis of DaVita. We believe that reimbursement risk is a key credit constraint. The dialysis industry has attracted controversy in recent years and public opinion toward it has been negative. As a top two dialysis operator in the U.S., the company’s policies are highly visible and have been under public scrutiny. DaVita has faced multiple regulatory challenges since 2016, principally around steering patients to much higher-paying commercial payers, that if implemented would have impaired profitability and hurt credit metrics. In late 2016, the industry’s alleged practice of steering Medicaid-eligible patients to sign up instead for commercial payers, a third-party charity program that helps dialysis patients pay their insurance premiums, allowing patients to obtain higher-paying commercial coverage. The federal government (through CMS) and various states (such as California) tried to introduce measures regulating

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Charitable premiums, which we believe could shift payer mix away from higher-paying commercial payers. DaVita has estimated a potential EBIT impact from this of $100 million-$250 million (about 12% of total EBIT), if CPA was eliminated in the market. There have also been other unsuccessful labor union-backed attempts to cap profitability, which could have significant financial ramifications. Although all of these challenges were unsuccessful, we believe there is a risk that some of these or similar proposals will be reintroduced in the next couple of years.

Endo International PLC (B/Stable/--)

Relative to other health care companies, we see social risk as somewhat elevated for Endo given that it is a defendant in a large number of opioid litigation lawsuits. Endo marketed an opioid product, Opana ER, which had a high rate of abuse. The company withdrew it from the market in 2017. Given the uncertainties surrounding the size and timing of a judgment or settlement, we have not incorporated a cash payout in our base case. In addition, Endo has made significant cash payments related to prior product liability (pelvic mesh) and other litigation. Moreover, increasing scrutiny of pharmaceutical prices in the U.S., which are much higher than in other countries, raise social risks that could hamper Endo’s future profitability and growth. Endo’s portfolio of drugs includes life-extending and life-enhancing branded and generic drugs across a number of therapeutic areas. The company traditionally focuses less on discovery and development of innovative, new-in-kind medicine, and its R&D is below the industry average (about 5% in 2017 and 6% in 2018). This is partially because Endo invests mostly in developing generic products and drugs through the 505(b)(2) U.S. regulatory pathway, requiring a lower R&D investment than novel pharmaceutical products. Endo’s branded (non-generic) pharmaceutical pipeline is currently focused on a new application for an aesthetic product that we view as less critical to human health but also less exposed to reimbursement risk.

EssilorLuxottica (A/Stable/A-1)

We see governance as a significant credit driver of our assessment of EssilorLuxottica. We noted public friction at the board level in past months, and its largest shareholder, Delfin, filed an arbitration request to verify the compliance of power-sharing at the board. The 2017 combination agreement questions the board’s effectiveness to steer the company toward profitable growth. On May, 13, 2019, EssilorLuxottica and Delfin agreed to end all current disputes and legal proceedings, including the arbitration request. In terms of social factors, the group plays a key role in ensuring and improving the vision of hundreds of millions of people worldwide. It achieves this through significant R&D spending and superior technology for both lenses and frames, as well as through its commitment towards sustainable development. To support its brand reputation and legacy and to increase awareness surrounding eye care, it makes its products accessible and affordable, including to lower-income people. The group also undertakes both local and global philanthropic initiatives to enable the most destitute people to have access to vision correction. The group is also trying to optimize the use of natural resources and reduce its environmental footprint across the value chain, from manufacturing to distribution by reducing energy and water consumption to address climate change and to reduce waste.

Eli Lilly & Co. (A+/Stable/A-1+)

We believe Eli Lilly provides significant social benefits by investing in the development of safe and effective life-extending and life-enhancing drugs in therapeutic fields such as diabetes and oncology. In 2018, the company invested $5.3 billion in R&D, about 22% of revenues. However, increasing scrutiny of pharmaceutical prices in the U.S., which are much higher than in other areas and persistently rise more quickly than inflation, raise social risks that could hamper Eli Lilly’s profitability and growth. Moreover, the company and pharmaceutical peers that sell insulin products have been the focus of criticism given insulin prices and affordability issues among some groups of patients, despite various patient access programs, and very high rebates Eli Lilly pays to pharmacy benefit managers. As a partial response, the company announced in March 2019 plans to launch an authorized generic version of Humalog (in the U.S. at 50% below the list price, which lowers out-of-pocket costs to many patients (i.e. those whose out-of-pocket costs are tied to list prices) and also increases demand for the company’s products.

Fresenius SE & Co. KGaA (BBB-/Positive/A-3)

Via its subsidiary Fresenius Medical Care, Fresenius provides life-extending dialysis treatments. However, it has a high exposure to the U.S. market, where there have been attempts to change reimbursement. The company is exposed to potential pricing pressure and negative publicity. Recently, there was an attempt in California to cap profitability of private dialysis providers, which was defeated. As such, the management of regulatory affairs and reimbursement risk in this key market is a major factor in our view of governance and the rating. In addition, as a geographically diversified company with a presence in developing countries, it is important that Fresenius monitors compliance with regulatory demands. In terms of sustainability, it helps to addresses the growing need for affordable medication with a broad range of generic products. Via its Helios division, to ensure sustainable growth and to address changes in demographics and the trend of volumes shifting to outpatient settings from inpatient settings and other regulatory changes, the company is investing in processes, infrastructure, and staff to meet new and future requirements, albeit at the cost of slightly lower near-term margins.

Gilead Sciences Inc. (A/Stable/--)

We believe Gilead provides significant social benefits by investing in the development of safe and effective life-extending and enhancing drugs in therapeutic areas such as HIV and hepatitis C (HCV). In 2018, the company invested $5 billion (or about 23% of revenues, in R&D. However, increasing scrutiny of pharmaceutical prices in the U.S., which are much higher than in other areas and persistently rise more quickly than inflation, raise social risks that could hamper the company’s profitability and growth. Moreover, Gilead was widely criticized...
for its $1,000 per pill price for Sovaldi (or $84,000 for the 12-week treatment) despite the remarkable social benefits of providing a cure (as opposed to just a treatment) for HCV. Despite that, we believe the company is more progressive than peers regarding drug pricing and social responsibility. For example, Gilead does not materially increase prices when next-generation HIV products are introduced, but rather uses that to strengthen its market share and increase the rate of adoption. In January 2019, the company launched an authorized generic version of Epclusa and Harvoni (HCV) in the U.S. at a list price of $24,000 (comparable to the net price for these products), which lowers out-of-pocket costs to many patients and increases demand. The company also licenses a generic version of its HIV drugs without profit for patients in developing countries.

GlaxoSmithKline PLC (A+/Negative/A-1) U.K. Guiseppe Setzi

We believe GSK provides significant social benefits by investing in the development of safe and effective life-extending and life-enhancing drugs. GSK is a leading drug provider for people suffering from HIV. HIV is a global problem and R&D is focused on developing treatments in both developed (recently launched Juluca) and developing countries (via ViiV Healthcare it is developing treatments for children and adolescents). GSK has also developed innovative treatments for asthma. New tri-therapies and biologic products (Nucala) now provide enhanced benefits to patients. Lastly, GSK recently launched a best-in-class vaccine against shingles. In 2018, the group spent slightly less than £4 billion in R&D, refocusing on immunology and oncology. The company is also investing in the researching malaria, tuberculosis, and neglected tropical diseases to address the needs of developing countries. However, increasing scrutiny of pharmaceutical prices could affect GSK’s profitability and growth. For its part, the company is constantly striving to enhance access to medicine in poor countries and provide assistance programs in developed countries. It has consistently ranked at the top of the Access to Medicines Index since it began in 2008. In some developing countries, it neither files patents for medicines nor forces historical ones. This allows generic companies to manufacture and supply generic versions of GSK medicines in those countries.

HCA Healthcare Inc. (BB+/Stable/--/--) U.S. David P. Peknay

For HCA, we believe social factors are more material to the rating than environmental ones. Hospital companies must adapt to the changing landscape to meet the challenges of health care reform. This entails strong, sophisticated management to understand the issues and follow the appropriate strategy. HCA has been the leader in this regard against for-profit hospital company peers. The company has effectively operated as an integrated delivery system with strong local market strategies. This has helped it better manage reimbursement risk, gain market share, and generate strong margins. Its margins are the highest among its peer group, and we expect this to continue. Also, HCA’s governance has effectively managed its historically aggressive financial policy, which is to give all free cash flow back to shareholders.

Johnson & Johnson (AAA/ Stable/ A-1+) U.S. David A. Kaplan, CFA

We believe JNJ provides significant social benefits by investing in the development of safe and effective life-extending and life-enhancing drugs and medical devices. In 2018, the company invested $10.7 billion in R&D, or about 13% of revenues. However increasing scrutiny of pharmaceutical prices in the U.S., which are much higher than in other areas and persistently rise more quickly than inflation, have increased social risks that could hamper JNJ’s profitability and growth. Moreover, the company is being sued for billions of dollars, including allegations it sold talc-based powder products that contained asbestos fibers, in its consumer segment. It has also been named in lawsuits related to the marketing of opioid products. The company has $10 billion-$15 billion in incremental debt capacity within the rating and generates about $9 billion in discretionary cash flow annually (after dividends), which we expect will be more than sufficient to satisfy any legal obligations.

Koninklijke Philips N.V. (BBB+/Stable/A-2) Netherlands Maxime Puget

Philips has been recognized for leading sustainability efforts. In our rating, we consider the company’s strategy to address a shift to value-based health care initiatives; that is, efforts to curb health care spending in the light of aging populations and the rise of chronic diseases. Philips is focusing on integrated forms of health care, developing medical technologies that help clinicians deliver better diagnoses and treatment, and cloud-based technologies that support data sharing and analysis, which in turn should enable more effective, lower-cost integrated health solutions. It is also preparing its business for a future where value is shifting from stand-alone products to solutions combining systems, smart devices, software, and services. This also applies for its consumer products division, where customers are increasingly interested in healthy living and prevention and are looking for new ways to proactively monitor and manage their health.

Mallinckrodt PLC (B+/Watch Negative/--) Ireland Matthew D. Todd, CFA

We see social risk as somewhat higher for Mallinckrodt than peers, primarily because of litigation related to its top product, Acthar gel. Payers, doctors, and patients view Acthar gel as expensive because the price was raised significantly (by Questcor Pharma, the prior owner) and the product has not faced competition for much longer than a typical branded pharmaceutical product. The company is also a defendant on a federal department of justice complaint alleging Questcor improperly promoted the product. In addition, the company manufactures, distributes, and markets opioid products, exposing it to recent social concerns and subsequent potential legal and regulatory action. Given the uncertainties surrounding the size and timing of legal expenses, we have not incorporated a settlement payout in our base case. The company announced plans to divest its specialty generics business, and we believe the divestment, if completed, would reduce the company’s exposure to opioid litigation risk. However, increasing scrutiny of pharmaceutical prices in the U.S., which are
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much higher than in other countries, raise social risks that could hamper Mallinckrodt’s future profitability and growth. We think these factors are only somewhat offset by the fact that Mallinckrodt’s portfolio of drugs include life-extending and life-enhancing drugs in immunology, neonatal respiratory critical care, and analgesics. The company traditionally focused on acquiring products rather than internal development, but it has been increasing R&D investment. In 2018, R&D as a percentage of revenue grew to 11% from under 8% in 2016.

Mckesson Corp. (BBB+/Stable/A-2)  U.S.  Tulip Lim

For McKesson, the aging population and growth of lower-cost generic drugs, which are more profitable for the company, are tailwinds for the industry. However, increased public scrutiny on drug pricing and price transparency could be risks to profitability. We believe branded drug pricing pressure will not cause absolute EBITDA to decline in the next two years. We also expect generic deflation to be a modest issue, and have not incorporated the risks of rebate removal into our base-case projections. In addition, the company faces opioid-related litigation and expenses. Given the uncertainties surrounding the timing and size of a settlement, we have not incorporated a settlement payout in our base-case scenario, although it could be material for the distributors. We expect the company to generate $2 billion in discretionary cash flow, so it could pay a sizable settlement without affecting the rating, especially if it were one-time.

Medtronic PLC (A/Stable/A-1)  Ireland  Maryna Kandrukhin

Medtronic is one of the world’s leading companies for sustainability. The company focuses on the ESG issues that are material to its long-term success, including access to health care, product quality and patient safety, ethical business practices, responsible supply management, employee engagement and development, human rights, and environmental stewardship. At the same time, and like many of its peers, Medtronic remains exposed to industrywide ESG risks, including rising global health care costs and limited price transparency of health care products in some markets. While Medtronic does not have direct reimbursement exposure, most of its customers do, which compels them to negotiate tighter contract terms with medical device manufacturers. Over the past decade, the company has been navigating moderate pricing pressure stemming, among other factors, from global health care cost-containment efforts affecting its customer base. While we do not expect this factor to have any effect on the rating over the next several years, we incorporate it into our analysis as a key long-term industry risk.

Merck & Co. Inc. (AA/Stable/A-1+)  U.S.  David A. Kaplan, CFA

We believe Merck provides significant social benefits by investing in the development of safe and effective life-extending and life-enhancing drugs in therapeutic areas such as oncology, diabetes, and vaccines. In 2018, the company invested $9.8 billion in R&D, or about 23% of revenues. However increasing scrutiny of pharmaceutical prices in the U.S., which are much higher than in other areas and persistently rise more quickly than inflation, have increased social risks that could hamper Merck’s profitability and growth.

Merk KGaA (A/Stable/A-1)  Germany  Remi Bringuier

Merck is both a pharmaceutical and chemical company. Its life science division, which provides solutions and testing capabilities to the industry, and its pharmaceutical division accelerate access to health globally. The group’s fight against worm disease, or schistosomiasis, in Africa is a good example. Merck’s approach is to ensure availability, affordability, and accessibility of its products, as well as patient awareness. The group’s performance material division contributes to environmental sustainability: new display technologies both with liquid crystals and organic light-emitting diodes (OLEDs) are an example. OLEDs lower the power consumption of some electronics. In the cosmetics industry, Merck is addressing the continuing trend for ingredients that meet stringent sustainability criteria. The group’s portfolio of fillers dispenses entirely with microplastic particles, which have been criticized for polluting waters and harming marine life. Merck is looking for greener alternatives, such as the new solvent Cyrene. Cyrene is derived from waste cellulose and is employed as an alternative to solvents that are widely used but under increasing regulatory restrictions due to their associated toxicity.

Möllycyle Holding AB (BBB-/Stable/A-3)  Sweden  Marketa Horkova

With its broad portfolio of wound care and surgical products, Möllycyle is helping to address issues rising from the aging population an increase in chronic conditions and society’s rising expectations of care. It is investing about 5% of revenues into R&D and clinical trials to bring to market innovative products that promote efficient wound healing, increases efficiency in the operating rooms, and ensures doctor and patient safety. Möllycyle also demonstrates cost efficiency to health care providers and helps to curb their spending. The company has clearly stated targets to reduce the consumption of materials and resources, avoiding waste wherever possible and reduce carbon dioxide emissions from product related transportation. During 2015-2018, it missed some of its targets within those areas.

Mylan N.V. (BBB-/Negative/A-3)  Netherlands  Matthew D. Todd, CFA

We believe Mylan provides significant societal benefits by developing and manufacturing cost effective, safe, and high-quality generic and novel life-extending drugs. A recent report estimates that generic drugs saved the health care system $265 billion in 2017 just in the U.S., and Mylan has launched more generic products over the past five years than any other company. The U.S. generic pharmaceutical industry has seen considerable price pressure in that time from competition, but we believe that the industry is generally viewed as an instrument to lower the overall cost of health care. However, increasing scrutiny of pharmaceutical prices in the U.S., which are much higher than in other areas, have increased social risks that could hamper Mylan’s profitability and growth. The company was scrutinized for the out-of-pocket
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cost for its EpiPen product, but price reductions, competition, and revenue declines have largely satisfied the criticism. In addition, Mylan manufactures, distributes, and markets opioid products, exposing the company to recent social concerns and subsequent potential legal and regulatory action. However, we believe Mylan’s generic opioid products expose the company to less legal risk than peers because its small revenue contribution and lesser marketing activity for these products.

Novartis AG (AA-/Stable/A-1+)

We believe that innovation that produces breakthrough, life-extending medicines will remain the cornerstone of business sustainability in the pharmaceutical industry. In our opinion, Novartis is well positioned, with one of the best pipelines in the industry. The company has more than 200 projects in its development pipeline, with 23 molecules approved in 2018 and 33 projects under regulatory submission. To support drug development, Novartis invests about 18% of its revenue per year into R&D (approximately €7.6 billion). The company also invests in developing treatments for infectious and neglected tropical diseases such as malaria or sleeping sickness, where returns on investments will likely be low, but social impact high, with a corresponding R&D budget of about €24 million. Novartis participates in the transparency of clinical testing initiatives, which aim for greater cohesion in global medical science. For the highly innovative, but also highly priced medicines, we see a new model emerging, where pricing is based on the value measured by health outcomes relative to the care package. Novartis is one of the first companies to start entering value-based contracting for its medicines. The company is also at the forefront of initiatives to make medicine accessible. Launched in 2015, Novartis Access offers a portfolio of 15 on- and off-patent medicines addressing cardiovascular diseases, type 2 diabetes, respiratory illnesses, and breast cancer diseases. These medicines are offered to governments, nongovernmental organizations, and other institutional customers at a price of $1 per treatment, per month.

Novo Nordisk A/S (AA-/Stable/A-1+)

Novo Nordisk spent about $2 billion in R&D in 2018. As one of the world’s leaders for diabetes care, it has accomplished breakthrough improvements for the about 500 million people suffering from diabetes. The move from human insulin to modern and now new generation insulin improves convenience and patient compliance. In connection with obesity and cardiovascular diseases, diabetes care is a life-extending therapy. Novo Nordisk currently manages about 20 projects in its clinical pipeline, with a couple of drugs submitted for regulatory approval. However, the company might face increasing pricing pressure in the U.S. It has been criticized there for the rising out-of-pocket costs for insulin, but we believe the proposal to remove rebates will not have a material credit impact. Novo Nordisk has also tried to facilitate access to medicines in the U.S. and less developed countries. The company works to remove barriers to effective diabetes care with a guarantee to make low-priced human insulin available in less developed countries and humanitarian relief organizations.

Pfizer Inc. (AA/Stable/A-1+)

We believe Pfizer provides significant social benefits by investing in the development of safe and effective life-extending and life-enhancing drugs in therapeutic areas such as immunology, oncology, and vaccines. In 2018, the company invested $8 billion in R&D, or about 15% of revenues. However increasing scrutiny of pharmaceutical prices in the U.S., which are much higher than in other areas and persistently rise more quickly than inflation, have increased social risks that could hamper Pfizer’s profitability and growth.

Roche Holding AG (AA/Stable/A-1+)

Roche has been a pioneer in oncology and innovative leader for the second generation of cancer drugs, notably with the HER2 therapy, a breakthrough for breast cancers. Roche is now at the forefront of R&D for the third wave of cancer therapies: immuno-oncology. It is also improving the lives of patients suffering from multiple sclerosis and hemophilia. The group has 67 new molecular entities (NMEs) and 70 As in development, of which about 45 are in phase III. The group obtained 26 breakthrough therapy designations in six years, positioning it at the very top of the pharmaceutical industry in terms of R&D. However, increasing scrutiny of pharmaceutical prices could affect Roche’s profitability and growth. In terms of accessibility, the group is at the forefront of initiatives to bring medicine to patients in emerging markets. The strategy is to develop partnerships for tailored solutions country by country. The group’s initiatives mostly focus on cancer care, but Roche is also contributing to eradicating HIV through its diagnostics division. It is a leading provider of HIV viral load testing in Africa.

Sanofi (AA/Negative/A-1+)

Business sustainability based on innovation that produces breakthrough medicines, with demonstrable improvements in clinical outcomes in relation to the cost of care, are key to the rating. Sanofi has a long-term aspiration that about 80% of its portfolio will consist of molecules with first-in-class or truly differentiated best-in-class potential, with two-thirds of biologic compounds and two-thirds of the pipeline directly derived from the company’s internal research. Its R&D expenditures amounted to €5.9 billion in 2018, or about 17% of revenues. At Feb. 1, 2019, Sanofi’s R&D pipeline contained 81 projects including 33 NMEs and vaccine candidates in clinical development. Besides the expansions of complex antibodies and the addition of nanobodies with the integration of the Ablynx platform, the company has made important progress in genomic medicines. However, Sanofi might face increasing pricing pressure, particularly in the U.S. The company has been criticized there for the rising out-of-pocket costs of insulin, but we believe the current proposal to remove rebates will not have a material credit impact. At the same time, Sanofi invests in less-developed countries and areas. Since 2011, the company has made available its library of proprietary data on neglected tropical diseases (NTDs) to the Drugs for Neglected Diseases initiative and has continued to invest in R&D programs on malaria, tuberculosis, and NTDs.
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Takeda Pharmaceutical Co. Ltd. (BBB+/Negative/A-2)  
Japan  
Makiko Yoshimura

We believe ESG risks are not material rating factors for Takeda. Although we believe the company has potential exposure to social risks such as drug safety, we believe it will likely manage them. In the early 2010s, Takeda faced a large-scale lawsuit over its in-house diabetes drug, which was its top-selling product, and paid a large settlement of about ¥290 billion. The case was not the direct driver of a downgrade, but the downward pressure on the rating increased temporarily because settlement payments drastically reduced cash on hand. Takeda is still involved in multiple lawsuits and has accrued provisions for litigation (approximately ¥23.2 billion for the company and US$76.2 million for its recently acquired subsidiary, Shire, in fiscal 2018), but we believe Takeda can sufficiently pay the provisions with its free operating cash flow of over ¥500 billion. Therefore, we believe the impact on the company's credit quality is limited. In terms of increasing pricing pressure on its drugs globally, Shire will increase Takeda's exposure to the U.S. market significantly, where we believe pricing pressure is increasing. We believe this pressure will not affect the rating because the company focuses on rare diseases and life-enhancing drugs, rather than lifestyle ones.

Tenet Healthcare Corp. (B/Positive/--/--)  
U.S.  
David P. Peknay

We believe social factors are more material for the rating on Tenet than environmental ones. Hospital companies must adapt to the changing landscape to meet the challenges of health care reform. This entails strong, sophisticated management to understand the issues and follow an appropriate strategy. Although Tenet is one of the largest for-profit hospital companies, it needed to improve its operating strategy. The company made significant management changes and revised both its financial and operating strategy. The company increased its business diversity, rationalized its hospital portfolio resulting in significant divestitures, and implemented an aggressive cost-cutting program. As a result, the company is improving its ability to compete in its key markets and strengthening margins, providing a better path to success. We believe this will continue and was a factor when we revised our outlook on Tenet to positive. Hospitals have often been subject to allegations of billing irregularities, which have resulted in penalties. However, we believe the company's governance practices are in line with industry standards, mitigating these risks.

Teva Pharmaceutical Industries Ltd. (BBB/Negative/--/--)  
Israel  
Matthew D. Todd, CFA

We believe Teva provides significant social benefits by developing and manufacturing cost effective, safe, and high-quality generic and novel life-enhancing drugs. A recent report estimates that generic drugs saved the health care system $265 billion in 2017 just in the U.S., and Teva produces about one in eight drugs administered in that market. The U.S. generic pharmaceutical industry has faced considerable price pressure over the past five years from competition, but we believe that the industry is generally viewed as an instrument to lower the overall cost of health care. Increasing scrutiny of branded pharmaceutical prices in the U.S., which are much higher than in other areas, have increased social risks that could hamper Teva's profitability and growth. In addition, the company manufactures, distributes, and markets opioid products, exposing it to recent social concern and subsequent potential legal and regulatory action. A number of states have filed complaints against Teva and other pharmaceutical manufacturers alleging collusion and racketeering. The size and timing of any cash outflows remains highly uncertain. Because Teva is at the center of the complaint, we suspect the company could face the greatest potential liability.

Thermo Fisher Scientific Inc. (BBB+/Stable/A-2)  
U.S.  
Arthur C. Wong

We believe ESG factors have a limited impact on the rating on Thermo Fisher. We believe the company provides environmental and social benefits given that many of its developed products are used to improve the environment and develop life-extending pharmaceuticals. The company's environmental products are used to analyze, treat, manage, and improve water supplies—a major worldwide initiative. Thermo Fisher's life-science products are also used in R&D, and production of pharmaceuticals. The company has programs to help customers responsibly dispose of Thermo Fisher consumable products. Ongoing controversies on drug pricing have not affected the company.

Walgreens Boots Alliance Inc. (BBB+/Stable/A-2)  
U.S.  
Andy Sookram

We view social and governance factors as moderate risks for Walgreens because of ongoing public scrutiny of spiralling health care costs and opioid abuse. If current proposals aimed at lowering drug prices in the U.S. became law, this could affect the company's profits, albeit less so than peers because it does not have a PBM business. Another focus is adequate controls relating to dispensing prescription drugs or selling tobacco and cigarettes to minors. The Food and Drug Administration recently cited Walgreens for selling more tobacco products to minors than other pharmacy chains, and the agency could block some Walgreens stores from selling tobacco products. If these issues are not remediated, and if potential issues arise from dispensing prescription drugs to unauthorized individuals, fines could result, which could hurt the company's long-term performance.

Appendix: Components In The Sector ES Risk Atlas

Here is a list of examples of factors we consider in evaluating sector-specific environmental exposure. For example, we examine to what extent each sector is relatively exposed to:
Greenhouse gas emissions (GHG): actual or potential regulations such as carbon taxes, emissions trading schemes, and other direct or indirect costs. The GHG emissions under the Kyoto climate change agreement are carbon dioxide (CO2), methane (CH4), nitrous oxide (N2O), hydrofluorocarbons (HFCs), perfluorocarbons (PFCs), and sulfur hexafluoride (SF6).

Sensitivity to extreme weather events: incremental costs or the potential physical impact on assets associated with recurring (for example, hurricanes) or infrequent (droughts) severe weather events.

Sensitivity to water scarcity: potential costs related to the need for extracting or sourcing large quantities of water, or requiring on-site water treatment, in comparison to other water users of the same water basins or utilities.

Waste, pollution, and toxicity: potential fines or rising costs associated with prevention and treatment of waste and pollution, including hazardous waste and air pollution.

Land use and biodiversity: asset retirement obligations, developing natural land or potential operating constraints, or increased costs associated with protecting plant and animal life.

The following is a list of examples of factors we consider in evaluating sector-specific social exposure. For example, we analyze to what extent each sector is relatively exposed to:

Human capital management: a sector’s capacity to develop a long-lasting productive workforce while reducing potential operational disruptions from workforce mismanagement; diversity and inclusion attributes; exposure to strikes and the sector’s general exposure to dealing with emerging skills scarcity or surplus labor.

Changing consumer or user preferences: We recognize that changes in consumer behavior are often the result of complex dynamics, such as changes in technology or fashion or other disruptive business trends. Therefore, we treat a change in consumer preferences as a social factor related to sustainability, health, safety, the environment, privacy, financial mis-selling, or community and human rights, particularly when an entity has triggered the change.

Demographic changes: potential costs or opportunities related to population growth and composition, such as an aging population, urbanization, changing living standards, or a growing middle class

Safety management: potential direct or indirect costs resulting from problems related to the safety of a sector’s production processes and final customer products.

Social cohesion: potential or actual costs in direct operations or in the supply chain resulting from geopolitical or community-related events such as conflicts, community unrest, and terror attacks.

This report does not constitute a rating action.