

A Three-Year Review of Performance and Operations at UnitedHealth

Dear Stephen Hemsley, CEO and Chairman of UnitedHealth Group,

I am writing to you today to review the financial state of UnitedHealth over the past three years, with a focus on examining the organization's performance in its financial statements and the operational realities behind these numbers. Additionally, I will summarize the industry and macro trends that could possibly be affecting these ratios, including suggestions on how these trends could be affected and improved upon. I will begin with a basic summary of your organization and its attributes.

UnitedHealth is a provider of managed care health services, operating solely in the United States. With 67,000 employees, the company is one of the two leading giants in its field, along with Anthem/Wellpoint. Founded in 1974, UnitedHealth has enjoyed riding a wave of expansion in managed care services in the United States. The largest trend contributing to this expansion has been the shift and reliance of the American healthcare system from fee-for-service payments for medical care to insurance reimbursements for medical. Begun as a small organization, the company has enjoyed dramatic growth, both through organic improvement of its operations and a successful history of acquisitions within its industry group. These deals included the buy-out of Mid Atlantic Medical Services, which strengthened the company's reach and exposure to the Midwestern market, and the acquisition of PacifiCare, a huge \$9.1 billion deal that gave the company a major presence on the west coast, specifically California, and high exposure to Medicare part-D.

A basic review of UnitedHealth's performance over the past three years is helpful in starting this examination. Looking at the cash position of the company on its balance sheet, it has remained stable and in fact grown, from \$6.0 billion to \$9.6 billion. This has happened while the company made a significant \$10.0 billion buyback of stock. Operationally, operating income has grown by \$2.5 billion while net income has grown by \$1.3 billion. In looking at cash flows, the major changes in flows stemmed from net income, investments and stock buybacks. These are the characteristics of a very healthy and well-performing organization in that the only major negative effects to cash have been optional distributions.

In taking a more direct focus of where the UnitedHealth's operations can continue to improve, it is important to remember that while UnitedHealth has grown to have divisional operations outside of its core managed care business, such as its Ingenix unit that offers healthcare IT services and support, even these auxiliary divisions mostly serve the function of supporting managed care operations. Thus, a conversation about UnitedHealth's performance and its improvement needs to focus on managed care operations. In managed care, executives place their primary operational obsessions upon patient quantity and patient mix in their organizations. Managed care organizations work to manage their patient blend between commercial payment, Medicare and Medicaid patients. Strictly from a financial perspective, the most reliable of these three forms of payment is commercial payment while the highest reimbursement comes from Medicare. Medicaid usually has the least reliability and the lowest reimbursements, but carriers are required by most state laws to hold certain percentages of Medicaid patients on their rolls. With this basic summary of the major trends in the managed care industry, we will

analyze the company's performance through its financial ratios and the explanations for performance behind these ratios.

Liquidity Ratios

As a general comment for the company's liquidity ratios, it should be noted that performance improved significantly because 2005 and 2006 because of the finished integration of the PacifiCare acquisition and strong performance from commercial HMO and Medicare patient rolls. The balance sheet weakened a bit in 2007 on the asset side of the balance sheet because the company made a big push into repurchasing stock. This, however, decreased shares outstanding and improved the company's equity position for shareholders. UnitedHealth has shown a regular habit of buying back stock, and this is commended and a good practice for the company. It is a very simple and direct method of increasing returns to shareholders and delivers greater longer-term rewards than simply paying out cash dividends.

Current Ratio

The company's current ratio has risen from 0.64x to 0.84x. As a general measure of asset strength, this is positive because it indicates better coverage of overall financial health on the balance sheet. This change has mostly occurred because of a steady ramp-up in cash and a reduction in short-term debt. UnitedHealth has seen improvements in its cash generation and increases in its assets, debt paydown and repurchases of stock because of its ability to shift its customer mix into Medicare, through the PacifiCare acquisition and improvement of its own current patient rolls, and the increased payment boon of the

Medicare Part-D plan. Furthermore, due to negotiating strengths and effective cash cycle management, UnitedHealth is able to control its days payable better than many of its competitors, giving the company a better asset ratio.

Quick Ratio

The quick ratio has increased from 0.48x to 0.63x. This has been aided by improvements in operations and cash flow. It should be noted that most of UnitedHealth's current asset concentration is in its cash and equivalents and accounts receivable, which is quite healthy given the liquid nature of its asset base if there ever should be a capital emergency.

Acid Test Ratio

The acid test for the company has risen from 0.36x to 0.52x, a very good trend in that the acid ratio is now above 0.50x. As a general benchmark for large private conglomerates, a liquidity test of cash and equivalents securing half of the company's current liabilities shows good strength that can be used to make hard negotiations with creditors for the best terms. It also gives lenders and providers a high degree of security around the company not having a cash crunch.

Days of Accounts Receivable

The days to accounts receivable collection decreased significantly from 2005 to 2006 and stayed stable in 2007 as the company used its leverage on the west coast and its Midwest

states to significantly tighten its leniency on collection. The collection period from commercial HMO customers decreased by 42% and the company was able to lobby for 15% faster collections from the government. The scale of UnitedHealth's operations gives it a stranglehold on other healthcare agencies in many areas in which it dominates the patient care market. Overall collections have decreased from 15.6 days to 9.5 days. This means the company is now turning over its receivables 38 times a year instead of 23 times. UnitedHealth has seen a bigger improvement in its receivables collection than any of its competitors in the last three years and it is now the industry leader in this category.

Days cash on hand

While days cash on hand has decreased slightly, from 56 days to 53 days, this cash level is still above 50 days, a good benchmark for the industry that shows exemplary health to meet obligations. Additionally, operating expenses have stayed relatively under control and this cash on hand level would have remained higher if it were not for the high level of stock and debt paydown by the company.

Average Payment Period

The average payment period for UnitedHealth has sped up significantly from 154 days to 101 days as the company has shifted a significantly higher percentage of its patient rolls into Medicare and Medicaid patients. The quicker demands of governmental standards of payments have not allowed the company to stretch its payments the way that it is accustomed to with commercial HMO patient rolls.

Profitability Ratios

Operating Margin

The company's operating margin has stayed stable but come down slightly from 11.8% to 10.4% as a more challenging macro environment for healthcare costs and the more expensive costs of paying for Medicare reimbursements has taken a drag on profits. However, overall profits and the scale of the company's operations have improved significantly as it takes on more seniors. Without this important area for business expansion, finding other ways to increase patient rolls would be difficult.

Return on Total and Net Assets

The company has been able to push more revenues out of its asset base due to the expansion of its business into the Medicare business. While margins have been slightly compromised, they have remained stable. For a managed care company like UnitedHealth, there is a significant and large fixed expense involved in setting up a network and beginning service in new geographic areas. Once this infrastructure is established, the organization functions like a large bank and payment processing organization. Thus, the marginal expenses to each additional dollar of revenues are quite small. This is why UnitedHealth has had such a success in expanding its business further into Medicare and west coast operations and why returns on assets have improved so much. Return on total assets improved from 13.05% to 15.4% while return on net assets improved from 30.3% to 39.1%.

Activity Ratios

Total Asset Turnover

Total asset turnover soared not only because of revenue improvements but because of strong growths in cash and equivalents and investments as the company generated cash and put much of this cash back into reserves and improving the company's financial position.

Fixed Asset Turnover

Fixed assets in a managed care organization are typically quite low. They mostly encompass the bricks and mortar and computers that people at the organization use. To the point on expandability and scale of UnitedHealth through solid infrastructure, this ratio has improved significantly from 27.5x to 35.6x.

Capital Structure Ratios

Capital structure is the one area of major concern for the organization. Due to the buyouts of PacifiCare and Mid Atlantic Medical Services and the choice to use cash towards improving the company's equity position, debt has increased significantly and the reserves to pay it down have been limited due to management's strategic choices. These difficulties can be seen in long-term debt, interest coverage and debt coverage. The company needs to be careful in decisions to undertake further acquisitions and in making sure that it considers a pause on equity paydown to remove debt concerns.

Long-Term Debt to Net Assets Ratio

The ratio of long-term debt to net assets has increased from 0.22x to 0.45x due to an acquisition buying spree by the company. Normally, companies in this industry like to keep long-term debt ratios below 0.2x-0.3x because of the strong shifts that can occur in reimbursement and the lack of foresight that often exists around healthcare costs.

UnitedHealth has regularly kept its long-term debt level higher than peers because of its high levels of cash generation and its strategic focus on acquisitions in addition to organic improvements. However, it might be advisable for the company to take an acquisition pause as it shores up its debt levels. To some extent, this will happen due to macro and legal pressures anyway, in that the company has reached a point of size where acquisitions in many markets would be blocked by the FTC and state health commissioners.

Net Assets to Total Assets Ratio

Net assets to total assets have also declined from 0.43x to 0.39x due to expansions of total debt that have increased the company's leverage while feeding a revenue expansion.

Times Interest Earned Ratio and Debt Service Coverage Ratio

Normally, if a company's debt levels increase, this can be mitigated if interest cost levels are falling and the company is still able to cover its short-term interest costs. The logic behind this is that even if debt is high, it can continue to be refinanced and that the impact of these obligations on the firm are long-term and not of immediate concern. However, when a company sees its times interested earned ratio fall from 23.3x to 15.4x and its debt service coverage ratio fall from 25.2x to 16.7x, these coverage levels are still strong

but they indicate a trend that deserves immediate notice. When a company's interest coverage levels fall below 10.0x, CFOs usually become concerned. UnitedHealth has not reached this level, but the company would likely lose the A rating on its bond issuances if its debt levels and interest coverage levels deteriorated further. Debt rating downgrades create a snowball effect that can cause major problems for a company. Losing its A rating should be a worry that makes UnitedHealth management very concerned about careful acquisition, debt paydown and cash management going forward.

Custom Ratios for UnitedHealth

Medical Cost Ratio

The medical cost ratio is probably the most important ratio that managed care executives look at within their companies. This is the cost of goods sold equivalent for healthcare providing agencies and represents the percentage of every dollar of revenues that the organization needs to pay out in medical benefits. In the industry, an MCR below 80% is considered excellent. An MCR below 75% is considered sublime. UnitedHealth has been able to keep its MCR at 73.7%. While this is an increase from 72.1%, the level is still very strong. However, even a 1% increase in MCR is extremely significant in an industry where net margins are usually less than 10%. While UnitedHealth is doing a great job fighting against the trends of higher healthcare costs, particularly amongst Medicare patients, this is an important area of focus to work against. However, it should be noted that many of the impacts on MCR are macro trends that are pushed on companies and that they can not greatly control beyond patient mix.

SG&A as a % of Revenues

SG&A as a % of revenues is an important cross-industry indicator of how a company controls its own fixed costs, something that is very micro and can be affected through responsible management quite easily. On the corporate level, UnitedHealth runs a relatively lean operation, despite the organization's deceptively huge size. SG&A has come down from 15.0% to 14.8%, although it did trend up last year. If UnitedHealth can keep its SG&A at or below 15.0%, that is very strong performance.

Net Income Margin

UnitedHealth operates in an industry, managed care, which has always had very low net margins. Between medical payouts for benefits, administrative costs and organizational upkeep, 5.0% was always seen as an excellent benchmark for net margin in HMOs.

UnitedHealth has managed to push the envelope by raising its net margins above this level. However, UnitedHealth's historical net income margin levels were 7.0% or higher. Recently, this has fallen to 6.2%. Much of this net income pressure is due to rising interest expenses and higher MCR levels. While, again, MCR levels are hard to control, paying down debt would be an effective way of bringing net income margin levels back up.

Capital Expenditures % Revenues and Depreciation % Capital Expenditures

Capital expenditures as a percentage of revenues give a nice indicator of how much a company is spending every year to improve its facilities and equipment. For UnitedHealth, this level has remained at around 1%. This is an effective level because the

company is still only depreciating 91.4% of its capital base. If this depreciation level went over 100%, the company should become concerned because it is depreciating more capital than it is replacing through expenses. However, since depreciation as a percentage of capital expenditures has been increasing, this is likely an indicator that company will have rising capital expenditures in the next few years as it seeks to replenish its capital.

Purchase Stock % Cash and Purchase Stock % Net Income

Purchase of stock as a percentage of cash has increased from 35.5% to 61.2% and purchase of stock as a percentage of net income has increased from 64.7% to 126.5%. As mentioned earlier, these are good trends for a company with high cash generation, high cash and debt coverage and low debt and interest. However, these drastic increases in stock buybacks should be reconsidered given the elevating levels of debt at the company and the more urgent attention that should be paid towards retiring this debt. Not only is this debt alarming to the capital structure but the resulting interest costs are affecting net income margins.

SWOT ANALYSIS AND CONCLUSION

UnitedHealth is a first-in-class organization in managed care but its rising debt levels are troubling and healthcare cost trends and reimbursement trends are unpredictable.

Strengths

The company has shown the ability to maintain operational strength and excellence in light of difficult trends in reimbursement and elevations in healthcare costs. The company has made strong acquisitions that have leveraged its asset base to boost revenues while keeping margins stable. The company has a dominant market share in many markets and is in an oligopolistic position of shaping the healthcare and managed care industries anywhere that it chooses to compete.

Weaknesses

UnitedHealth's focus on stock paydown, while effective in giving shareholder returns and lowering sharecount, is perhaps misdirected as the company has increasing debt levels that it needs to paydown. Additionally, the company may have been too aggressive in making its acquisitions, although they have been good deals, not allowing enough time to integrate previously finished deals and stabilize its capital structure.

Opportunities

The company continues to expand its patient rolls, particularly in the Midwest and west coast and amongst Medicare patients. With its incredible economies of scale, the company could use cost pressures to take business away from competing HMOs in its core markets while using lower price points to drive away competitors in its new markets.

Threats

As is always true in managed care, the looming and unpredictable threats of reimbursement decreases, significant healthcare reform and a government takeover of health insurance could break UnitedHealth's business model.

Nonetheless, the final analysis is that UnitedHealth is an excellent and well-operating organization that will maintain its first-in-class managed care leadership if it abstains from acquisitions before paying down and stabilizing its debt levels. During this time, it can place its operational focus on improving its existing markets and lobbying and protecting the role of managed care insurance and reimbursement in the United States healthcare system.

Appendix: Selected Breakdown of Financials and Ratios

Figure 1 – UnitedHealth Group Balance Sheet

UnitedHealth Group Balance Sheet			
(December Fiscal Year End, \$ in MM)			
	2005	2006	2007
Cash and Equivalents	\$5,421	\$10,320	\$8,865
Short-Term Investments	590	620	754
Cash and Short Term Investments	\$6,011	\$10,940	\$9,619
Accounts Receivable	\$1,935	\$1,884	\$1,960
Other Current Assets	2,694	3,220	3,965
Total Current Assets	\$10,640	\$16,044	\$15,544
Long-Term Investments	\$8,971	\$9,642	\$12,667
PPE	1,647	1,894	2,121
Goodwill	16,206	16,822	16,854
Intangibles	2,020	1,904	1,737
Other Long-Term Assets	1,890	2,014	1,976
Total Assets	\$41,374	\$48,320	\$50,899
Accounts Payable	\$10,602	\$11,789	\$11,985
Short-Term Debt	3,261	1,483	1,946
Other Current Liabilities	2,781	5,225	4,561
Total Current Liabilities	\$16,644	\$18,497	\$18,492
Long-Term Debt	\$3,850	\$5,973	\$9,063
Total Debt	\$7,111	\$7,456	\$11,009
Other Liabilities	\$1,761	\$1,850	\$1,849
Deferred Income Tax	1,386	1,190	1,432
Total Liabilities	\$23,641	\$27,510	\$30,836
Common Stock and Addtl Capital	\$6,935	\$6,419	\$1,036
Retained Earnings	10,798	14,391	19,027
Total Equity	\$17,733	\$20,810	\$20,063
Total Liabilities & Equity	\$41,374	\$48,320	\$50,899

Figure 2 – UnitedHealth Group Income Statement

UnitedHealth Group - Income Statement			
(For The Period Ended December Fiscal Year, \$ in MM)			
	2005	2006	2007
Total Revenue	\$45,365	\$71,542	\$75,431
Medical Costs	32,725	53,907	55,586
Gross Profit	\$12,640	\$17,635	\$19,845
SG&A	\$6,814	\$9,981	\$11,200
Other	453	670	796
EBIT	\$5,373	\$6,984	\$7,849
Interest Expense	\$241	\$456	\$544
Income Tax Expense	1,832	2,369	2,651
Net Income	\$3,300	\$4,159	\$4,654

Figure 3 – UnitedHealth Group Cash Flow Statement

UnitedHealth Group - Cash Flow Statement			
(For The Period Ended December Fiscal Year, \$ in MM)			
	<u>2005</u>	<u>2006</u>	<u>2007</u>
Net Income	\$3,300	\$4,159	\$4,654
Depreciation	\$453	\$670	\$796
Amortization	167	137	378
Changes in Accounts Receivable	(83)	(411)	(580)
Changes in Liabilities	489	1,971	629
Total Cash Flow From Operating Acts	\$4,326	\$6,526	\$5,877
Capital Expenditures	(\$509)	(\$728)	(\$871)
Investments	(55)	(755)	(3,014)
Other Cashflows from Investing Activities	(2,925)	(618)	(262)
Total Cash Flow from Investing Acts	(\$3,489)	(\$2,101)	(\$4,147)
Dividends Paid	(\$19)	(\$41)	(\$40)
Purchase or Sale of Stock	(2,134)	(1,948)	(5,887)
Net Borrowings	2,656	577	3,569
Other Cashflows from Financing Activities	90	1,886	(827)
Total Cash Flows from Financing Acts	\$593	\$474	(\$3,185)
Change in Cash and Equivalents	\$1,430	\$4,899	(\$1,455)

Figure 4 – UnitedHealth Group Ratio Calculations

UnitedHealth Group - Ratio Calculations			
	<u>2005</u>	<u>2006</u>	<u>2007</u>
Liquidity Ratios			
Current Ratio (Current Assets / Current Liabilities)	0.64x	0.87x	0.84x
Quick Ratio ((Cash + Securities + AR) / Current Liabilities)	0.48x	0.69x	0.63x
Acid Test Ratio ((Cash + Securities) / Current Liabilities)	0.36x	0.59x	0.52x
Days of Accounts Receivable (AR / (Revenues / 365))	15.6	9.6	9.5
Days cash on hand ((Cash + Securities)/(Op Ex - Dep)/365)	55.5	62.5	52.6
Average Payment Period (Current Liabilities / (OpEx - Dep)/365)	153.6	105.7	101.1
Profitability Ratios			
Operating Margin (Operating Income / Total Operating Revenues)	11.8%	9.8%	10.4%
Return on Total Assets (Rev - Exp / Total Assets)	13.0%	14.5%	15.4%
Return on Net Assets (Rev - Exp / Net Assets)	30.3%	33.6%	39.1%
Activity Ratios			
Total Asset Turnover (Total Revenues / Total Assets)	1.10x	1.48x	1.48x
Fixed Asset Turnover (Total Revenues / NET PP&E)	27.54x	37.77x	35.56x
Capital Structure Ratios			
Long-Term Debt to Net Assets Ratio (Long-Term Debt / Net Assets)	0.22x	0.29x	0.45x
Net Assets to Total Assets Ratio (Net Assets / Total Assets)	0.43x	0.43x	0.39x
Times Interest Earned Ratio (EBIT + Int. Exp.) / (Int. Exp.)	23.29x	16.32x	15.43x
Debt Service Coverage Ratio (EBIT + Int. Exp. + Dep. Exp.) / (Int. Exp.)	25.17x	17.79x	16.89x
My Custom Ratios			
Medical Cost Ratio (Medical Cost / Revenues)	72.1%	75.4%	73.7%
SG&A as % Revenues (SG&A / Revenues)	15.0%	14.0%	14.8%
Net Income Margin % (Net Income / Revenues)	7.3%	5.8%	6.2%
Capital Expenditures % Revenues (CapEx / Revenues)	-1.1%	-1.0%	-1.2%
Depreciation % Capital Expenditures (Dep / Cap. Ex.)	-89.0%	-92.0%	-91.4%
Purchase Stock % Cash (Stock / Cash + ST Inv.)	-35.5%	-17.8%	-61.2%
Purchase Stock % Net Income (Stock / Net Income)	-64.7%	-46.8%	-126.5%