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CLIENT BULLETIN

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➢ *Healthcare Policy*

One of the presentations at a recent continuing education seminar was titled: "The Changing Healthcare Landscape – Perspectives on Profitability." It was an excellent look at the most likely financial and economic impacts of the Affordable Care Act (ACA) without a political slant. Some of the observations and informed projections (but still just projections) included:

- Healthcare expenditures currently represent 20% of the U.S. economy and growing – we clearly cannot afford to spend 1/5th of our national output on one sector of the economy.
- Medicine has been a "craft" profession with independent practitioners, nothing scarce and price irrelevant. The field of medicine must transition to evidence-based decision-making teams that pay attention to budgets and effectiveness of care.
- The link between health insurance and employment will be decoupled. The penalty under the ACA when an employer drops a health plan is typically cheaper than providing a health insurance plan. As a result, an increasing number of businesses are likely to cancel their health insurance plans in favor of letting employees get coverage on the exchanges.
- More money will flow to health insurance providers that are organized as Affordable Care Organizations (or ACOs – similar to HMOs) that will act as cost centers. As such they will measure everything and focus on providing health, not more healthcare. Keeping people healthy and out of hospitals will become more important because a hospital visit will mean less profitability for the ACO.
- Technology, especially information technology, will take huge strides forward and lead the way in reducing the cost of delivering health.

➢ *Search for Income*

With interest rates at historic lows, many investors are looking for higher-yielding investments to replace their CDs and money market funds. Some are over-reaching in this quest for income and investing in holdings that carry with them significant risks. They may want to look instead to companies with stable dividends derived from recurring revenue models.

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➢ *Razors and Blades*

Although companies shifting to a recurring revenue model are gaining focus, it certainly isn't a new idea. More than a century ago, K.C. Gillette came up with a plan: sell customers an inexpensive razor and then sell them the blades. The real profit was in the thin, inexpensive disposable pieces of stamped steel that men (and women) around the world have been buying over and over ever since. The list of companies that are shifting to a similar recurring revenue model includes the following:

- ***Rolls-Royce***. The British company produced its first aircraft engine in 1914. A century later, the company's engines can be found on commercial jets, fighter planes, helicopters, and ocean liners. Selling engines, however, is not where the company makes their money. The maintenance, repair and overhaul of the engines they sell are worth as much as seven times the original equipment value of an engine. By the end of an engine's life, every part has been replaced, some numerous times.
- ***Diebold.*** This company sells and installs ATM machines, but the bulk of their revenues come from the service contracts for the ATMs, which have a 90% renewal rate.
- ***Verizon, et. al***. These companies may be the classic examples of recurring revenues. By the end of 2018, there will be an estimated 8.2 billion wireless subscriptions in the world (there are only 7.2 billion people) generating $1.2 trillion in total mobile service revenues.

➢ *Corporate Exodus*

Recently some U.S companies have undertaken mergers with foreign corporations to help reduce their tax rates. These ties-ups are called inversions because the larger U.S. company purchases a smaller target company domiciled in a tax-friendlier jurisdiction such as Ireland or the U.K. A reorganization then makes the larger US wing of the new entity a subsidiary of the smaller foreign one thereby allowing the new company to pay the lower foreign corporate tax rate. These transactions are legal under current laws but significantly cut the domestic tax base and eventually ship desirable jobs and profits overseas. Politicians are falling all over themselves vowing to institute new policies and laws that would make these inversions illegal.

➢ *A better Idea*

Instead, Congress should consider ***why*** companies are doing these inversions in the first place. The U.S. corporate tax rate is 35% - the highest in the developed world. This encourages U.S. companies to locate their production and employment in foreign countries. Additionally, the U.S. is one of the few developed nations that taxes a company's worldwide earnings, rather than just domestic earnings. This double tax is due when a company returns its overseas earnings to America, thereby incentivizing companies to leave profits overseas which they have done to the tune of $2 trillion. Asking "How do we stop inversions?' is the wrong question. The right question is "How do we make America a more favorable location for jobs, headquarters and R & D activities?" Congress needs to undertake fundamental, pro-growth tax reform by lowering the corporate tax rate, changing the territorial tax system and scrapping the deductions and special credits in the current tax code and these inversions will not be an issue.

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