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Potential Humana sale to rival health insurers could spark market changes

Rival health insurers look for diversification



By **Matt Dunning**

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Vishnu Lekraj, senior research analyst, Morningstar Inc.

A sale of Humana Inc. would further consolidate the U.S. health insurance market, potentially increase insurers' influence with regulators and even benefit employers that provide group health coverage.

Rival health insurers including Aetna Inc. and Cigna Corp. have reportedly approached Humana within the last six months about the possibility of acquiring or merging with the company, industry analysts said.

The nation's second-largest insurer, Anthem Inc., also is believed to be interested in a potential deal, analysts said.

Valued at \$31.87 billion as of Friday, analysts said Humana's primary lure for potential buyers is its substantial foothold in the fast-growing Medicare and Medicare Advantage markets.

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Some 7.5 million of Humana's 14.2 million members were enrolled in individual or group Medicare-related products as of March 31, more than double the combined number of Medicare enrollees at Aetna, Cigna and Anthem. The company's Medicare enrollments represent an estimated 13.6% of all current Medicare beneficiaries nationwide, according to a report by the U.S. Centers for Medicare and Medicaid Services.

"If you're looking to acquire a prime asset in one of the fastest-growing membership groups in the U.S. health insurance market, this is the one you want," said Vishnu Lekraj, Chicago-based senior research analyst at Morningstar Inc.

Humana's pursuit of a Medicare-heavy portfolio during the past five years has been deliberate, with premiums and service fees from those products accounting for 71.8% of the company's total revenue in 2014.

Analysts said Humana has accelerated its strategy of building its brand around Medicare and Medicare Advantage products as the threat of drastic funding cuts and/or structural reforms for the program seems to have subsided in Congress.

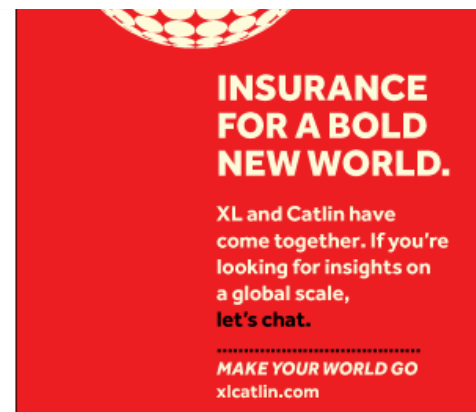
"That makes the financial outcome of being heavily involved in the Medicare business a lot more predictable today than it was five years ago," said Noel Obourn, director of emerging markets at Buck Consultants at Xerox in Hartford, Connecticut. "It's a much more straightforward exercise to figure out how to create value in your relationship to Medicare today, and the demographic trends in the U.S. are obvious" amid a bulge of baby boomers entering retirement. "When you can marry those things, it becomes quite attractive."

As far as the non-Medicare group health plan portion of Humana's business, that accounted for less than 17% of its membership and about 25% of revenue last year.

"I don't think one of the 'big four' absorbing Humana's commercial book would be anything but a positive, scale-driven value proposition for employers," Ms. Obourn said. "If the acquiring company is one that has a dominant share of the national commercial employer space, but a de minimus play in Medicare, then I'd say you have a capabilities merger that is probably going to be value-accretive to both marketplaces and not highly disruptive or negative for either."

Amid a continuing consolidation trend, a Humana sale could result in three or four major health insurers dominating the market, Deb Mabari, CEO of Tampa, Florida-based Cody Consulting, said in an email.

"These larger plans may begin to push back on (Centers for Medicare and Medicaid Services') regulations," Ms. Mabari said. "Even now, many health plans see CMS' aggressive style as a



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hindrance to providing the best and most cost-effective services to their clients; and with increased clout in the market, plans may begin resisting further changes and enhanced oversight.”

Analysts also said that if the acquiring company already has substantial enrollments in group health and Medicare, such as UnitedHealth Group Inc., that could disrupt the market, damage the combined firms' value proposition and draw regulators' attention.

“Combining those two companies might push (UnitedHealth) into the 'highly concentrated' category, which is something the Department of Justice is probably going to notice,” said Tom Mason, a Charlottesville, Virginia-based senior financial analyst at SNL Financial L.C.

Additionally, Mr. Mason said, “UnitedHealth has such a huge presence in the Medicare market already, it might not make as much strategic sense either for them to go out and buy Humana as it would for one of the other firms.”

Analysts said Humana's reported interest in a sale likely is driven in part by its poor performance on health insurance sold through public exchanges established under the health care reform law, as well as higher overall medical expenses.

Humana's first-quarter 2015 medical expenses were “driven higher by flu season, as well as profitability challenges within the Georgia public exchange,” Jennifer Lynch, New York-based research analyst at BMO Capital Markets, said in an investor report.

She said Humana has signaled that it will address its public insurance exchange difficulties by relying more on the risk adjustment programs that are part of the health care reform law, but said they are unlikely to provide sustainable profits.

“This is a totally inbounds strategy for maintaining the 2015 break-even performance target for the business line, but does not allay general concerns that the exchange business will drag on the enterprise longer term,” Ms. Lynch said.

Should Humana merge with one of its rivals, Cody Consulting's Ms. Mabari said there could be another outcome: “nimble cost-effective startup plans.” Such “startups will likely be niche players and focus on small geographic areas in order to compete with the larger players.”

Aetna, Anthem, Cigna, Humana and UnitedHealth all declined comment for this report.