

P • U • L • S • E

Dashboard for Health Plan Financial Management

January 2005

MEDICARE PILOT PROGRAMS

ADDRESSES NEEDS OF CHRONI-

CALLY ILL. Several of the publicly traded health plans are participating in a CMS initiative involving the use of disease management techniques intended to improve clinical outcomes and patient satisfaction while remaining budget neutral. *Page 2.*

HUMANA WILL ACQUIRE

CAREPLUS HEALTH PLANS OF

FLORIDA. Humana signed a definitive agreement to acquire CarePlus Health Plans of Florida as well as ten medical centers and a pharmacy management business. Consideration was approximately \$408 million. *Page 2.*

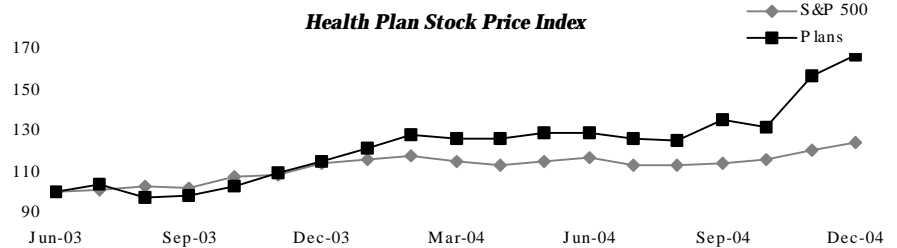
Capital Cost Comments. Health Plan stocks performed well again last month, rising 8.6% and outperforming the market which was up 3.2%. The Blues outperformed the Commercial plans which in turn outperformed the Medicaid Plans. *Page 2.*

Industry Notes. **Molina** was granted a Certificate of Authority to operate as an HMO in Indiana. The top two executives at **United** exercised almost 2.5 million stock options. A subsidiary of **WellPoint** was awarded a three year contract to manage the pharmacy benefit for members of Blue Cross Blue Shield of Rhode Island. *Page 2.*

Mergers & Acquisitions. **Centene** closed its acquisition of FirstGuard. The special meeting of **First Health** shareholders to vote on the company's acquisition by **Coventry** has been set for late January. **Molina** has signed a definitive agreement to acquire the assets of Universal Care. **PacifiCare** and American Medical Security completed their merger and **United** completed its acquisition of Definity Health. *Page 3.*

HEALTH PLAN DASHBOARD

Capital Cost Indicators	Commercial	Blue	Tot. Com	Medicaid	All
Equity Capital Costs					
Price to Sales	0.83	0.69	0.80	1.06	0.88
Price per Member	\$2,916	\$2,131	\$2,742	\$1,710	\$2,439
Price to Operating Earnings	11.8	11.0	11.7	16.1	13.0
Price / Earnings	18.0	18.2	18.0	25.0	20.2
Price / 2005 Earnings	15.2	15.7	15.3	18.2	16.2
Health Plan Industry Beta					0.366
Health Plan Industry Discount Rate					6.25%



Financial / Operational Metrics	Commercial	Blue	Tot. Com	Medicaid	All
Revenue Growth					
Revenue Growth	9.5%	11.5%	9.9%	38.2%	18.3%
Price Change	8.4%	10.8%	8.9%	6.8%	8.6%
Membership Growth	0.2%	0.0%	0.1%	32.3%	9.9%
Profit Margin					
Operating Margin	7.1%	6.6%	7.0%	7.3%	7.1%
Health Benefit Ratio	81.0%	83.8%	81.6%	81.0%	81.4%
Administrative Exp. to Premium	11.5%	10.0%	11.2%	11.8%	11.5%
Return on Equity	23.5%	12.6%	21.3%	15.7%	20.4%
Leverage and Solvency					
Debt to Capital	10.8%	6.8%	10.0%	3.5%	7.7%
Medical Mo. Tang. Book Value	2.26	2.42	2.29	2.38	2.45
Days of Claims Payable	71.9	60.7	69.7	51.3	64.3
Chg. Days of Claims Payable	0.8	(2.1)	0.2	(3.4)	(0.5)

Financings. **AMERIGROUP's** board authorized a two-for-one stock split. **WellCare Health Plans** had a follow-on offering of 7.5 million shares. **WellPoint** repurchased outstanding surplus notes of its subsidiary, Anthem Insurance Companies. *Page 3.*

Company Profile. **AMERIGROUP Corporation.**

Insert. *Economies of Scale in Administrative Expenses.* This month's study tests data from the *Sherlock Expense Evaluation Report*

(SEER) for evidence of economies of scale. Our study identifies several functional areas where economies of scale are statistically significant. The study has implications for business process outsourcing and other contractual relationships as well as for business combinations.

SHERLOCK

COMPANY

www.sherlockco.com

Phone (215) 628-2289

FAX (215) 542-0690

Capital Costs Comments...

Stock prices for the publicly traded health plans generally increased last month, with the only two decliners (losing less than 1%) out of fourteen health plans. Stock prices increased 8.6% on average, and are up 58.4% for the year. The market capitalization of the industry rose 6.2% during December and is up 45.3% year-to-date, while the broader market, as measured by the S&P 500, was up 3.2% for the month and 9.0% for the year. For the month, Blue Plans outperformed the Commercial plans which in turn outperformed the Medicaid plans. For the year, Medicaid plans were the biggest gainers, followed by the Blues and then the Commercial plans.

Humana, Inc. gained 19.6%, the most of any of the plans. PacifiCare Health Systems, Inc. followed with a gain of 16.8%, while CIGNA Corporation rose 16.5%. WellPoint, Inc. was up 13.5% following the consummation of the merger with Anthem. As mentioned, only two plans saw price declines. Sierra Health Services, Inc. slipped 0.9% and WellCare Health Plans, Inc., last month's top gainer, dipped 0.8%.

Since none of the plans reported earnings last month, increases in valuation indicators are the results of changes in investor sentiment rather than improved fundamentals, with one caveat. Please note that the Price / Estimated Earnings changed this month from 2004 earnings estimates to 2005 earnings estimates.

The average Price / Earnings (trailing twelve months) increased 3.9% as the average Price to Operating Income rose 10.8%. The average Price / 2005 Estimated Earnings fell 11.5%. Price per Member and Price to Sales increased 8.8% and 8.5%, respectively. All rates of change are calculated holding the universe of companies constant. At the end of December, the health plan industry beta was 0.366 and the discount rate was 6.25%.

MEDICARE PILOT PROGRAMS ADDRESSES NEEDS OF CHRONICALLY ILL

The Centers for Medicare and Medicaid Services (CMS) recently awarded contracts for the development of Voluntary Chronic Care Improvement Programs (CCIPs), several of which were awarded to publicly traded health plans (Figure 1). CCIPs target beneficiaries with chronic conditions such as diabetes, congestive heart failure and pulmonary artery disease. The purpose of the CCIPs is to improve clinical outcomes, increase beneficiary satisfaction and achieve cost savings targets relative to unmanaged fee-for-service beneficiaries through the use of disease management techniques. This initiative was authorized by the Medicare Modernization Act of 2003.

CCIP contractors will work with physicians and beneficiaries to help ensure that patients "adhere to evidence based treatment plans regarding diet, medicine schedules and other self-management techniques." The CCIPs will be independently evaluated by a CMS contractor at the end of the three year trial period to determine if the initiative, any program under the initiative or any component of any program has been successful in meeting the clinical, satisfaction or financial objectives.

Figure 1. CMS Pilot Program Organizations and Locations

Firm	Region
Aetna Health Management	Chicago
American Healthways Inc.	District of Columbia and Maryland
CIGNA HealthCare	Georgia
Health Dialog Services Corp.	Pennsylvania
Humana, Inc.	Central Florida
LifeMasters Supported SelfCare, Inc.	Oklahoma
McKesson Health Solutions	Mississippi
Visiting Nurse Service of New York and	Queens and
United HealthCare Services, Inc.-Evercare	Brooklyn
XLHealth	Tennessee

In Phase I of the program, the pilot phase, CMS will identify beneficiaries of traditional Medicare within a particular region with chronic conditions. CMS will then assign the beneficiary to either an intervention group or a control group. Beneficiaries in the intervention group will then receive a letter describing the program and instructions as to how to opt out if they wish.

Phase II is the expansion phase of the program. The Secretary of Health and Human Services is authorized to expand programs or components of programs deemed successful in meeting the initiative's objectives. This phase may begin within two to three and a half years after Phase I.

According to CMS, Medicare beneficiaries with congestive heart failure account for 43% of Medicare spending but are only 14% of the Medicare population. Similarly, 18% of Medicare beneficiaries are diabetic, however they represent 32% of Medicare spending.

HUMANA WILL ACQUIRE CAREPLUS HEALTH PLANS OF FLORIDA

Humana Inc. signed a definitive agreement to acquire CarePlus Health Plans of Florida, a subsidiary of CPHP Holdings, Inc. The transaction includes CarePlus' 10 CAC-Florida Medical Centers and PrescribIT Rx pharmacy management company. Total consideration will be \$408 million plus any amounts exceeding statutory capital requirements. The acquisition will be financed through internal cash and \$300 million borrowings under Humana's existing \$600 million revolving credit agreement.

CarePlus Health Plans has almost 50,000 Medicare Advantage members in Miami-Dade, Palm Beach and Broward counties. The health plan posted (statutory basis) 2003 revenues of \$393.4 million, operating income of \$13.9 million and net income of \$9.3 million in 2003. Humana currently has 131,000 Medicare Advantage members in South Florida and 230,000 statewide.

Figure 2 contains valuation indicators based on 2003 fundamentals for the health plan. Note that we have implicitly assumed that the medical centers and pharmacy management business operate at break-even and have no value independently of the health plan. Note that while the valuation ratios appear to be high, they are extremely so for the price per member ratio, especially when compared with the price to sales ratio. The reason for this is that substantially all of the members are Medicare Advantage. While the income statement amounts were drawn from the 2003 statutory blank, membership was taken from Humana's press release and is probably more current, certainly much larger than the 43,750 members reported at the end of 2003.

Figure 2. Humana to Acquire CarePlus Valuation Indicators (\$000s)

Consideration	\$408,000
Debt	0
less Working Capital	13,442
Enterprise Value	\$394,558
Fundamentals	
Members	50,000
Revenues	\$393,338
Operating Income	\$13,900
Net income	\$9,300
Operating Margin	3.5%
Valuation Ratios	
Price per Member	\$7,891
Price / Sales	1.00
Price / Operating Income	28.4
Price / Earnings	43.9

According to the company's most recent 10-K, Humana owns seventeen medical centers and leases another forty-four centers, nationally. Of those, the company owns two and leases thirty-nine medical centers in the state of Florida. Humana leases the medical centers to provider operators.

Humana reported in its press release announcing the acquisition that it anticipates the acquisition will be accretive and will add \$0.15 to \$0.18 per diluted share during 2005, including integration costs.

Industry Notes...

Molina Healthcare, Inc. said that Molina Healthcare of Indiana, Inc., its wholly-owned subsidiary, was granted a Certificate of Authority by the Indiana Department of Insurance which licenses it to operate as a health maintenance organization in the state of Indiana. This license award will be followed by a two year contract to provide managed care services to Medicaid recipients in thirteen counties in the state beginning January 1, 2005. Molina reported that it expects revenues to be generated under the contract beginning in the second quarter of 2005. It has not yet been assigned its Medicaid enrollees under this contract.

UnitedHealth Group announced that its top two executives exercised almost 2.5 million stock options. Dr. William W. McGuire, Chairman and CEO, exercised nearly 1.7 million options for a profit before transactions costs and taxes of \$114.6 million. President and COO Stephen J. Hemsley exercised 800,000 options for a profit of \$56.5 million before transaction costs and taxes. These transactions involved less than 9% of the options held by Dr. McGuire and 10% of the options held by Mr. Hemsley.

WellPoint Pharmacy Management, the Pharmacy Benefits Management (PBM) subsidiary of WellPoint, Inc., was awarded a three year contract, effective July 1, 2005, to provide PBM services to Blue Cross & Blue Shield of Rhode Island's (BCBSRI) membership. BCBSRI has more than 550,000 members.

Mergers & Acquisitions...

Centene Corporation closed its acquisition of FirstGuard Inc., adding 94,000 members in Kansas and 42,000 members in Missouri. Consideration for the transaction was approximately \$93 million, or \$684 per member. Centene financed the transaction with \$53 million from cash and borrowings of \$40 million under its revolving credit facility.

Coventry Health Care, Inc. is proceeding with the acquisition of First Health Group Corp. First Health reported that a special meeting of shareholders has been scheduled for January 28, 2005 at the company's executive offices in Downers Grove, Illinois to vote on Coventry's proposed acquisition of First Health. Shareholders of record as of December 22, 2004 will be entitled to vote at the meeting. Since all regulatory approvals have been received, the companies expect to close the acquisition by January 31, 2005, provided First health shareholders approve the transaction.

Molina Healthcare, Inc. signed a definitive Asset Purchase Agreement with California-based Universal Care, Inc. to transfer its San Diego County Medicaid and CHIP contracts, representing 17,000 members, and provider network to Molina Healthcare of California. According to the InterStudy Competitive Edge, Universal Care had approximately 168,000 members in seven southern California counties as of July 1, 2003. Consideration for the transaction is \$6.2 million, or \$365 per member. The consideration will be adjusted proportionally in the event that the last month's revenue prior to closing is higher or lower than the baseline revenue amount (October 2004) by more than 15%. The transaction is expected to close in the second quarter 2005.

PacifiCare Health Systems, Inc. proposed merger with American Medical Security, Inc. (AMS) was approved by AMS shareholders at the special meeting of shareholders. Shares representing 61.4% of the shares outstanding and eligible to vote were voted in favor of the transaction. The transaction was subsequently completed.

UnitedHealth Group completed its previously announced acquisition of Definity Health, a provider of consumer-driven health benefit plan. This was originally noted in the December 2004 issue of *PULSE*.

Financings...

AMERIGROUP Corporation reported that its board of directors authorized a two-for-one stock split. The split will be distributed as a 100% stock dividend payable on January 18, 2005 to shareholders of record as of December 31, 2004. The number of shares outstanding will increase from approximately 25 million to approximately 50 million.

WellCare Health Plans, Inc. priced its previously announced follow-on public offering of 7.5 million shares at \$32 (see November, 2004 issue of *PULSE*). Selling shareholders will be selling 6 million shares and the company will sell 1.5 million shares. One of the selling shareholders, Soros Private Equity Investors LP, granted an underwriters' over allotment option for 1.1 million shares.

WellPoint, Inc. initiated a tender offer to repurchase the outstanding 9.125% Surplus Notes due April 1, 2010 (2010 Notes) and 9.00% Surplus Notes due April 1, 2027 (2027 Notes) of its subsidiary, Anthem Insurance Companies, Inc. The offer expired December 10, 2004. The 2010 Notes were priced at \$1,241.89 per \$1,000 of principal and the 2027 Notes were priced at \$1,445.94 for each \$1,000 principal amount.

The repurchases will be financed by a portion of the new borrowings under a \$1.6 billion offering of senior unsecured notes in four tranches: \$300 million 3.75% due 2007; \$300 million 4.25% due 2009; \$500 million 5.0% due 2014 and \$500 million 5.95% due 2034.

Company Profile...

We are initiating a new feature intended to provide a more in-depth perspective on the companies that we cover in *PULSE*. It will focus on each company's niche, growth strategies, risks, product portfolio and financing history. The company profiles are not intended as investment advice. A list of leading Wall Street sell-side analysts may be found through the **Tools** menu on our website, www.sherlockco.com.

AMERIGROUP CORPORATION (AGP)

Summary

AMERIGROUP Corporation is a publicly-traded managed care organization focused on serving individuals receiving health coverage through government-sponsored and public programs, primarily Medicaid, State Children's Health Insurance Program (SCHIP), and FamilyCare. It also offers disease and medical management programs for members facing such health problems as high-risk pregnancy, congestive heart failure, sickle cell disease, diabetes, asthma and other respiratory conditions, Human Immunodeficiency Virus, and neonatal diseases. These services are not only provided in an effort to improve the overall health of its members but also to improve its providers' quality of care and aid

in cost reduction. In addition, AMERIGROUP administers educational programs aimed at increasing its members' knowledge of various diseases and prevention methods, which in turn facilitates higher member loyalty and brand awareness. As of

December 31, 2003, it generated revenues of \$1.6 billion and served approximately 857,000 members in Texas, Florida, Maryland, New Jersey, Washington, D.C., and Illinois.

Growth Factors

Acquisitions are an important component of AMERIGROUP

Corporation's growth strategy, with approximately 219,000 additional members in Florida through its integration of PHP Holdings, Inc. and St. Augustine Medicaid, a division of AvMed, Inc., in 2003. Membership growth for 2003 was also attributed to the exit of a major competitor from its Texas market, which added 28,000 individuals to its enrollment. As of September 30, 2004, approximately 43% of its total membership was generated through nine acquisitions. Recently, it entered into a definitive agreement to acquire CarePlus, LLC, which operates as CarePlus Health Plan, for \$107.0 million, which reflects a cash consideration of \$125.0 million minus CarePlus' net assets of \$18.0 million. CarePlus serves New York State's Medicaid, Family Health Plus, and Child Health Plus programs in New York City and Putnam County, New York. This acquisition will result in 115,000 additional members for AMERIGROUP.

Internally generated growth is also an important element of its strategy with approximately 47,000 new members in 2003 excluding the effects of acquisitions. Even though this was only 17.7% of its total increase in enrollment for the year, it enrolled approximately 70,000 new members, or 58.8%, of its total membership growth of 119,000 internally in 2002.

Risk Factors

AMERIGROUP currently faces a risk involving the State of Texas' reorganization of its Medicaid managed care program, which will affect all of the service areas in Texas in which the firm operates. Although AMERIGROUP has requested permission to expand into new service areas in addition to its current Texas service areas, it said that its operating results could be materially affected if it lost one or more of its contracts. The State of Texas will announce contract awards in the beginning of 2005, and these changes will take effect in mid to late 2005.

Product Portfolio

AMERICAID is a family focused Medicaid managed care product that provides health coverage primarily for low-income mothers and their children. This product is offered in all markets served. As of September 30, 2004, AMERICAID had 649,000 members, up from 578,000 one year prior, and composed 69.5% of its total membership.

Figure 3. AMERIGROUP Corporation Valuation

EPS est. 2004	\$3.27	P/E 2004 est.	23.1
EPS est. 2005	\$3.67	P/E 2005 est.	20.6
Growth Rate	13.3%	PEG Ratio est.	1.74
Revenue LTM	\$1,748,747	Price to Sales	1.07
Membership	934,000	Price per Member	\$1,999

Figure 4. AMERIGROUP Corporation Financials

	2001	2002	2003
Revenues	\$880,510	\$1,152,636	\$1,615,508
HBR	80.5%	81.0%	80.2%
Admin to Prem.	13.5%	12.4%	13.0%
Op. Margin	5.9%	6.6%	6.8%
Net Margin	3.9%	4.3%	4.2%
EPS	\$2.08	\$2.30	\$2.95
Pct. Chg.	NA	10.6%	28.3%

P · U · L · S · E

AMERIKIDS is a managed care product that is targeted to children who are not eligible for Medicaid. This product is designed for children covered under SCHIP, which is a federal/state program that provides health benefits to children who are not eligible to be covered under Medicaid. Therefore, this has the effect of providing coverage for the uninsured. AMERIGROUP offers this product in Maryland, Washington, D.C., New Jersey, Texas, Chicago, and Florida. As of September 30, 2004, AMERIKIDS constituted 20.8% of its total enrollment and served 194,000 individuals, down from 195,000 for the comparable period.

AMERIPLUS provides health care coverage to low-income aged, blind, and disabled individuals. It is currently offered in New Jersey, Maryland, Houston, and Florida. As of September 30, 2004, AMERIPLUS had 78,000 members, up from 73,000 in September 2003, and composed 8.4% of AMERIGROUP's total membership.

AMERIFAM is its managed care product designed for the uninsured families of the children covered under SCHIP, its AMERIKIDS product. AMERIGROUP offers this product in New Jersey and Washington, D.C., where it covers the parents of children who receive benefits under SCHIP. As of September 30, 2004, AMERIFAM served 13,000 individuals, down from 20,000 one year prior. Membership for this product is 1.4% of AMERIGROUP's total enrollment.

Financing History

AMERIGROUP Corporation completed its initial public offering on November 9, 2001, when it raised approximately \$77.2 million, net of \$7.5 million in fees and expenses. It used the proceeds to repay the balance of its long-term debt facility of approximately \$4.4 million, redeem approximately \$13.3 million of its redeemable preferred stock, and purchase the assets of the MethodistCare, Inc. Houston, Texas Medicaid business for approximately \$1.6 million. Also, \$7.0 million was used to acquire the assets of Capital Community Health Plan's

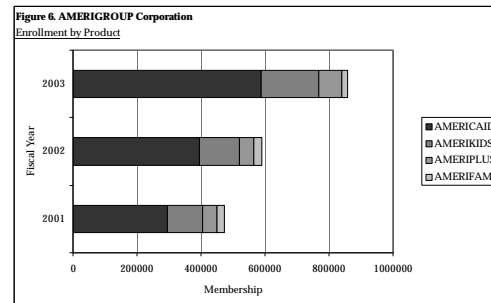
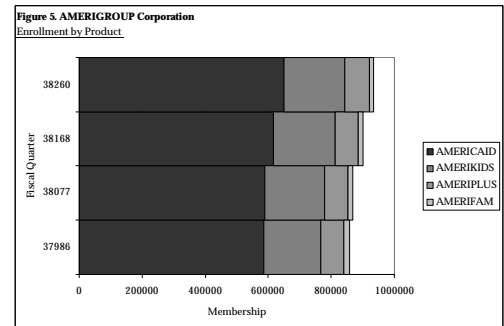
Analysts' Earnings Estimates

Consensus estimates are the average of brokerage house estimates that are reported to us. Firms contributing to the consensus estimates have an analyst who has expertise in the HMO industry. Contributing firms are **Advest, Inc., Banc of America Securities, Fox-Pitt, Kelton, Inc., Morgan Stanley Dean Witter, Prudential Securities, SG Cowen & Co. and Wachovia Securities.**

No representations are made by Sherlock Company or the polled brokerage firms as to the likelihood of the occurrence of the projected EPS estimates or the accuracy or completeness of the information required to interpret these estimates. It should be understood that the actual EPS may not necessarily occur based on the projections here enclosed. Indeed, it is probable that the EPS will not occur as projected here and the magnitude of the differences between the projections and the ultimate results cannot be reliably estimated. Also, some of the consensus estimates are based on only one analyst's estimate.

In the event that Sherlock Company, in its financial advisory business becomes so close to a company covered by Sherlock Company's research that it has access to material inside information, Sherlock Company will temporarily cease coverage of the public company. No comments, written or oral, will be made about the company in question until after the material in question is either disseminated or no longer material.

Although the information in this report has been obtained from sources which Sherlock Company believes to be reliable, we do not guarantee its accuracy, and such information may be incomplete or condensed. All opinions in this report constitute our judgment as of this date and are subject to change without notice. This report is intended for information purposes only and is not intended as investment advice. Sherlock Company is a Pennsylvania Corporation.



Medicaid business in June 2002. The remaining proceeds of \$51.3 million was placed in an escrow account with additional company funds to finance its acquisition of PHP. According to Julie Trudell, AMERIGROUP Vice President of Investor Relations, it spent \$141.0 million on four acquisitions within thirteen months of its initial public offering.

On October 16, 2003, it completed a public offering of 3,162,500 common shares, including an over-allotment issuance of 412,500 shares, for a total offering price of \$147.1 million, or \$46.50 per share. It received proceeds of \$138.8 million, net of approximately \$7.4 million in underwriting fees and \$900,000 in expenses. It used \$30.0 million of the proceeds to repay the outstanding balance of its credit facility. The remaining balance of \$108.8 million was used for general corporate purposes, including acquisitions. As of September 30, 2004, AMERIGROUP had no long-term debt outstanding. However, it did report \$10.9 million in deferred income taxes, capital leases, and other long-term liabilities.

P · U · L · S · E

is published by Sherlock Company, a Pennsylvania Corporation. **PULSE** is published monthly.

Subscription price is \$505.00 for an annual subscription.

To order, please send a **check** to our offices at:
 Sherlock Company
 P.O. Box 413
 Gwynedd, PA 19436

• • • •

All copyrights reserved. Reproduction or distribution is prohibited.

The User I.D. for web site access to next month's **PULSE** is "pulse" and the password is "_____".