

*That's OK;  
I'll make it up on volume!*

Future of Medicare Managed Care

August 22, 2000

Health Care Financing Administration

SHERLOCK COMPANY

# *Key Observations*

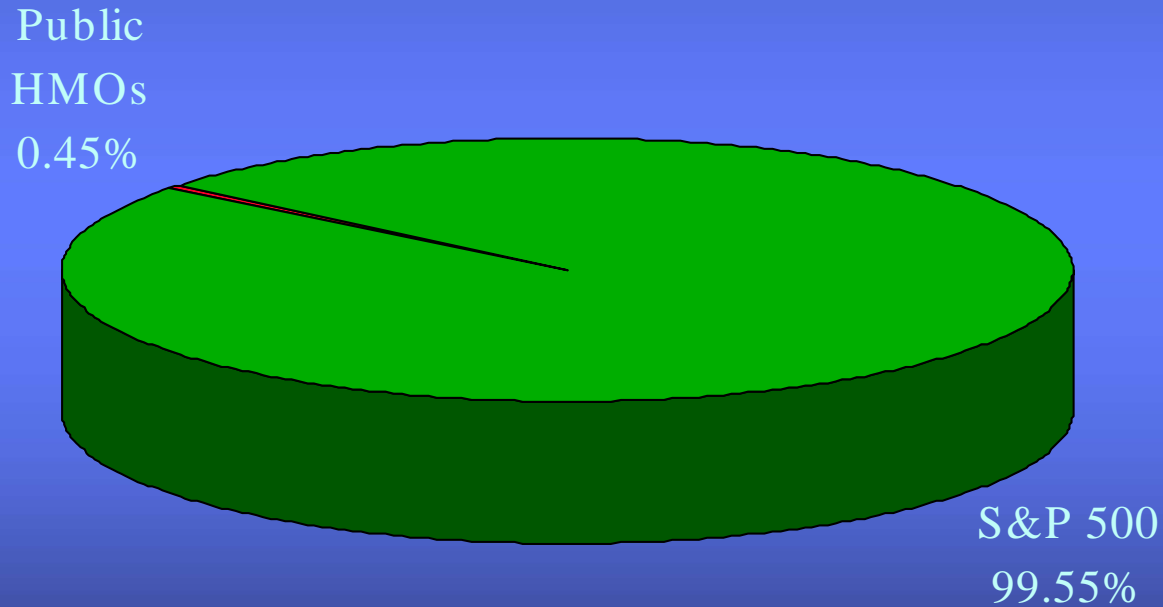
- Small firms in a small industry.
- Not highly profitable businesses.
- Not proven to be attractive to investors.
- Not a deeply capital intensive business.
- Few synergies necessitating Medicare.
- Face troubling issues in the long term.

# *Conclusions*

- Barriers to exit are not high.
- Health plans would not be especially happy about it, however.

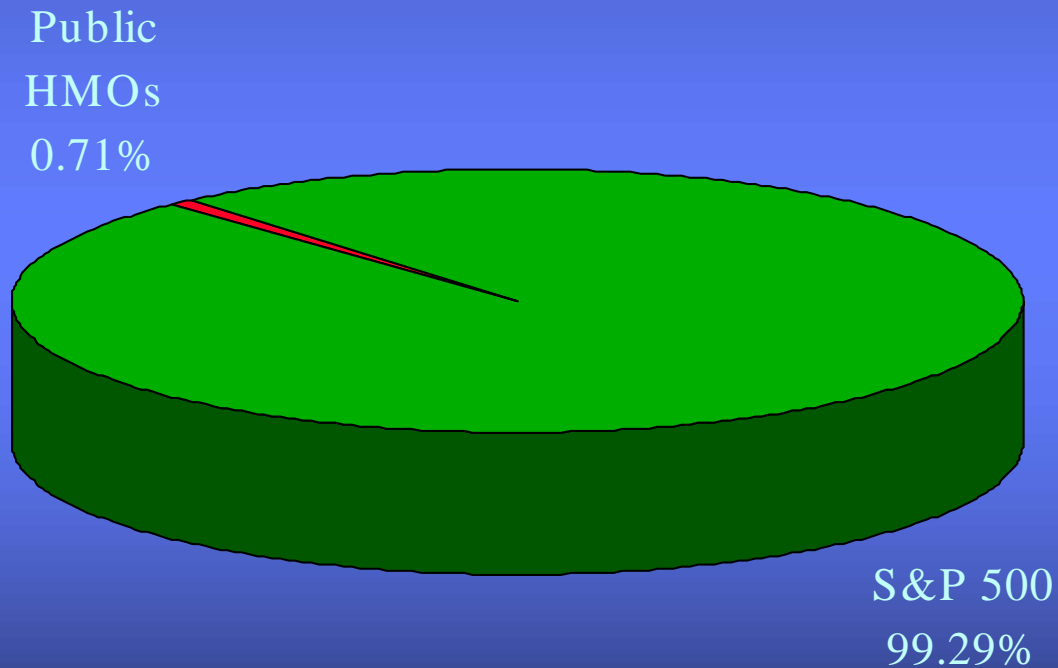
# *HMOs are a Small Industry*

## Valuation of Public HMOs vs. Market



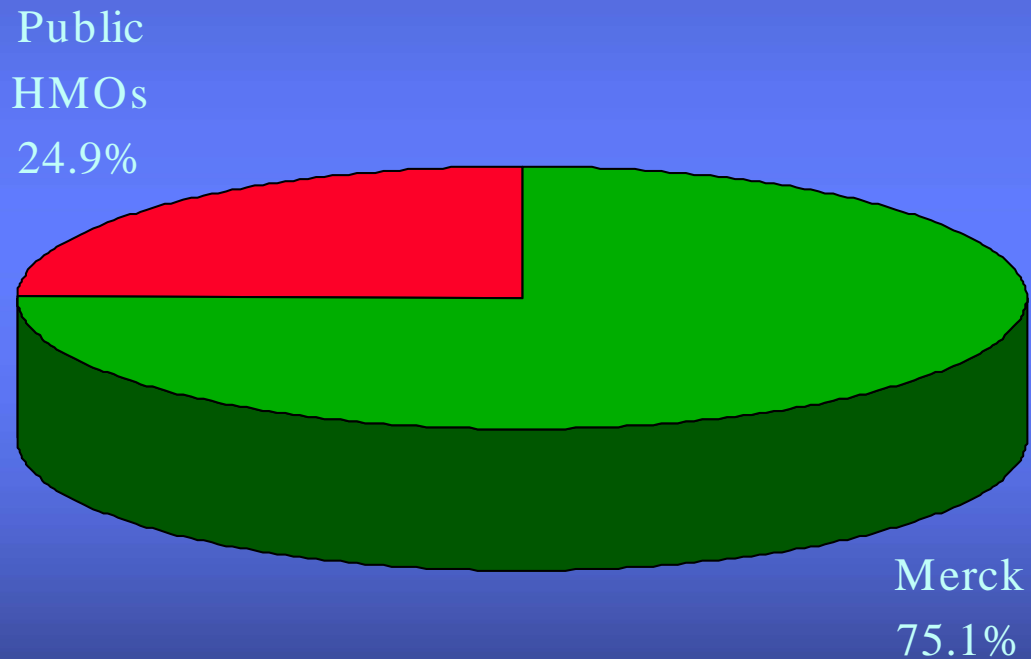
# *HMOs are a Small Industry*

## Earnings of Public HMOs vs. Market



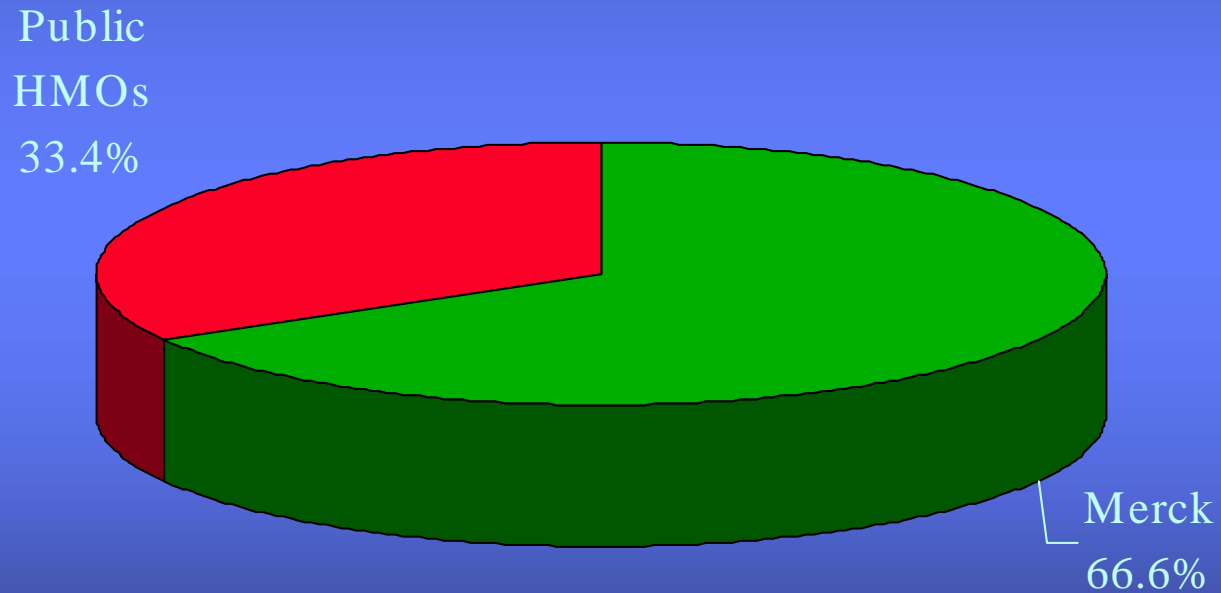
# *HMOs are Small Firms*

## Valuation of Public HMOs vs. Merck

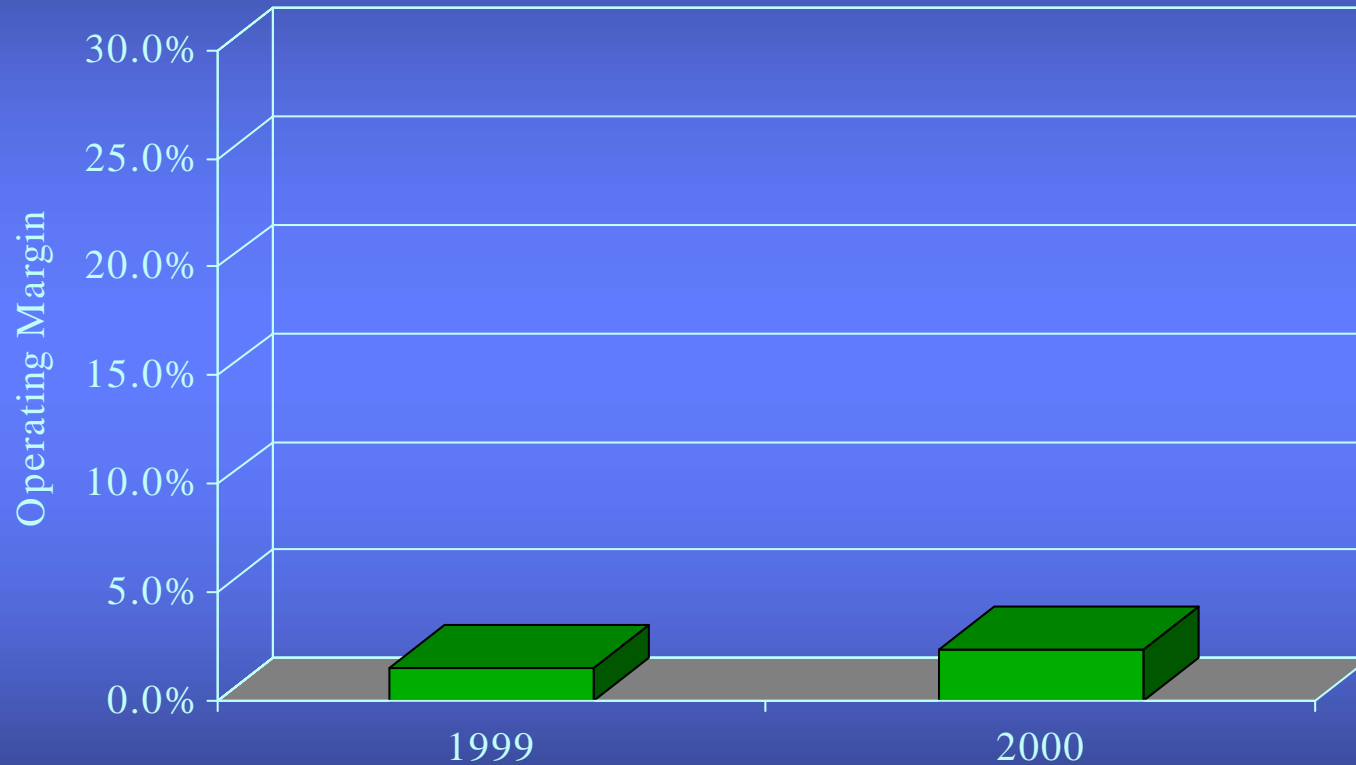


# *HMOs are Small Firms*

## Earnings of Public HMOs vs. Merck

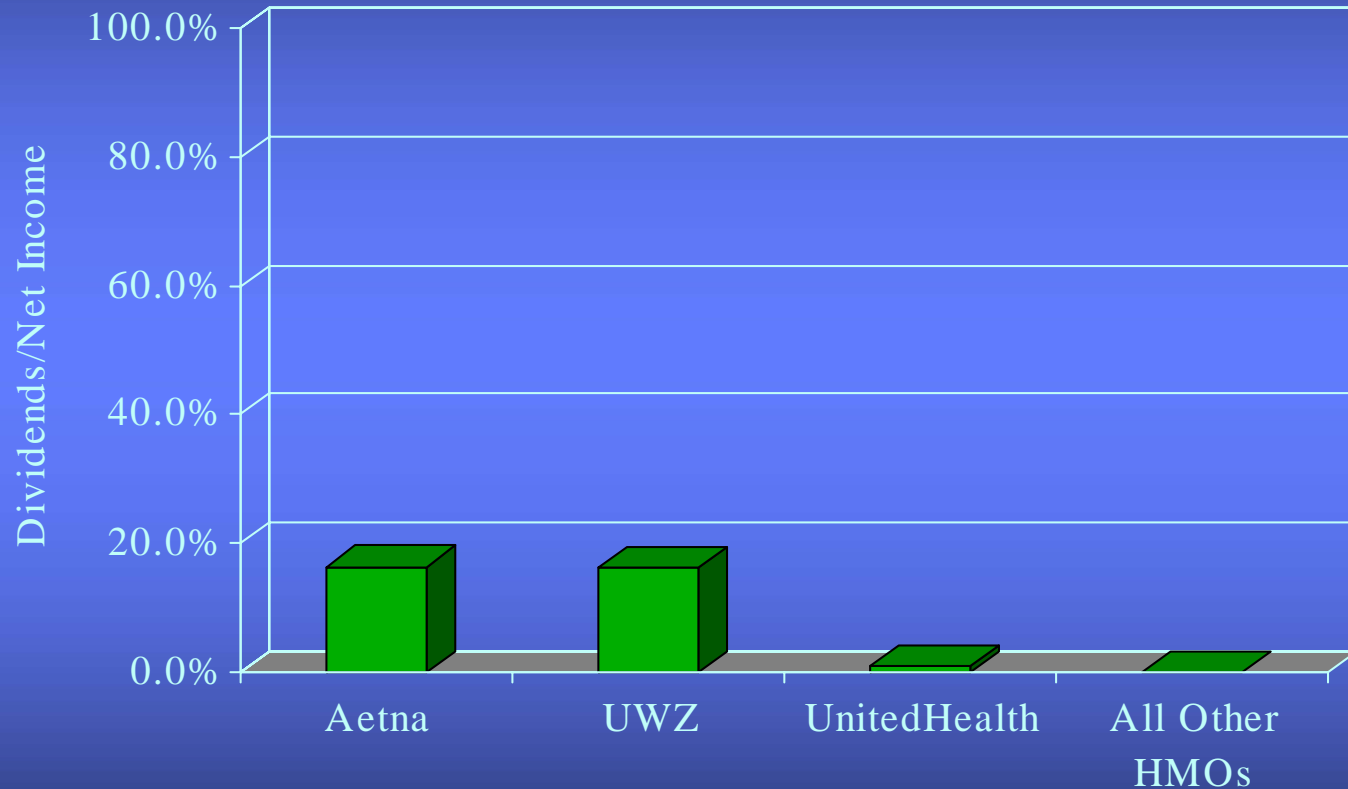


# *HMOs have modest (but improving) earnings*

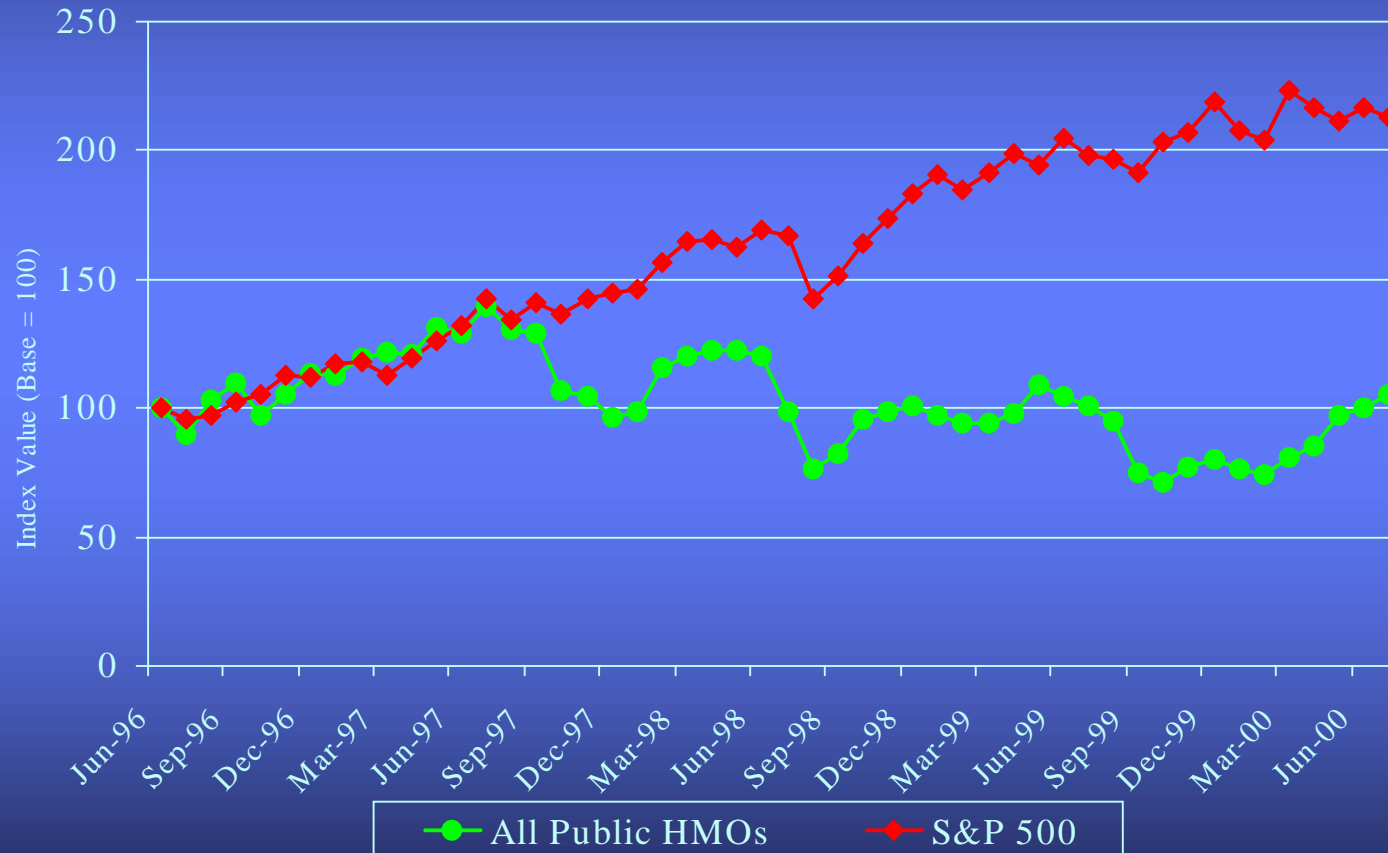


*Source: PULSE Newsletter, August 2000.*

# *HMOs Pay Little or No Dividends*

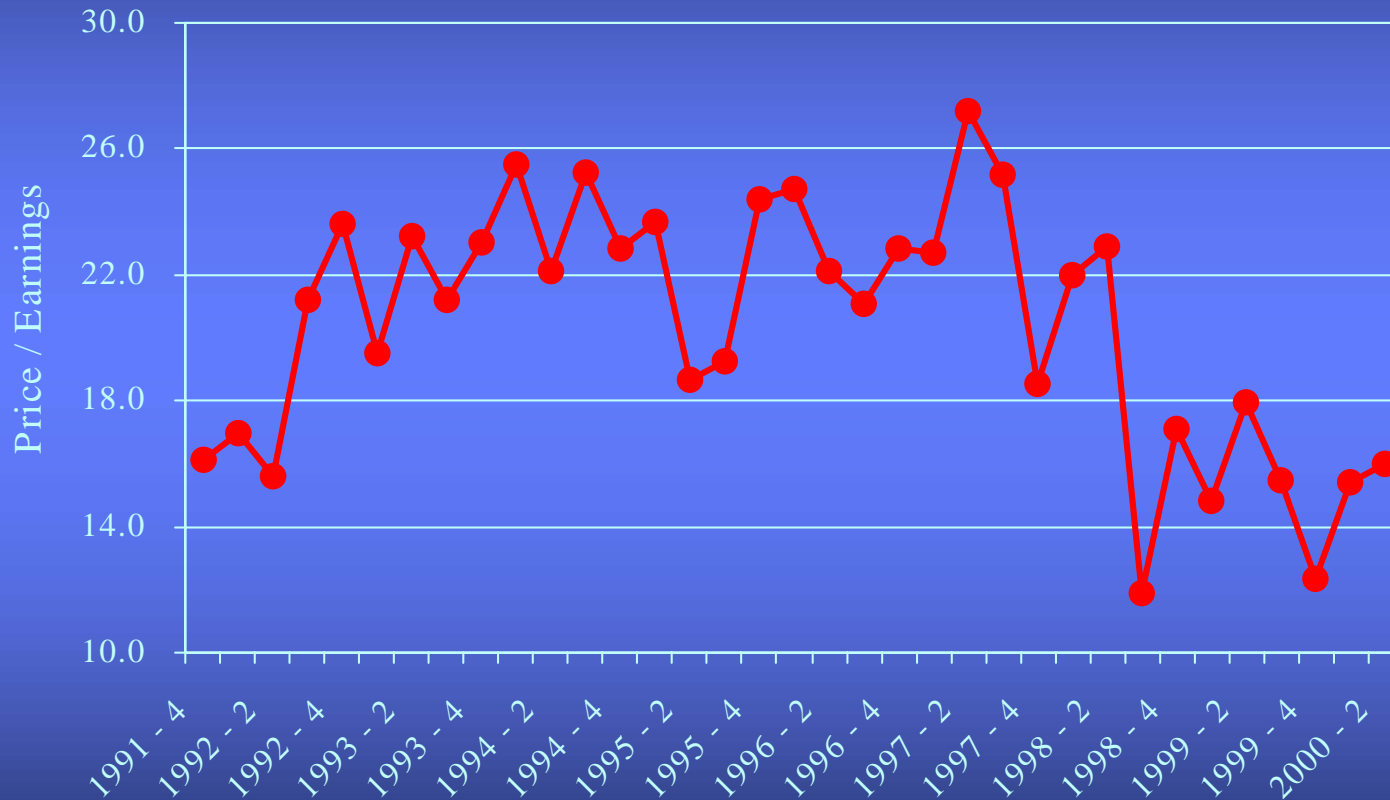


# *HMO Stocks Have Languished*



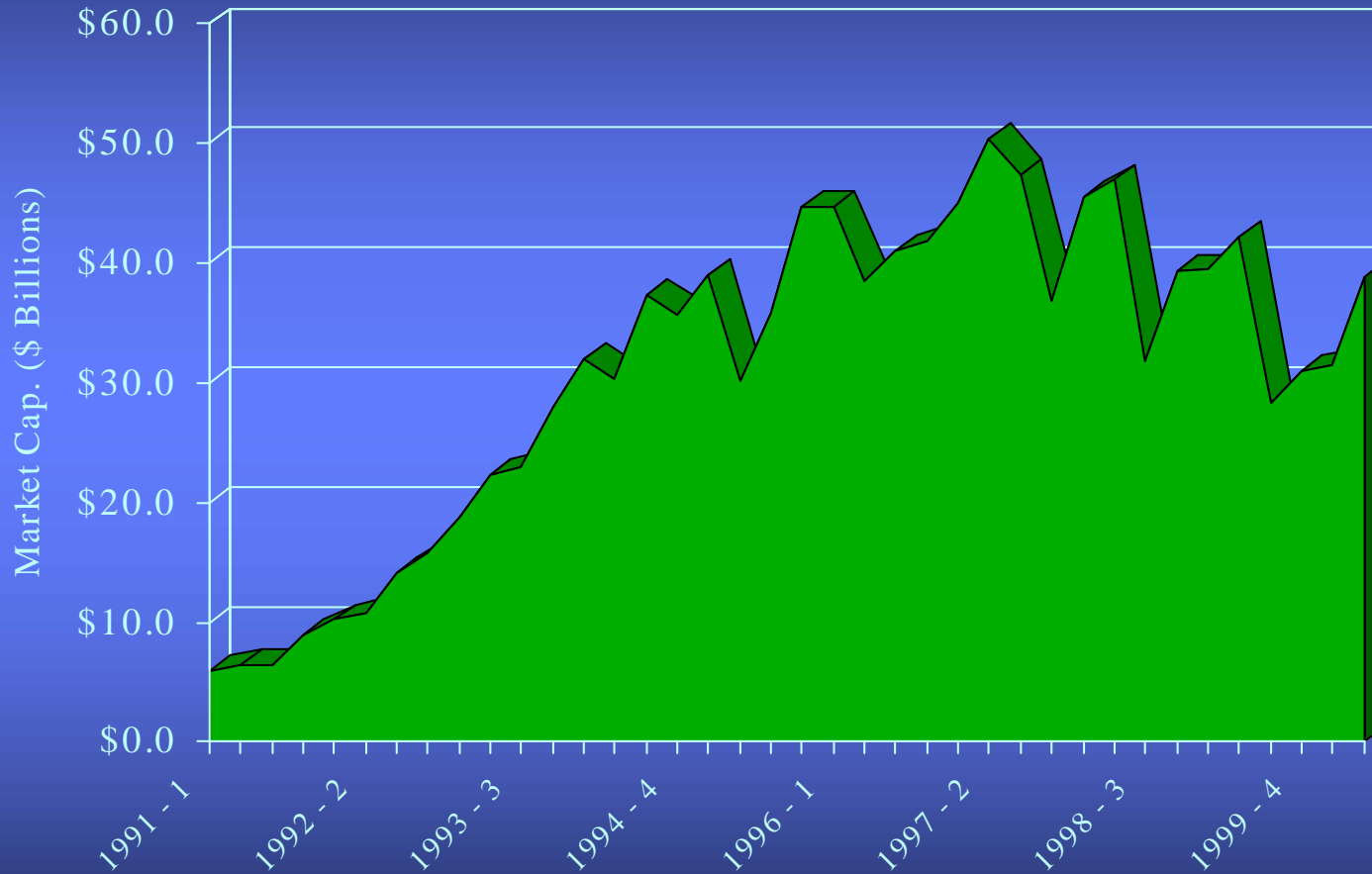
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# *Declining P/Es for Public HMOs*



*Source: PULSE Newsletter, Various Issues.*

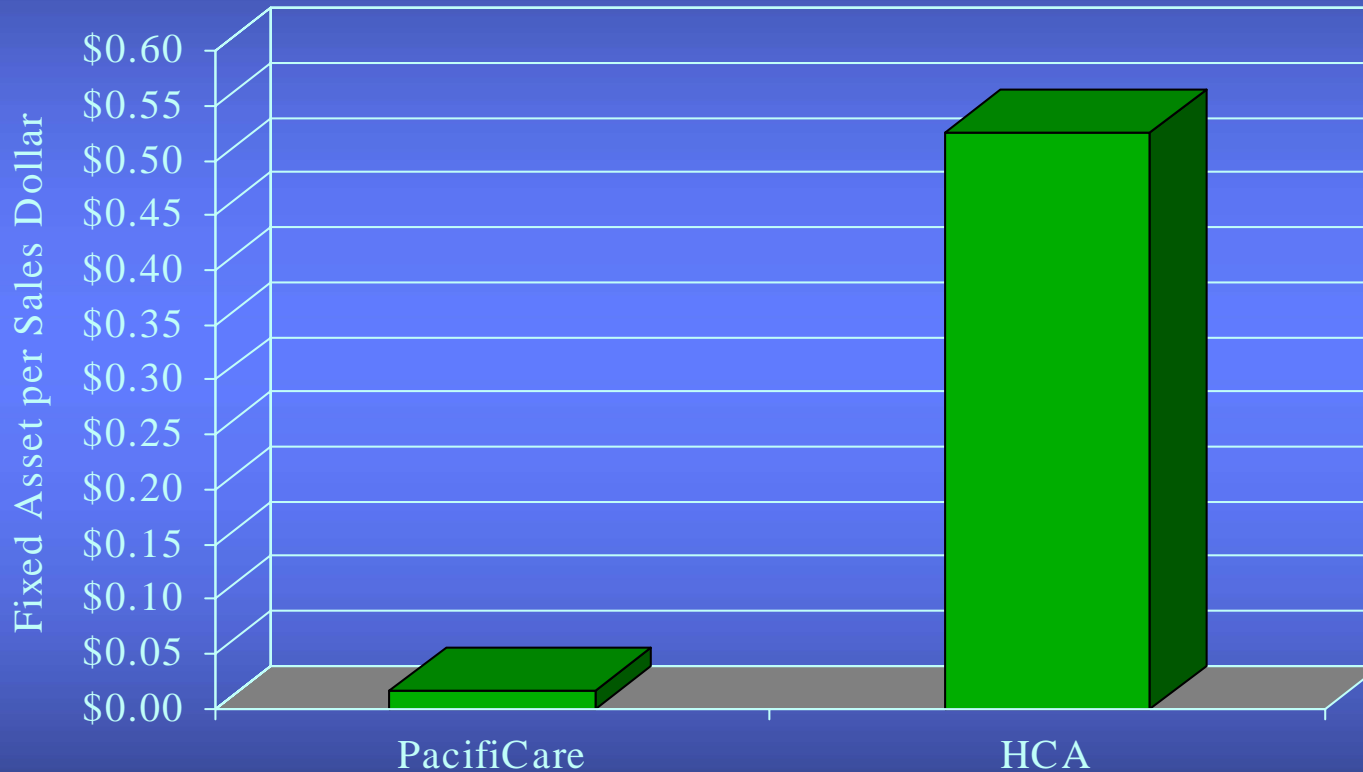
# Market Capitalization of Public HMOs



Source: PULSE Newsletter, Various Issues. Excludes CIGNA.

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# *HMOs: Less Capital Intensive - Costs More Variable*



*Source: PULSE Newsletter, August 2000.*

# *HMOs have few synergies that require continuation of Medicare*

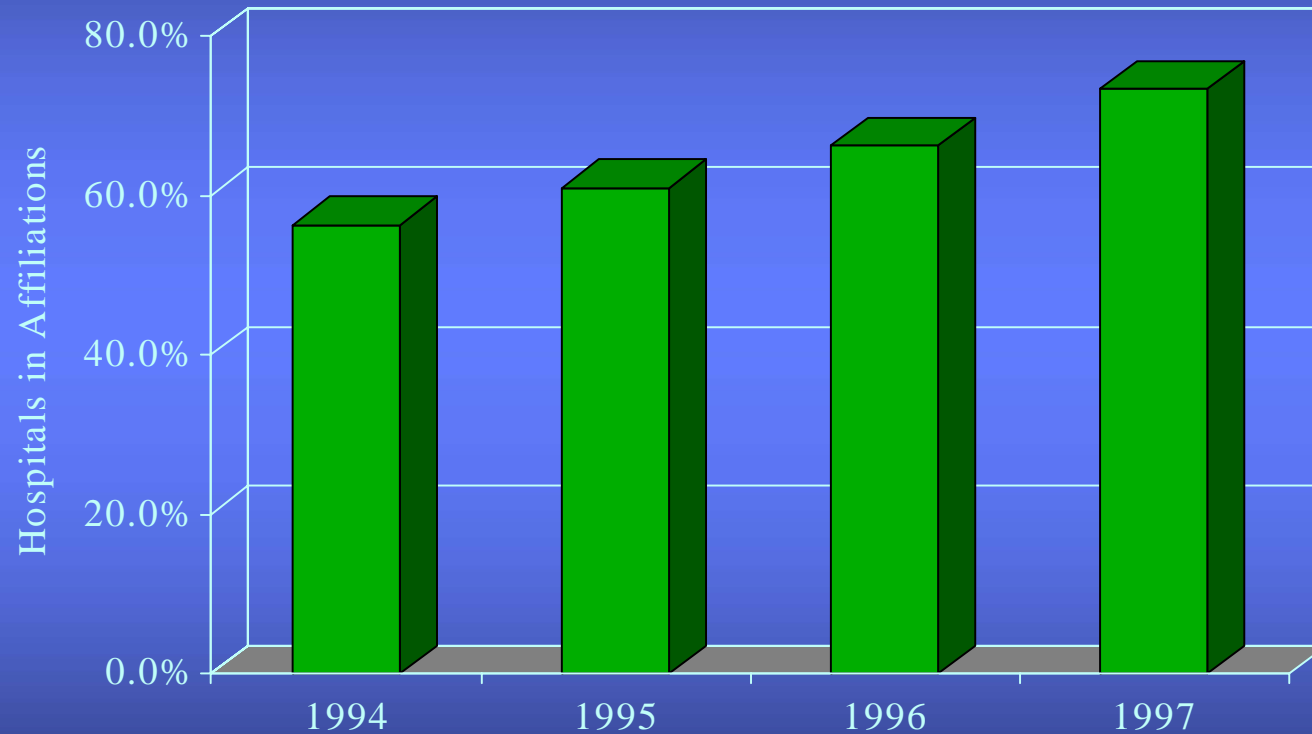
- Few operating and marketing synergies.
- Some purchasing economies but limited by differing mixes of services.

# *HMOs have other Worrisome Issues*

- The Absence of Defined Contribution
- Diffusion of the Technology of Conservative Practice Styles
- Provider Consolidation and Purchasing Issues

# *HMOs have other Worrisome Issues*

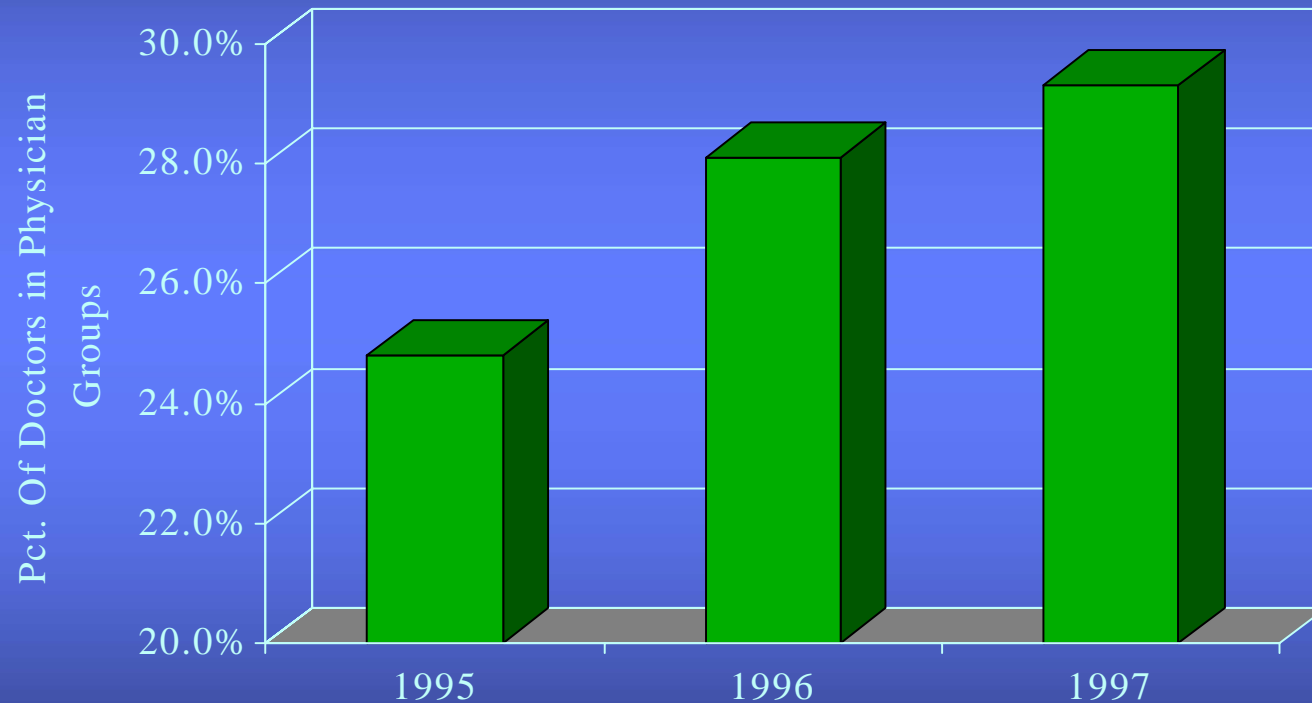
## More Hospitals in Affiliations



*Source: Hospital Statistics - 1999 Edition. There is, we believe, double counting in this.*

# *HMOs have other Worrisome Issues*

## More Doctors in Group Practice



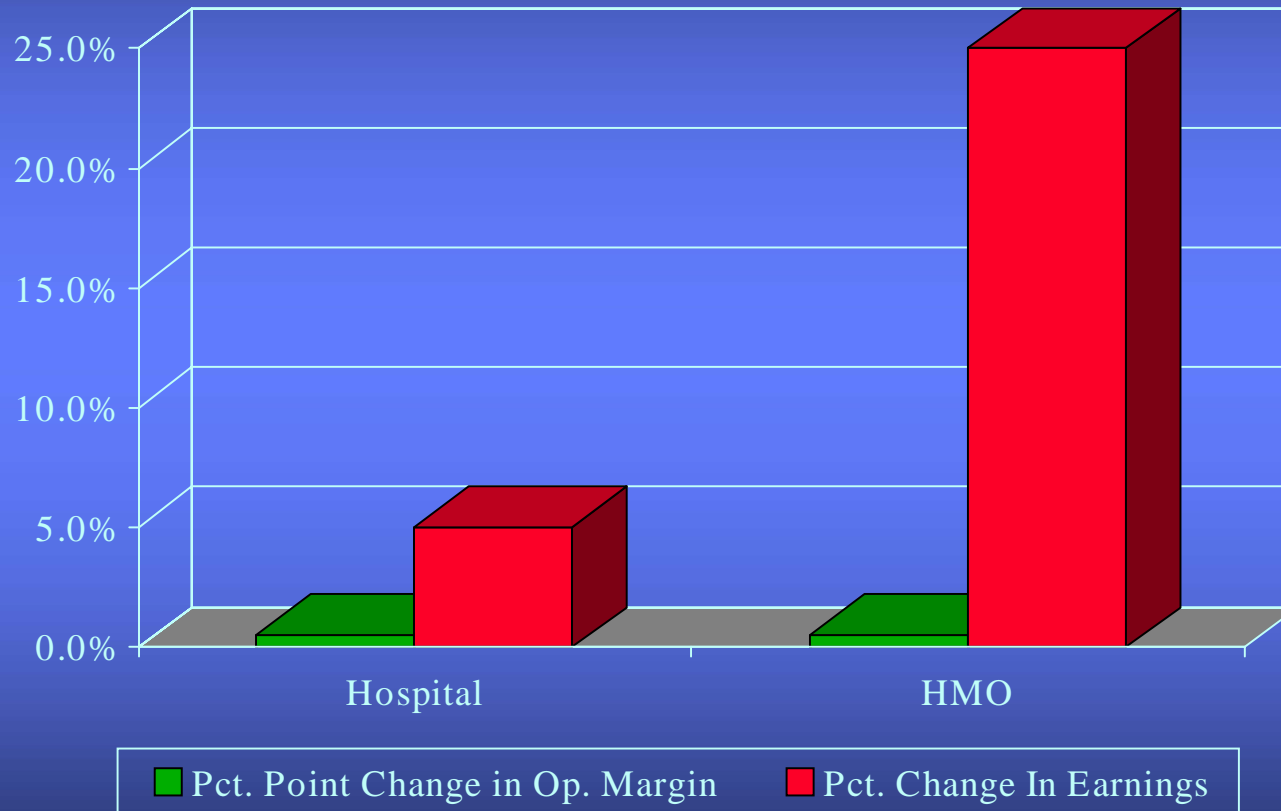
*Source: MGMA Member Database: via Hoechst Marion Roussel.*

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# *Implications*

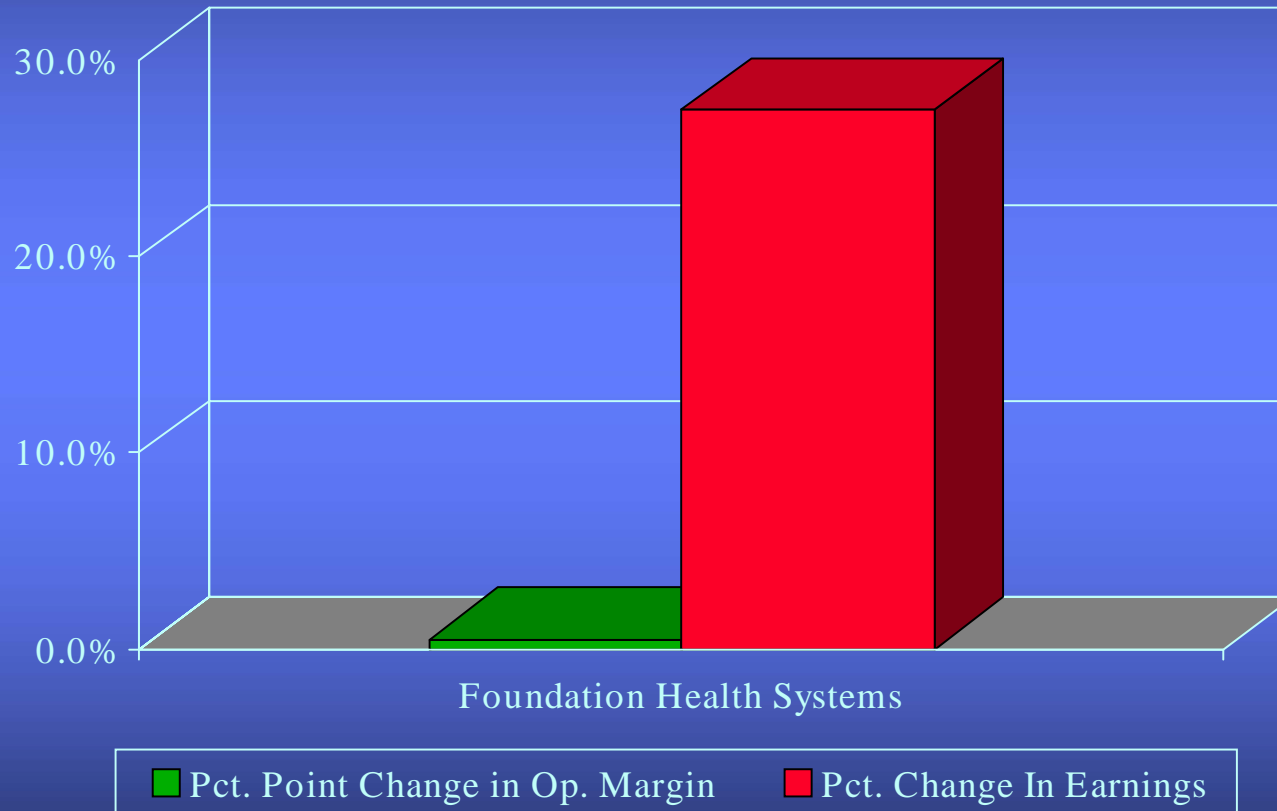
- Barriers to exit aren't high
  - Few synergies
  - Costs are Variable
- Rewards for quick response is great
- Other matters are pressing

# *High Return on Modest Changes in Margins*



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# *Example: Foundation Health*



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# *Regulatory Impact*

- Relative to Revenues -0.1%
- Relative to Earnings -5.0%
- Relative to Value of Earnings \* -42.5%
- Relative to Value of Earnings † -12.2%

\* *Using Gordon Constant Growth P/E Model. P/E declines from 14.8 to 8.5 times 2000 earnings.*

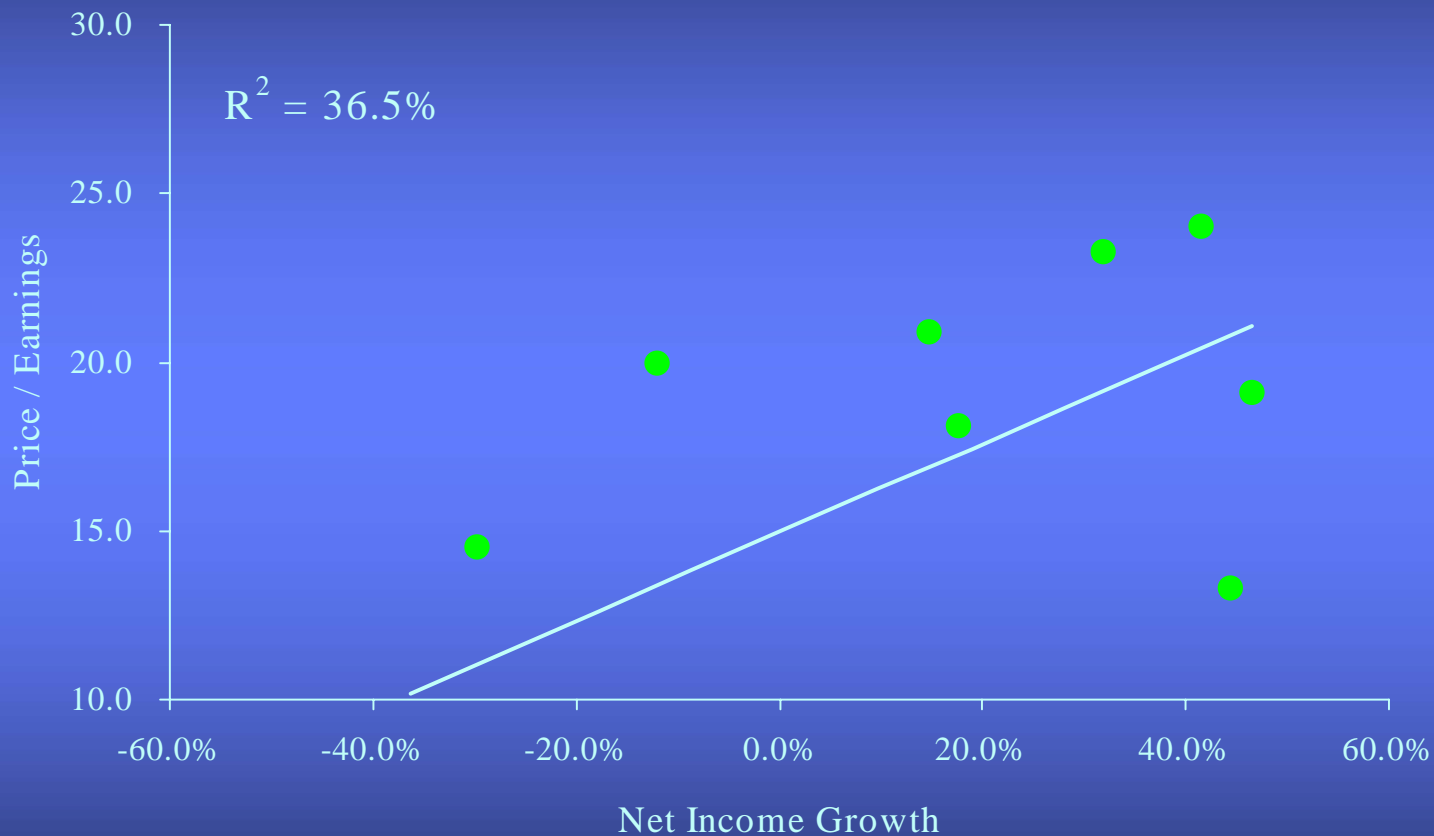
† *Using regression approach. P/E declined from 14.8 to 13.0 times 2000 earnings.*

# *High Cost of Modest Changes in Earnings Growth*

	<u>Current</u>	<u>Decline</u> 5 Pct.
Expected Growth Rate	5.8%	0.8%
Price / Earnings	14.82	8.51

# High Cost of Modest Changes in Earnings Growth

## Net Income Growth versus Price / Earnings



*Note: Excludes two firms with growth rates over 100%.*

# *Selected Firms Dropping Medicare + Choice*

## For-profits

- Aetna 209,107
- CIGNA 97,009
- Humana 66,176
- UnitedHealth Group 53,164

## Non-profits

- Blues 143,012
- HIP of Greater NY 11,294
- Medica Health Plans 13,460
- Penn State Geisenger 12,558

*Source: HCFA via Health Market Survey*

# *Diffusion: Health Care Pct of GDP*

