MEDICAL SERVICES INDUSTRY

INDUSTRY TIMELINESS: 20 (of 98)

After a topsy-turvy 2010, the Medical Services Industry has reentered the top 25 of the *Value Line* industry rankings. The group began the year at the top of the mountain after President Obama's sweeping reform plans were met with applause. In the months following, it came to light that perhaps the effects might not be as pleasant as initially perceived. And now, as the year draws to a close, we have some more color as to the breadth of the changes, and can more visibly see which companies stand to prosper the most, and which will be voting Republican in the next election.

The core goal was to decrease the number of Americans that do not have health insurance. Clearly, hospital operators and clinical laboratories will laud such a feat. Health Maintenance Organizations (HMOs) likely will as well, in time. A lengthy adjustment period seems unavoidable for these entities.

The exact negative near-term ramifications are difficult to gauge. Therefore, we are not surprised that many of the equities in this space are currently carrying neutral Timeliness (3) ranks.

Lab Leadership

For the time being at least, it appears that *Laboratory Corporation of America* has a leg up on the other member in its duopoly, *Quest Diagnostics*.

The former company has been active on the acquisition front, which should generate substantial cost savings. Trimming expenditures is vital in the current market because, with the specter of reform hanging overhead, labs are doing everything in their power to rein in costs. On that same note, the use of in-house testing is being stressed due to its preferred pricing characteristics. The latter company, on the other hand, is struggling with volume issues. This weakness has been further highlighted owing to the aforementioned favorable light shining on its primary competitor.

Health Maintenance Re-organization

Much of the negative chatter surrounding the reform has been centered on the fact that HMOs will now have minimal spending limits. In other words, a set amount of every dollar assigned must go to medical care costs or be rebated to policyholders. The current mandates are $0.85 on the dollar for large group plans and $0.80 for individuals. In the past, unused funds were recorded as profits or used to pay administrative costs. This presents an immediate setback to companies like *Aetna*, *Humana*, *UnitedHealth Group*, and *WellPoint*, but well-managed firms will roll with the punches and churn out profits after aligning business models to this wave of change.

Premium intake should get a shot in the arm from a clause in the new act that warrants an increase for preventive benefits for screenings and wellness programs. Pricing power and cost management will be more vital then ever, and the cream will almost certainly rise to the top in this crop.

Hospital Recovery

Bad-debt expense stemming from the treatment of uninsured patients has undone any positive momentum that hospitals have generated over the last few years. Now, with charity care expected to dip, these companies may well get back on their feet.

Health Management Associates has been adding beds via acquisition to gear up for the fortuitous wave of paying customers that should surface. Physician retention, particularly in its rural areas, has also been made a priority in order to keep patients coming back. Elsewhere, *Tenet Heathcare* has reinvested its profits to spruce up existing facilities in efforts to get its volume figures on the rise once again.

When all the reform is said and done, it will likely be the hospitals that will be the last to stop cheering, as the benefits afforded to them seem to be the largest.

Conclusion

Ground-shaking changes are currently under way in the Medical Services Industry. Some investors may choose to avoid this space. For the more advantageous, we recommend the few equities that are ranked favorably (1 and 2) for Timeliness. Too, many stocks that are expected to struggle in the near term offer wide appreciation potential for the pull to 2013-2015.

As always, we suggest that potential investors thumb through each of the forthcoming pages before selecting a stock.

Erik M. Manning

Composite Statistics: Medical Services Industry

2006	2007	2008	2009	2010	2011		13-15
254961	280716	304802	323622	***348000***	***370000***	**Revenues ($mill)**	***477000***
12.2%	12.5%	10.6%	7.9%	***9.5%***	***10.0%***	**Operating Margin**	***12.5%***
3966	4653	5267	5552	***5850***	***6150***	**Depreciation ($mill)**	***6900***
13842	15149	12443	13071	***14800***	***18000***	**Net Profit ($mill)**	***26800***
36.9%	36.6%	34.5%	34.8%	***36.0%***	***36.0%***	**Income Tax Rate**	***37.0%***
5.4%	5.4%	4.1%	4.0%	***4.3%***	***4.8%***	**Net Profit Margin**	***5.5%***
10578	698.9	d5174	14758	***15750***	***17000***	**Working Cap'l ($mill)**	***20000***
37111	58716	61372	58367	***56500***	***55000***	**Long-Term Debt ($mill)**	***50000***
85592	83799	80589	95331	***105000***	***114500***	**Shr. Equity ($mill)**	***155000***
12.3%	11.8%	10.1%	9.7%	***10.0%***	***12.0%***	**Return on Total Cap'l**	***13.5%***
16.2%	18.1%	15.4%	13.7%	***14.0%***	***16.0%***	**Return on Shr. Equity**	***17.5%***
15.8%	17.7%	15.1%	13.6%	***13.5%***	***15.5%***	**Retained to Com Eq**	***17.0%***
2%	2%	2%	1%	***2%***	***2%***	**All Div'ds to Net Prof**	***3%***
16.6	15.3	12.4	9.3	***Bold figures are Value Line estimates***		**Avg Ann'l P/E Ratio**	***15.0***
.90	.81	.75	.62			**Relative P/E Ratio**	***1.00***
.1%	.2%	.2%	.1%			**Avg Ann'l Div'd Yield**	***.2%***