

SHERLOCK

C O M P A N Y

In this podcast, we will review the performance of the managed care industry for the third quarter 2008 and its valuation performance since the beginning of the year.

So far this year, health plan industry stock prices decreased by 54.0% on average. By contrast, the broader market, measured by the S&P 500, decreased by 38.8%. The market capitalization of the industry had decreased 66.4% to \$72.4 billion. This is a decline from \$215.4 billion in December 2007, which was just below the peak market capitalization of \$217.6 billion in December 2005.

That stock price decline was universal: all publicly-traded health plans decreased. Commercial plans fared the worst, followed by Medicare and then Medicaid plans. Health Net declined the most at 78.7% and Coventry Health Care was close behind at 78.2%. CIGNA declined by 73.7% and UnitedHealth Group fell by 65.4%. HealthSpring had the lowest decline at 13.3%.

Valuation metrics were lower compared to year end. While 5 companies reported positive growth in net earnings, which I'll summarize later, the stock prices and valuation ratios reflected greater concerns about the relative performance of health plans.

Since the beginning of the year, Price to Trailing Twelve Months Earnings decreased 58.3% to 7 times. Price to Operating Income decreased by 66.9% to 4 times, while Price to Sales fell 68.8% to 0.23 times. Price per Risk Member and Price per Total Member were down 55.0% to \$1,531 and 49.4% to \$1,243, respectively.

The bulk of the decline in stock prices has occurred during the past two months. Since the beginning of September, health plan stock prices fell 37.3%, compared with the S&P 500, which fell 29.9%. CIGNA and Coventry experienced losses of 66.2% and 63.2%, respectively. Health Net fell by 62.8%, while Aetna had a decline of 48.3%. AMERIGROUP had the smallest decline at 6.4%.

While all stock prices declined for health plans during the year, for the third quarter health plans reported mixed net earnings. Medicaid and Medicare plans performed better than commercial plans. Investment income, however, was drastically lower due to worsening conditions in the equity and bond markets.

At the end of the third quarter, membership in publicly traded health plans totaled 110.5 million Americans, a 12.0% increase. Year-over-year, ASO membership increased its share of total membership by 1.7 percentage points to 49.1% of the total. Total risk

membership was 56.2 million among public companies as of the end of the third quarter.

Quarterly revenues for the average health plan increased 19.1% year-over-year and totaled \$62.5 billion. Medicare Plans outperformed their commercial counterparts in revenue growth, growing on average by 39.1%. Especially notable was HealthSpring's 45.7% increase in revenues driven by an acquisition and increased premium rates. Revenues in Medicaid and Commercial plans increased by 23.6% and 11.9%, respectively.

Membership by type of plan differed from revenue growth: Medicare plans had the lowest increase at 8.3%, on average. This was followed by the Medicaid plans, which had an 11.2% increase in membership and Commercial plans, which had a 13.3% increase in membership.

Operating earnings were mixed for the health plans. The Medicare plans experienced growth of 133.0%. Notably, Universal American's operating earnings grew by 200.6% due to an improved health benefits ratio. HealthSpring, the other Medicare plan, posted a 65.5% operating earnings increase. Medicaid plans reported operating earnings growth of 35.9%, on average. This contrasts with the commercial plans, which on average reported operating earnings declines of 19.4%. On average, operating earnings for all health plans increased by 18.1%.

While the typical health benefits ratio for all plans increased 0.6 percentage points to 82.3%, Medicare and Medicaid plans experienced declines. As mentioned above, Universal American had a decline of 4.1 percentage points. On the Medicaid side, AMERIGROUP had decline of 2.8 percentage points. All commercial plans reported increases in their health benefits ratio. Health Net had the largest increase at 4.6 percentage points, followed by Coventry with 3.5 percentage points.

The ratio of administrative expenses to premiums declined by 0.2 percentage points on average and was mixed by segment. Medicare plans had no net change, while Medicaid plans had an increase of 0.5 percentage points. Commercial plans typically had lower administrative expense ratios compared with the same quarter last year. The administrative expense to premium ratio was 9.9% for commercial, 12.3% for Medicare Advantage, and 14.0% for Medicaid.

While operating earnings improved for health plans as a whole, net earnings decreased by 5.8% on average due to large declines in non-operating earnings. Non-operating income for all health plans declined by 132.3% on average. Commercial plans fared the worst with a 187.5% decline, followed by Medicare plans with a 108.3% decline. Medicaid plans reported a 41.4% decrease.

The decline of non-operating earnings is primarily due to the deteriorating capital market conditions. WellPoint, for example, reported a net realized investment loss of \$562.6 million due to equity and fixed income “impairments.” Coventry Health Care reported a \$36.2 million loss also due to “investment impairments.” Centene, which was the only Medicaid company to have a non-operating income loss, reported a \$5.2 million loss due to the Reserve Primary money market fund’s exposure to Lehman Brothers commercial paper. Aetna reported after-tax investment losses of \$232 million, which included \$70 million related to holdings in Lehman Brothers and Washington Mutual.

Some publicly traded plans have revised their expectations for the year. Aetna reported a decline in operating earnings guidance, while WellPoint lowered its range to the downside. More broadly, as UnitedHealth Group CEO Stephen Hemsley told analysts, “The negative economic climate and outlook severely limits our visibility into 2009.”

That “negative economic climate” has created worries for enrollment growth. Also, the volatility of certain investment vehicles and Federal Reserve activities has reduced the potential for non-operating earnings. Finally, the recent election of President-elect Obama raises concerns about trends in Medicare Advantage rates. Accordingly, many plans have increased their focus on optimizing administrative expenses.

In conclusion, the stock prices of publicly traded health plans have lost more than half of their value since the beginning of the year; market capitalization has fallen by over 65%. Operating earnings trends, however, were mixed in the third quarter of 2008, while sharp declines in non-operating incomes led to decreases in net income. Overall, Medicaid and Medicare plans outperformed their commercial counterparts in risk membership growth, revenue growth, operating income and net income growth.

This is Doug Sherlock of Sherlock Company