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Managed Care

February 09, 2021

Health Care Sector

Stock Rating **Overweight**

Investment Thesis

We recommend an **overweight** rating for the Managed Care industry over the next two years. The increase in the number of Americans insured has steadily risen and should continue to grow as more of the population qualifies for Medicare. Furthermore, given the current volatility in the market, we believe the defensive nature of the health care sector is appealing.

Tailwinds

- The Health Care sector as a percentage of GDP is expected to increase and account for nearly 20% of the U.S. GDP by 2028. [2]
- Health Insurance premiums have continued to grow faster than inflation over the last ten years. In 2022, Medicare Part B premiums alone have increased by 14.8%.[4] Health Insurance companies will have higher premium revenue than in previous years and with rates rising, will get a better return on their short-term investments.

- Innovations in health care services and technology will increase the efficiency of providers and increase profits for health insurers.

Headwinds

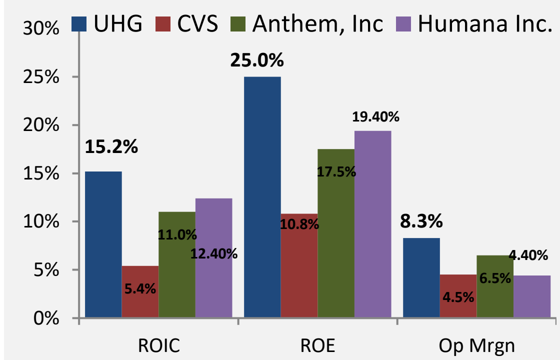
- Amazon Care and Walmart Health could be major disruptors for the entire health care sector.

- Given the high inflationary environment, Managed Care Organizations may see their medical loss ratios increase in the short term. In addition, we believe postponed medical procedures due to the pandemic may increase costs in the coming years.

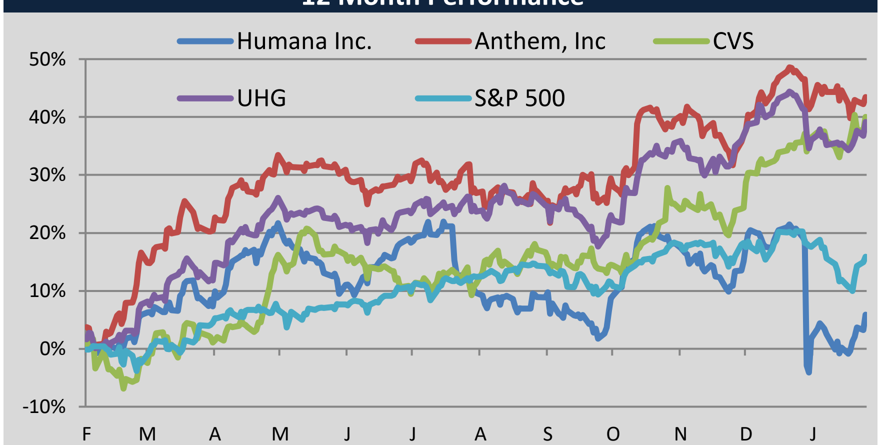
- Possible changes and/or increases in regulatory, legal, and compliance functions will create more challenges for not only MCO's but the entire health care system.

Key Industry Statistics

Market Cap	(In $Billions)
UnitedHealth Group	$502.2
CVS Health Corp	$137.3
Anthem, Inc.	$122.9
Humana,Inc.	$56.9
P/E (NTM)	
UnitedHealth Group	23.8x
CVS Health Corp	12.4x
Anthem, Inc	17.3x
Humana, Inc.	17.9x
P/B	
UnitedHealth Group	6.5x
CVS Health Corp	1.9x
Anthem, Inc	3.0x
Humana Inc.	3.7x
EV/EBITDA	
UnitedHealth Group	18.1x
CVS Health Corp	10.3x
Anthem, Inc.	12.8x
Humana, Inc.	15.4x



12 Month Performance



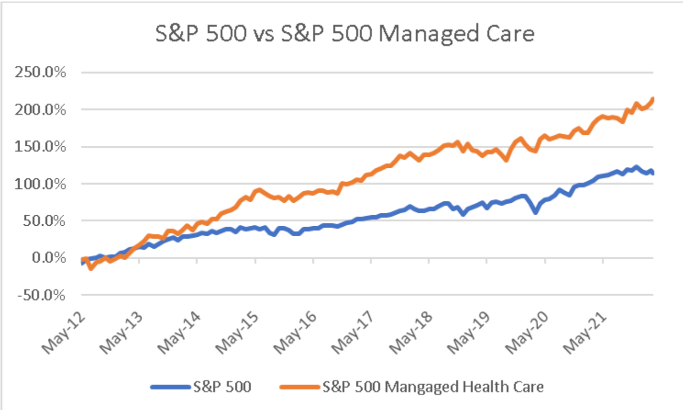
Industry Description

Managed Care is a type of health insurance intended to manage costs while maintaining quality care. Managed Care organizations (MCOs) negotiate with health care providers and hospitals to provide treatment for their members. Organizations charge a premium in exchange for helping cover medical expenses for their members. The premium charged and services covered depend on the medical plan. The top four MCOs are estimated to account for 71% of total industry revenue in 2021. [3]

Important disclosures appear on the last page of this report.

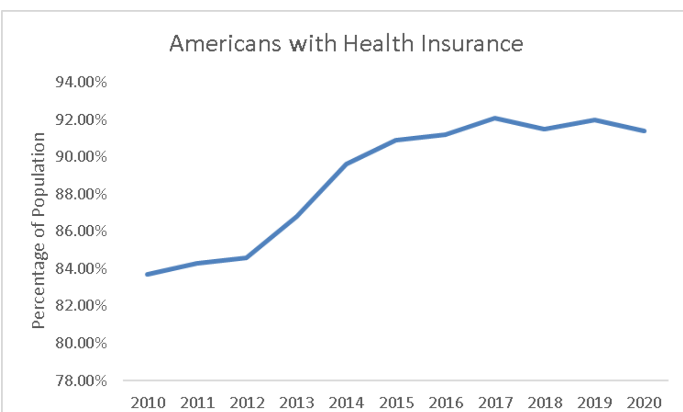
INDUSTRY OVERVIEW

Industry Trends



Source: FactSet

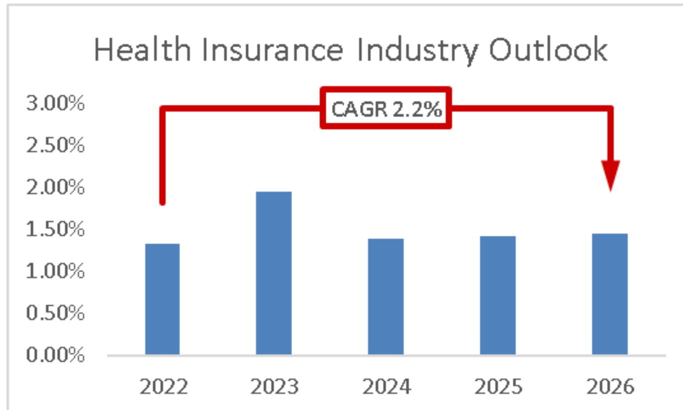
The chart above displays the performance over the last ten years of the S&P 500 and S&P 500 Managed Health Care Sub Industry Index. As shown, the Managed Care industry has done well against the market. We think this comes down to three things. The first one is the increase in the number of Americans insured. As shown below, about 91% of the American population had health insurance in 2020, compared to 84% in 2010. More Americans insured means more members in MCO's networks, leading to topline growth.



Source: Statista

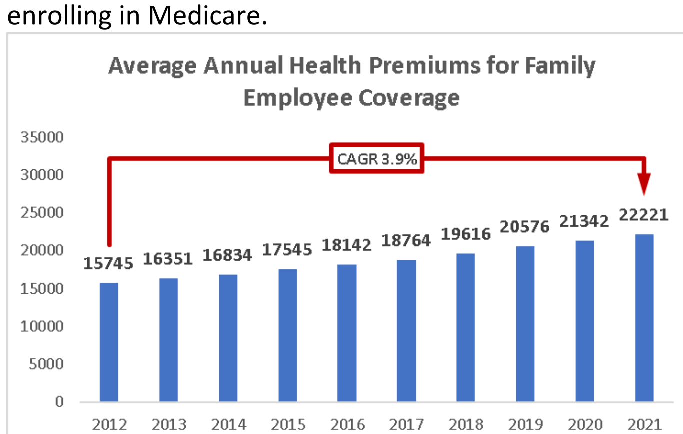
The second reason we believe the Managed Care industry has done well is because of the defensive nature of the health care industry. People will always need access to health care products/services, regardless of the economic environment. People employed are not likely to cancel their health insurance, and people recently laid off may enroll in COBRA insurance or Medicaid. Thirdly, we'd argue innovations in the healthcare space have allowed MCO's to provide better care while reducing costs. One example of this is the development of electronic health records (EHRs). EHR's are not a new thing, but as technology has evolved, EHR's have allowed for increased transparency of a patient's medical history. As a result, professionals can diagnose faster and better, saving money for insurers.

Industry Projections



Source: IBISWorld

The Health and Medical insurance Industry is expected to achieve a 2.2% CAGR from 2022 to 2026, reaching $1.1 Trillion by 2026. This revenue growth is driven primarily by an anticipated increase in demand for insurance coverage. The growth in insurance coverage may come if the current administration is able to expand the affordable care act. In addition, with the aging population, the expectation is that medical coverage will only continue to grow from seniors enrolling in Medicare.



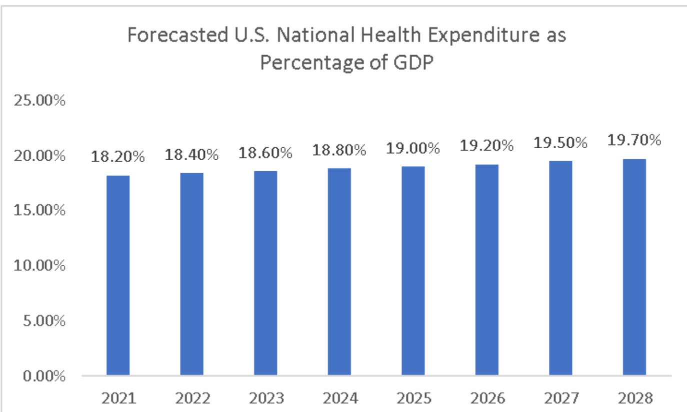
Source: Statista

Monthly health insurance premiums have been increasing too. As shown above, the average annual health premium for family employee coverage has reached a 3.9% ten-year

CAGR. MCO's bringing in more monthly premiums allows them to offset risk and gives them more premium revenue to invest while waiting to payout claims. We do not have a full outlook for 2022 and beyond; however, Medicare Part B premiums have risen 14.5% in 2022. [4]

Forecasted National Health Expenditures

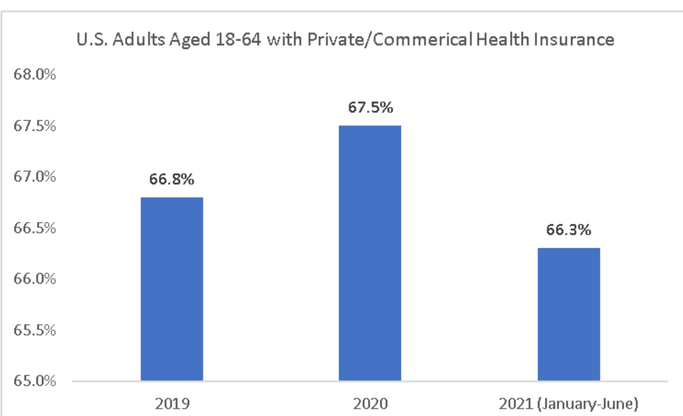
The healthcare sector accounts for a significant portion of the Country's annual GDP. As shown below, by 2028, the U.S. national health expenditure is expected to account for almost 20% of GDP. If MCOs can control costs the expected increase in national health expenditures will play to their favor.



Source: Statista

INDUSTRY SEGMENTS

Private & Commercial Insurance



Source: CDC.Gov

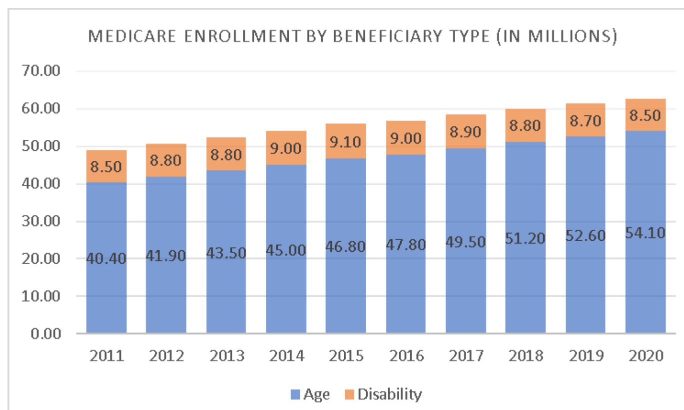
Above displays data on how dependent Americans are on private/commercial health insurance. In general, there is not a large difference between commercial and private health plans. Commercial and private plans are provided by private companies instead of insurance plans initiated by the U.S government. An employer sponsors commercial plans, while individuals can purchase private plans. The most common health plans are the health maintenance organization (HMO) and preferred provider organization (PPO) plans. [5]

Government Sponsored Insurance

Medicare & Medicare Advantage

Medicare is a federal health insurance program that is mostly used by retirees who are aged 65 and older. Some younger people with disabilities and dialysis patients may qualify for Medicare coverage.

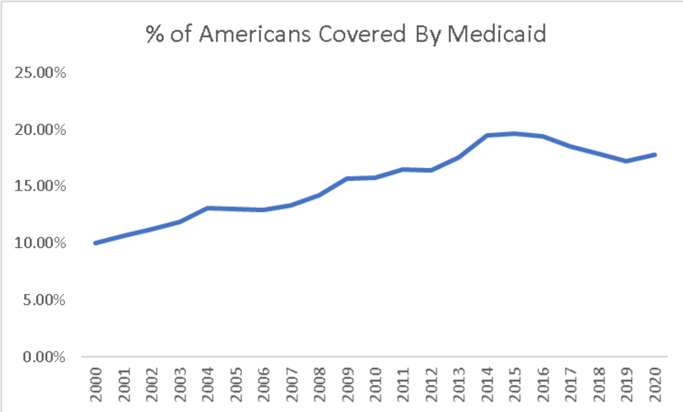
Medicare advantage sometimes called "Medicare Part C" is a Medicare approved plan managed by private insurance organizations. Finally, there is also a Medicare part D. Part D is prescription drug coverage. [5] The Henry Fund team expects managed care organizations to see the most membership growth within Medicare & Medicare Advantage plans.



Source: Statista

Medicaid

Medicaid is a federal-state health insurance program. Low-income families, qualified pregnant women and children are the most common groups who utilize Medicaid. The chart below displays the growth within Medicaid plans. The affordable care act was passed in 2010, which opened Medicaid insurance plans to more Americans. [8] As of July 2021, the Medicaid Enrollment Report indicated that 76.7 million people were enrolled in Medicaid- making it a vital part of health care coverage in the United States. [6]



Source: Statista

VHA &TRICARE

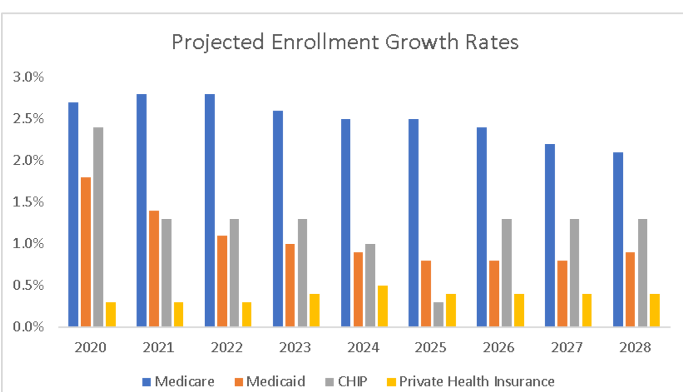
The Veterans Health Administration provides medical care to qualified military veterans. Tricare is health Insurance for U.S. military service members and their families. VHA and Tricare are primarily funded by the U.S. Government. [9]

Children's Health Insurance Program (CHIP)

CHIP is low-cost health insurance offered in each state. CHIP is specifically for children whose families earn too much to qualify for Medicaid. [10]

Industry Segment Growth

Below displays the expected growth rates of the different health insurance types. Considering the aging population, it is not a surprise that Medicare has the most anticipated growth. Therefore, when evaluating MCO's for a possible investment, it's clear that one would want to understand how they plan to capture growth in the Medicare segment. [11]



Source: Centers for Medicare & Medicaid Services

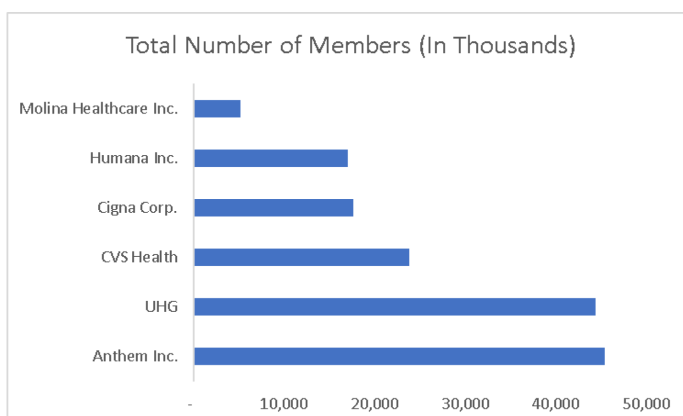
MARKETS AND COMPETITION

Threat of New Entrants

Due to significant barriers to entry, there is a low threat of new entrants in the health insurance industry. One of the largest barriers is regulation/compliance requirements. Due to state-based regulation, health insurers that provide Medicaid and Medicare benefits are under higher scrutiny, leading to a necessary increase in operating costs. Also, scale is significant in the managed care industry, and the market is already dominated by the existing MCO's. This leaves little room for anyone new to enter the industry. Furthermore, the existing MCO's have incredible expertise within the health care sector and have established strong networks over the years.

Competition

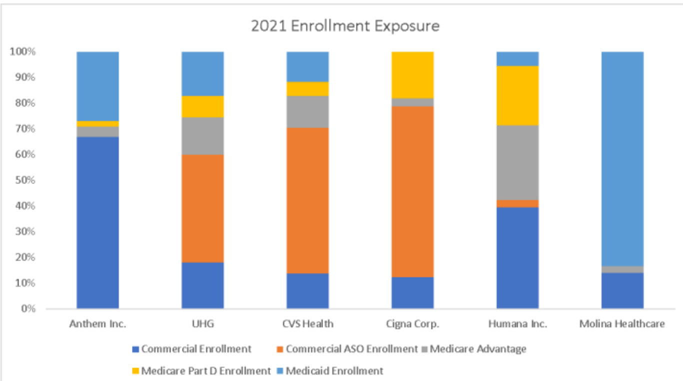
Having a large membership base is key for all MCO'S. Below is a graph of the total medical memberships for the most significant players in the managed care industry. Please note that "Members" does not necessarily mean just one person but could represent an entire family. Hence, if you add the totals up, we would be at less than half of the American population. One reason for this concentration is due to the high number of mergers and acquisitions within the industry. Successful M&A deals allow health insurers to gain from economies of scale, leading to lower costs and better care. For example, CVS Health acquiring Aetna in 2018 allowed synergies to be captured between CVS's pharmacy benefits manager and Aetna's insurance plans.



Source: FactSet

As shown above, the number of medical memberships for each MCO can vary greatly. For example, Anthem and UHG clearly have more members, but sell different insurance products. Molina has the fewest members but focuses on Medicaid, while Humana is well diversified.

Below displays the enrollment exposure of the previously mentioned Managed Care Organizations.



Source: Bloomberg

Peer Comparisons

In this section, we will dive a little deeper into the major players within the MCO industry. The table below displays some key metrics.

	Market Cap ($B)	P/E (NTM)	ROE	Op Mrgn
CVS Health	137.3	12.4x	10.8%	4.5%
UnitedHealth Group	502.2	23.8x	25.0%	8.3%
Anthem	122.9	17.3x	17.5%	6.5%
Cigna	81.1	11.0x	11.3%	4.8%
Humana	56.9	17.9x	19.4%	4.4%
Centene	50.0	15.2x	5.1%	2.8%
Molina Healthcare	19.5	18.6x	27.5%	3.7%

Source: FactSet

Anthem, Inc (ANTM)

In 2021, Anthem Inc. had the most memberships in their network. In 2021, Anthem had revenues of $137 billion [1] Anthem operates through three segments: Commercial and Specialty Business, Government Business, and Other. Anthem also operates as a licensee of the Blue Cross and Blue Shield Association. [22] As shown above, Anthem has a lot of exposure to commercial and Medicaid plans. We believe the lack of diversification is a weakness of ANTM.

UnitedHealth Group (UHG)

UHG has the second most members in their network. In 2021 they had approximately $288 billion in revenue. They earn revenue through two segments: UnitedHealthcare & Optum Health, which is their pharmacy benefits manager (PBM) and health care provider. Optum can be broken into three parts:

1. OptumHealth
2. OptumInsight
3. OptumRx

Although UHG has slightly less members than Anthem, Inc they had more than double the amount of 2021 revenue. [1] Optum Health gives UHG a significant advantage over other MCOs because Optum sales are not constrained to a medical cost ratio (MCR). We will be going over the MCR in a later section of this report.

CVS Health (CVS)

CVS Health generates revenue in four segments. Pharmacy services, retail/long-term care, health care benefits, and corporate/other. In 2021, CVS Health had over 9,900 retail locations and nearly 1,200 walk-in medical clinics. 2021 revenues were over $292 billion. Over 23 million members make up their health insurance network. [1] Like UHG, CVS Health does not have to rely solely on insurance premiums for revenue. We would like to see CVS grow its Medicare membership base. To be fair, CVS Health is still relatively new to the health insurance business. They entered the industry when they acquired Aetna in 2018.

Cigna Corp. (CI)

Cigna is a multinational MCO. Revenue segments include global health care, global supplemental benefits, group disability, life insurance, and other. [1] During 2021, Cigna had a little over 17 million members in their network. 2021 sales were over $174 billion. Cigna has their own Pharmacy benefits manager (PBM) which is called Express Scripts. As shown in the 2021 enrollment exposure chart, Cigna relies heavily on Commercial ASO enrollments. The Henry Fund team does not believe this is necessarily a “bad” thing, however, it is concerning they haven’t been able to grow their Medicare Advantage Plans.

Humana Inc. (HUM)

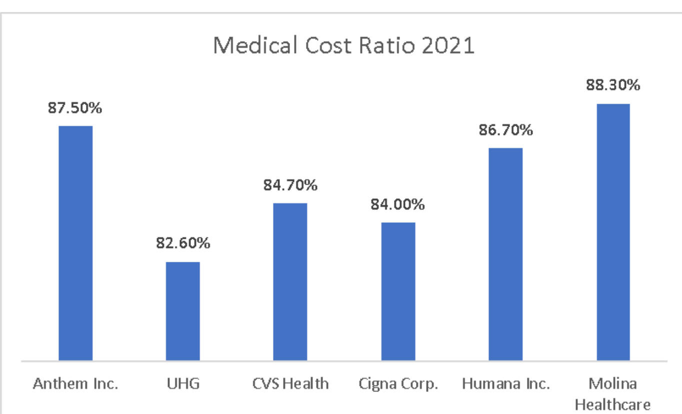
Humana is a MCO based out of Louisville, KY. In 2021, they had revenues a little over $83 billion. Humana has three revenue segments: Retail, Group/Specialty, & Healthcare Services. Unlike UHG and CVS Health, HUM relies heavily on insurance premium revenue. They have benefited from growing their Medicare membership base over the years. We believe that HUM's greatest strength is that they are well diversified. [1]

Molina Healthcare (MOH)

Molina Healthcare is an MCO based out of Long Beach, CA. In 2021, MOH had revenue a little over $27 billion. Molina Healthcare has customers in 11 states and Puerto Rico. The 2021 enrollment chart displays that MOH relies heavily on Medicaid enrollments. We believe depending on Medicaid enrollments creates a little more risk. On the other hand, specializing in Medicaid memberships could be beneficial if the government changes enrollment requirements.

Medical Loss Ratio

One important metric within the health insurance industry is the Medical Cost Ratio (MCR), sometimes referred to as the Medical Loss Ratio (MLR). The MCR is used to measure the profitability of health insurers. The lower the ratio, the higher the profitability. The Affordable Care Act requires MCOs to spend at least 80% of premiums on healthcare services and sometimes even 85% of premiums for more extensive plans. [5] If a managed care organization does not meet this requirement, it must give a rebate back to its members. Below displays the 2021 MCRs for the MCOs previously mentioned. Anything above 85% is considered high and makes investors question management's ability to control costs. In general, if an MCO sees a large increase in their medical cost ratio, it is usually a good indicator that the MCO is not properly underwriting the insurance and is not negotiating well enough with health care providers.



Source: FactSet

DISRUPTORS

Rise & Fall of Haven Healthcare

An example of how hard it is to enter the health insurance industry is Haven Healthcare. In 2018 Amazon, Berkshire Hathaway, and JPMorgan Chase teamed up and created Haven Healthcare. Considering how powerful these three organizations are, many thought that this venture would transform health care in the United States. Ultimately, the partnership disbanded in three years and did not do much for the health care sector. The Henry Fund team mentions this venture for two reasons: One, it demonstrates that three of the most influential companies could not change health care, and two, insurance companies must continue to evolve because Amazon has not accepted defeat. [12]

Amazon Care

Haven Failed, but Amazon is committed to being a player in the health care industry. For example, Amazon acquired PillPack, Inc. in September of 2018 and launched Amazon Care in 2019. In addition, there has been speculation that Amazon will add pharmacies in their Whole Foods stores. We mention this because although Amazon is not viewed as a health care company, it very well could be soon. We would also argue that Amazon has influenced some M&A deals, which will be covered in a later section.

Walmart Health

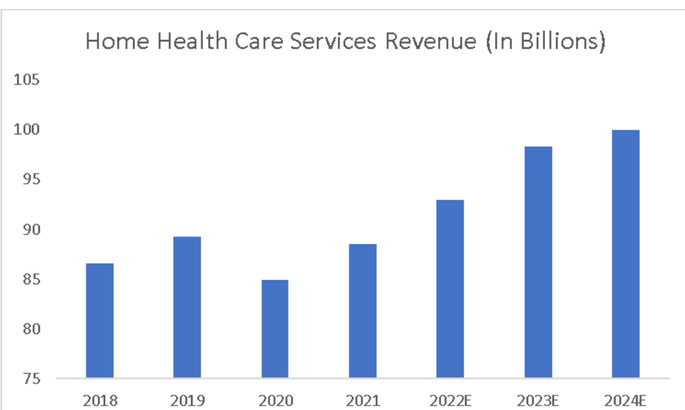
In 2019, Walmart entered the health care industry and built Walmart Health. Their medical clinics are just outside Walmart locations and offer a variety of services, including primary care, labs, X-rays, dental, optical, hearing, and many others. Considering Walmart has more than 5,000 stores across America, it could be possible for Walmart to change how many Americans receive their primary care. We do not foresee this happening very quickly, but it could affect MCO's over the long term. [14]

HEALTHCARE INNOVATIONS

As mentioned earlier, Innovations in the Health care sector are one of the drivers of industry. Below, we will cover some newer innovations in the space and how they are impacting the managed care industry.

Home health care

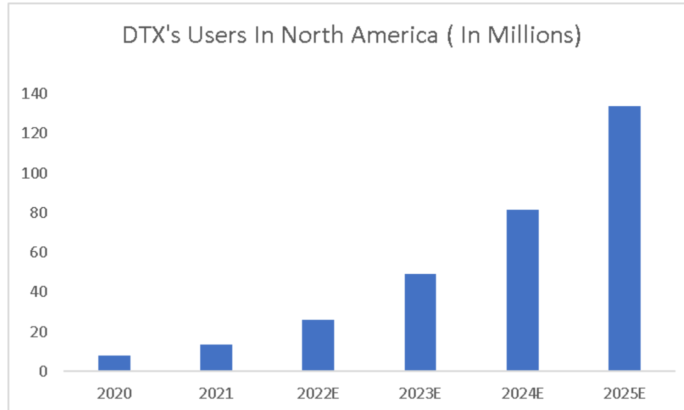
In recent years, home health care has gained in popularity. Home health care is a convenient option, especially for the aging population. Medicare.gov reports that home health care can be just as effective as some treatments you would get in a medical facility and is usually less expensive. Services provided range from treating chronic illnesses to conducting physical therapy. Research shows that patients who were treated in a home-based setting were less likely to be readmitted to the hospital. [21]Additionally, the study found that home health care patients had fewer visits to the emergency room. Fewer readmissions to the hospital and visits to the ER save money for patients and MCOs. As a result, home health care is expected to grow. As we can see in the chart below, experts predict revenue will reach $100 billion by 2024, creating opportunities for MCOs to save money. In March of this year, UnitedHealth Group acquired home health provider LHC Group for more than $5 billion. [1]



Source: Statista

Digital Therapeutics (DTx)

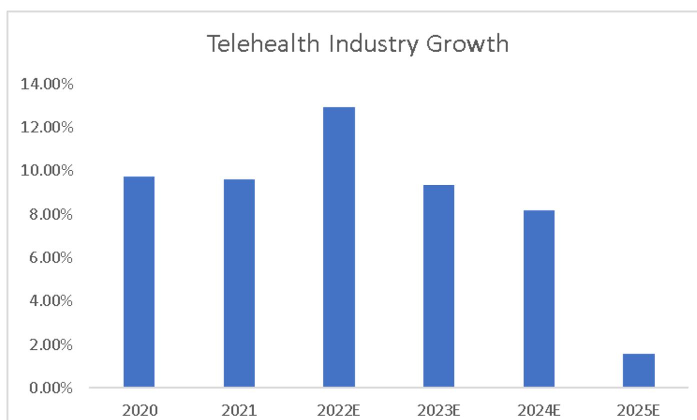
Digital Therapeutics are advanced software technologies that have passed clinical studies to help prevent, manage, or treat medical conditions. It's important to note that DTx's are not fitness or wellness apps and do require prescription. [15] For example, DTx's can help treat type 1 and 2 diabetes, migraines, ADHD, and other conditions. About 8.1 million people used a DTx technology in 2020 and that number is forecasted to be about 134 million by 2025. [15] Digital Therapeutics are another example of innovations helping improve health care and ultimately lower costs for health insurance organizations.



Source: Statista

Telehealth

Probably one of the most popular trends in the health care sector is Telehealth. Telehealth allows for health-related services and information to be administered remotely via telecommunication technologies. The Henry Fund team does not believe Telehealth will ever replace the typical doctor's visit, but IBISWorld expects to see some initial growth in telehealth services. However, by 2025 growth is expected to stall to about 1.5%, which will be around $4.8 billion annually. [3] Most health insurers have some type telehealth offerings within their membership plans.



Source: IBISWorld

M&A ACTIVITY

Centene Corp. Acquires Magellan Health

In January, Centene Corporation (CNC) acquired Magellan health for $2.2 billion. [1] As a result of this deal, CNC will now control one of the largest behavioral health networks. 5.5 million of Magellan's government sponsored plan members will be added to Centene's membership base. Centene estimates they will capture around $50 million in cost synergies. [18]

UnitedHealth Group Acquires DivvyDOSE

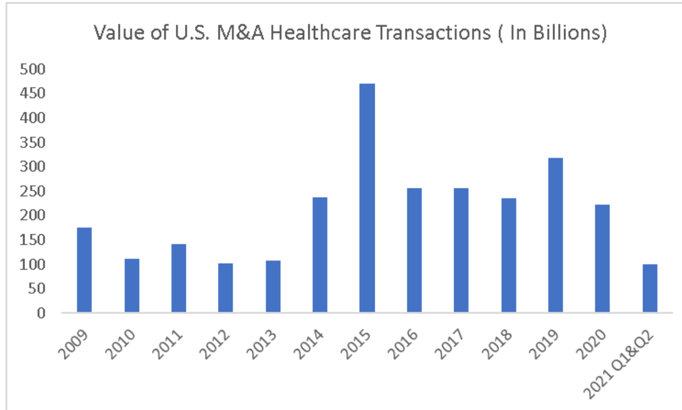
In September of 2020 UHG acquired DivvyDose for $300 Million. DivvyDose is an online pharmacy with prescription delivery services. [1]

Anthem Inc Acquires ZipDrug, Inc.

In July of 2020 Anthem acquired ZipDrug inc. ZipDrug is a prescription delivery service that provides patients with low-cost prescriptions. [1]

Analysis of M&A Transactions

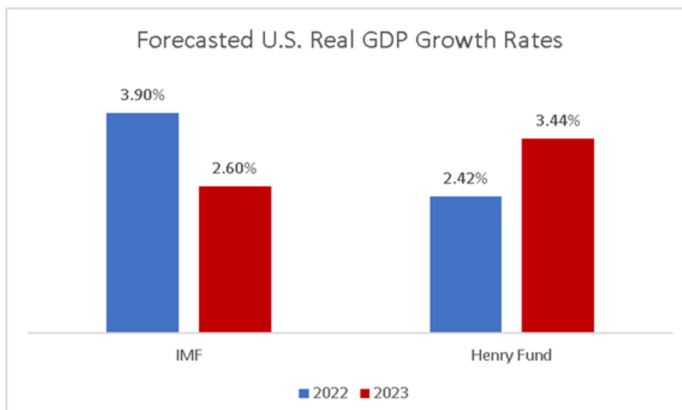
M&A activity plays an important role in the managed care industry. It would be challenging to list every acquisition that has been completed in the last few years, but we think a few important ones are mentioned above and are worth noting. Centene Corp. acquiring Magellan is a very recent deal and demonstrates consolidation within the industry. We think consolidation is likely to continue over the next decade. Considering United Health Group and Anthem Inc. have the most extensive membership base, the other major players will have to consider how to increase their memberships. Acquiring smaller MCO's seems to be the easiest, yet most expensive option. The 2nd and 3rd deals are examples of MCOs responding to Amazon's actions within the health care space. Amazon Pillpack is a direct competitor of DivvyDose, and ZipDrug. The chart below displays the high M&A activity that has occurred in recent years. In 2015, over $470 billion was spent on healthcare M&A deals. One reason for this increased amount of deal activity could be the low-interest-rate environment. Also, some deals shown below were most likely executed by financial buyers. In general, UnitedHealth Group executes the most deals out of any other MCO. [1] We do not believe this makes UHG better; however, it puts pressure on other MCOs to consider M&A activity.



Source: Statista

ECONOMIC OUTLOOK

GDP Forecast

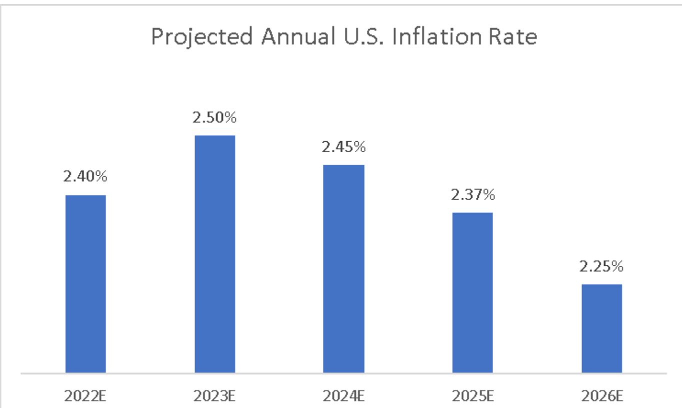


Source: Statista

The International Monetary Fund's expectations for U.S. 2022 real GDP growth rates are 3.9% for 2022 and 2.6% for 2023. [17] The Henry Fund team believes these views are too bullish for the short term and slightly bearish for 2023. We believe the real GDP growth in the United States will be closer to 2.42% for 2022 & 3.44% for 2023. We believe supply chain issues and high inflation will continue to impact the global economy in the short term. However, we predict by 2023, supply chains will be functioning properly, and the expected rate hikes will slow inflation.

Inflation Expectations

Below displays the International Monetary Fund's forecast for inflation in the United States. We believe this forecast is overly optimistic. Our short-term CPI inflation rate is about 6.5%, and our 2-year forecast is 4.1%. [16] That being said, we should expect MCO's operating cost to rise in the future but level off in the long term as they pass on higher costs to their members. As a result, we expect MCOs to have medical cost ratios closer to 85% for 2022. The high inflationary environment creates an opportunity for MCOs to demonstrate how well they can control costs.



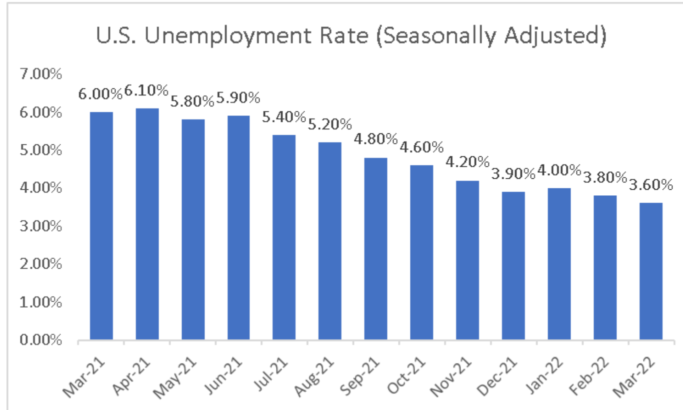
Source: IMF

Interest Rate Hikes

As we all know, the Federal Reserve intends to raise the federal funds rate. The Henry Fund team estimates there will be at least seven more 25 bps rate hikes. Bank of America and Citi Bank expect multiple 50-bps Fed hikes this year alone. [26] Overall, we think this is good thing for managed care organizations. MCOs will be able to earn a higher investment income on their premiums. In addition, it will lower the valuations on potential M&A targets.

Unemployment Rate

Over the last year, the U.S. unemployment rate has been on a relatively steady decline. It was at 6.0% last in March of 2021 and reached 3.6% in March of 2022. The drop in unemployment has a different impact on different MCOs. For example, MCOs with a lot of exposure to commercial insurance plans will benefit from people going back to work. On the other hand, MCOs with a focus on Medicaid memberships may suffer in the short term. Below displays the U.S. Unemployment rate of the last year.



Source: Statista

RECENT DEVELOPMENTS

COST PLUS DRUG COMPANY

Mark Cuban recently launched an online pharmacy called "Cost Plus Drug Company" which creates transparency in prescription drug pricing. As of February, the company offers 100 generic drugs and does not accept health insurance. Cost Plus Drug Company could provide patients with savings for those without health insurance. However, it's a little more complicated for patients that are already insured. Since Cost Plus does not take insurance, patients would not be allowed to use payments towards plans with a deductible. [19] The Henry Fund team believes Cuban's pharmacy venture won't hurt the managed care industry in the short term but will inevitably force MCOs to increase transparency in overall health care costs.

CONCLUSION

As discussed in *industry trends*, the managed care sub-industry has done well against the S&P 500 over the years. Of course, past performance does not guarantee future results. Increases in the number of Americans insured, the defensive nature of health care, and innovations have all helped the industry's performance. Although the industry is only expected to grow at a 2.2% CAGR until 2026, that would still put the managed care industry at $1.1 trillion per year. Furthermore, healthcare expenses in the United States make up about 18.2% of GDP and are forecasted to be nearly 20% of the total GDP in 2028. We believe the managed care industry will thrive from the increase in healthcare expenditures and the aging population. Of course, operating costs are steadily rising for Health insurers; however, so are premiums. Medicare part B has risen 14.8% in 2022, and other plans are also expected to rise. [4] Higher prices lead to more premium revenue, which will be invested in short-term securities with higher rates than in previous years. We believe the MCOs best positioned in the coming years are UnitedHealth Group and CVS Health. UHG has almost the same number of members as Anthem Inc. yet has more than double the revenue. UHG's Optum Health played a considerable role in their revenue generation and is only expected to grow. CVS entered the managed care space in 2018 and has done well at controlling costs. We like CVS because, like UHG, they do not solely rely on insurance premiums for revenue. In addition, CVS is a leader within the pharmacy benefits manager space and has enrollment exposure to the main types of health insurance. Overall, we have a positive outlook for the managed care industry and recommend an overweight rating over the next two years.

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