Baxter International, a vital supplier of medical products and devices, currently has several major catalysts for earnings normalization. We believe the company's material valuation discount is unjustified.

Baxter International is a diversified manufacturer of essential medical products and equipment, supplying hospitals and healthcare clinics in over 100 countries. In 2022, Baxter was hit by a perfect storm of headwinds that impacted all four of its segments in tandem, sending shares down over 50% to an eight-year low. This considerable decline in valuation for a durable business experiencing some cyclical pain was, in our view, an exploitable value opportunity.

BAXTER'S BUSINESS BREAKDOWN

Baxter has four operating segments, with its core Medical Products & Therapies (MPT) unit accounting for a third of total sales. Through this business, Baxter produces infusion pumps, clinical nutrition products, surgical instruments, and IV fluids—where it maintains a dominant ~70% market share, delivering more than one million IV bags per day.[1] Baxter's Healthcare Systems & Technologies business focuses on durable hospital products, such as smart beds, patient monitoring systems, and surgery room fixtures, while its pharma unit develops generic injectables and inhaled anesthesia. Lastly is Baxter's Kidney Care unit (~30% of revenue)—a stable, but low-margin, mostly non-U.S. business that skews heavily to peritoneal dialysis (PD) home use. Importantly, this business is earmarked to be spun off in 2024 in a transaction we believe could unlock significant value for shareholders.

BAX SHARES REACH CRITICAL CONDITION

Baxter's core earnings are largely a function of hospital utilization. During the pandemic, the company suffered a decline in revenue, as hospital admissions fell to the lowest levels in decades, while surgical procedures also dropped. Volumes rebounded in subsequent quarters but are still yet to fully recover to pre-pandemic levels, weighing on Baxter's top line.

		Earnings Per Share			Price/Earnings		
	Price	FY23E	FY24E	Normal*	FY23E	FY24E	Normal*
Baxter International Inc.	$38.66	$2.59	$2.97	$4.75	14.9x	13x	8.1x

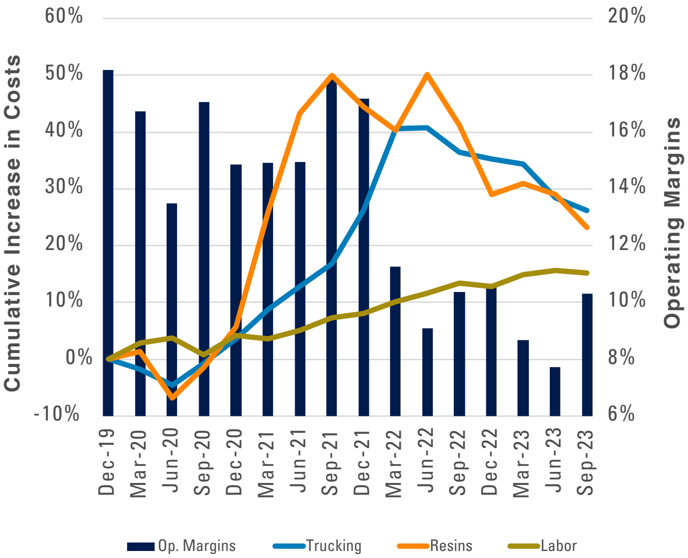
*Fiscal year-end December 29. *Pzena estimate of normalized earnings. Source: FactSet, Pzena analysis. Data as of December 29, 2023.*

Inflation began to rear its ugly head in 2021, increasing Baxter's costs by around $1B, with the breakdown roughly 50% materials, 30% logistics, and 20% labor. Due to the nature of Baxter's core products, which are mostly high-volume commoditized consumables, the manufacturer is particularly sensitive to inflationary pressures and supply chain snarls. Raw material prices like oil-based resins spiked, while fuel costs also swelled, taking a toll on its key medical therapies and renal businesses. Because Baxter's Kidney Care unit is predominantly PD-focused, a key aspect of the business involves the delivery of dialysis products and materials to patients' homes, making last-mile logistical costs especially damaging in an inflationary environment. Additionally, procuring semiconductors became nearly impossible, hindering Baxter's ability to meet demand in its healthcare systems business.

Many of Baxter's current contracts were negotiated with group purchasing organizations (GPOs) six or more years ago, when the notion of 9% headline inflation was inconceivable. As a result, Baxter's long-term, fixed price contracts had no serious price escalators embedded, rendering them far less lucrative once costs spiked, as evidenced by 1H23 margins at their lowest level in seven years (Exhibit 1).

[1] Company filings

Exhibit 1: PPI (indexed to pre-COVID) vs. BAX Margins



Source: FactSet, U.S. Producer Price Index, U.S. Bureau of Labor Statistics

As a result of these combined headwinds, Baxter's forward multiple collapsed from 24.5× just before the March 2020 pandemic sell-off, when it was on par with the industry, to 14.5× in the summer of 2023—41% below the industry.[2] We initiated a position with shares trading around 9× our estimate of the company's normal earnings.

THE OZEMPIC EFFECT

On October 10th, Novo Nordisk announced the early conclusion of its kidney outcomes trial, which aimed to assess whether Ozempic slows the progression of chronic kidney disease, citing significant efficacy. The news sent shares of Baxter (along with peers) down 15% on the premise that its renal business would be permanently impaired. After researching the issue, we determined that the impact to Baxter's normal earnings power, if anything, would likely be de minimis; with shares trading at under 7× our normal earnings estimate, we increased our stake in the company.

MARGIN RESET

Baxter's GPO contracts in the U.S. represent the lion's share of its core MPT revenue and are up for renewal in 2025. We point out that Baxter, as the largest IV manufacturer in the world, has significant scale and global reach, while high barriers to entry make for an attractive oligopolistic market structure. As such, we expect Baxter to negotiate materially better terms for its renewed contracts, which should provide a nice boost to MPT margins even if inflation remains elevated (margins have already begun to inflect even before the updated contracts, as high-cost inventory is being sold down).

While contract renewals are perhaps the most concrete near-term catalyst for earnings normalization, Baxter's management isn't stopping there. The company is taking self-help cost initiatives by increasing plant automation, improving suppliers' direct access (i.e., cutting out middlemen), and reducing single-source suppliers. Baxter has also been divesting non-core assets—most recently, its BioPharma Solutions business—to reduce leverage and simplify the company.

Baxter is expected to spin out its renal business next year, in what has the potential to be a value-accretive corporate action. Management's rationale for offloading Kidney Care is, in our view, sound. The business is distinct from Baxter's core operations, caters to different end users, is internationally focused, low-margin, and highly dependent on payor reimbursements. As such, it doesn't make much financial sense for Baxter to hold onto Kidney Care, and the math underpinning the future transaction is compelling. Earnings are currently depressed due to the aforementioned cost inflation in conjunction with pandemic-induced excess mortality. We estimate that Kidney Care should earn roughly $640M in normal EBITA[3], which equates to an EV of $10.1B[4]. After removing this business from Baxter's current EV of $30B, the pro forma medical products company's EV/ EBITA[5] multiple is roughly 8.2×. This compares

[2] FactSet, Russell 1000 – Medical Equipment and Services industry P/E - NTM

[3] Earnings before interest, taxes, and amortization

[4] Applying an industry median FY22 15.9× EV/EBITA multiple on the renal business

[5] Pzena's estimate of RemainCo's normal EBITA of $2.45B

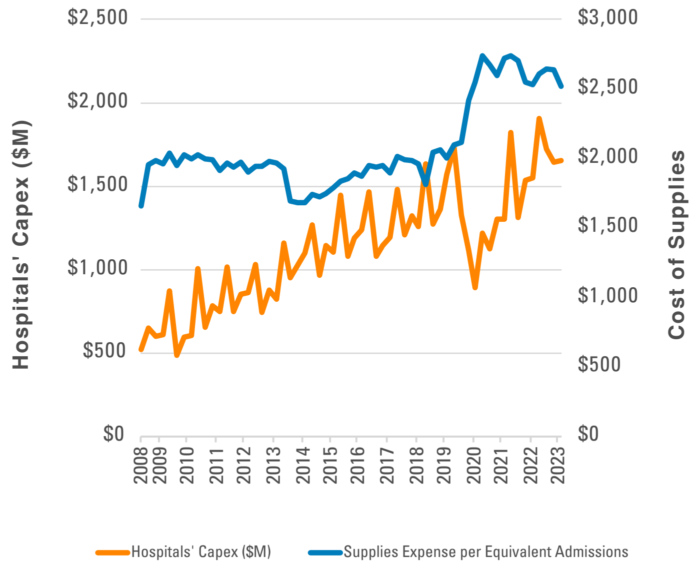
to an industry forward multiple of over 18×[6]—a considerable differential[7] we believe could be narrowed upon a successful spin-off of Kidney Care next year.

SECULAR EARNINGS DRIVERS

Beyond the more near-term tangible profit opportunities, Baxter has several structural tailwinds working in its favor. The pharma business, which has been contending with increased competition in the U.S. generic injectables market, is showing signs of life, as the FDA has become more aggressive post-pandemic. Baxter is also in the process of decentralizing its cost structure. For the first time, segment-level executives will be accountable for their own P&Ls. We believe this could lead to future cost savings and strategic divestments, as management will look to maximize profit at each individual business unit. Additionally, the company is awaiting FDA approval for its latest pump, which is expected to arrive in 2024 and should provide a major boost to its Infusion Therapies business.

Ultimately, Baxter's long-term earnings trajectory will be a function of total hospital expenditures, regardless of any short-term volatility on input costs, patient volumes, payor reimbursements, etc. The reality is that hospitals' outlays have only been increasing over time (Exhibit 2). Considering the nation's aging population, the expectation is for hospital utilization and capacity to keep rising over the long run—the benefits of which should accrue to Baxter, given the medical supplier's discernable economic moat. In fact, the U.S. government projects spending on medical equipment & products to top $277B by 2031,[8] representing a 5.2% CAGR[9] from 2022.

Exhibit 2: Hospital Spending Continues to Rise



Source: Bloomberg Intelligence (equivalent admissions incorporates both inpatients and outpatients).
Data includes only Community Health Systems, Tenet Healthcare Corp., Universal Health Services, and HCA Holdings

CONCLUSION

With hospital staffing back above its pre-pandemic trend, and healthcare job openings down over 28% from 2022's peak,[10] Baxter's end markets are rapidly improving. At the same time, inflation is moderating, while potentially major revenue drivers are on the horizon. The stock's 9.8× forward EV/EBITDA multiple is the lowest (outside of November's reading) since it became a separate company in 2015 (post-Baxalta spin-off), and an indication that the market is severely underappreciating Baxter's normal earnings power—which we estimate at $4.75/share, equating to a multiple of just 8.1×.

[6] Russell 1000 – Medical Equipment and Services
[7] Median NTM EV/EBITDA differential is ~3.1× (monthly data, Dec. '13–Dec. '23)
[8] Centers for Medicare & Medicaid Services projections for durable medical equipment and other non-durable medical products
[9] Compound annual growth rate
[10] FactSet, U.S. Bureau of Labor Statistics, Pzena analysis of Hospitals employment and Health Care & Social Assistance job openings

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Baxter International was held in our Focused Value, Global Focused Value, Global Value, Large Cap Focused Value, Large Cap Value, Mid Cap Focused Value, and other strategies during the fourth quarter of 2023.

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