INDUSTRY TIMELINESS: 37 (of 98)

With the third quarter drawing to a close, the Medical Services Industry has slipped a few notches in the rankings. Make no mistake, this sector remains in the top half of the list, but there is trepidation among investors.

The Affordable Care Act proposed by the Obama Administration, and upheld by the Supreme Court is inching closer to being enacted. When it is, the effects will be widespread. We continue to think the act will be a net positive for the field, but as is always the case, their will be winners and losers. Too, those that are the benefactors will endure an adjustment phase where they need to alter operations to get in step with new guidelines. Health Maintenance Organizations (HMOs) are a perfect example.

In the meantime, a bout of consolidation has hit this arena. Lesser entities that are looking cautiously at the pending reform have decided to be purchased by larger players. Too, there has been speculation that one of the country's largest clinical laboratories is confident that it is better off going forward as a privately held entity.

LabCorp May Be On The Auction Block

Recent studies have shown that 70% of doctor visits are followed up with a trip to a clinical laboratory for screening/testing. Too, an aging population will need more of these types of services. Add to that, it is estimated that an additional 32 million Americans will be receiving healthcare benefits once the reform is complete. Clearly, this legislation should be a boon for the duopoly that dominates this space, *Quest Diagnostics* and *Laboratory Corporation of America.*

Such a perfect storm has the private-equity sharks circling. Rumors are rampant that LabCorp is in talks with these firms. LabCorp management insists thatthese reports are untrue, but given the stock's compellingly inexpensive valuation, whispers on the Street are growing louder. The bottom line is that LH is a stable high-margin business with strong cash flow. A leveraged buyout is a possibility, in our view, especially when factoring in the coming winds of change and management's recent struggles with volume figures.

Musical Chairs In The HMO Field

A consolidation trend is gaining steam in the HMO subsector, due to the belief that many of the smaller players need to align themselves with the heavy hitters. Most recently, industry heavyweight *Aetna* announced plans to take over *Coventry Health Care*. The deal, expected to be consummated with a total price tag of $7.3 billion (includes $1.6 billion in debt assumption), makes sense to us. Coventry adds further diversification to the AET portfolio, particularly with its handsome amount of government contracts. Too, Aetna is picking up these assets at a reasonable price point.

Humana and other larger HMOs have also been bolstering their enrollment via strategic purchases. Anything that can be brought on board and reap considerable cost savings to the overall company as reform approaches is in play.

Ongoing Hospital Revival

We continue to view hospital operators as the best way to obtain exposure to the medical services sector from an investment standpoint. The crux of this belief is that these stocks have suffered for the better part of a decade, due to the lofty cost of caring for the uninsured. Bad-debt expense has afflicted each of the entities under our coverage, and some, namely *Tenet Healthcare*, were on the cusp of bankruptcy due to providing pricey care and receiving little in return.

Many hospitals, like *Health Management Associates*, have spruced up their facilities and placed a huge emphasis on retaining physicians ahead of the coming swell of insured patients that should be showing up once the act goes into effect. Too, many of these stocks trade at wide discounts to their historic P/E levels.

Conclusion

The future for the Medical Services Industry looks to be bright. However, before a boom period arrives, there are moving parts that need to fall into place. Several of the following issues are timely, while others offer immense potential for the stretch to 2015-2017.

As always, we recommend that potential investors peruse each of the coming issues to decide which stock is best for their investment strategy.

Erik M. Manning

Composite Statistics: Medical Services Industry

2008	2009	2010	2011	2012	2013		15-17
303137	322072	329819	347380	***365000***	***389000***	Revenues ($mill)	***485000***
10.5%	10.4%	11.1%	11.4%	***11.6%***	***11.8%***	Operating Margin	***13.5%***
5149	5433	5716	6119	***6400***	***6700***	Depreciation ($mill)	***7500***
12207	12943	15598	16748	***18500***	***20800***	Net Profit ($mill)	***29200***
34.4%	34.8%	34.9%	34.7%	***35.0%***	***35.0%***	Income Tax Rate	***35.0%***
4.0%	4.0%	4.7%	4.8%	***5.1%***	***5.3%***	Net Profit Margin	***6.0%***
d5293	14636	13694	15965	***17400***	***19200***	Working Cap'l ($mill)	***25000***
60822	57885	61034	68619	***67000***	***65000***	Long-Term Debt ($mill)	***50000***
79619	94440	101614	106894	***125000***	***144000***	Shr. Equity ($mill)	***200000***
10.0%	9.7%	10.7%	10.6%	***10.0%***	***10.0%***	Return on Total Cap'l	***11.5%***
15.3%	13.7%	15.4%	15.7%	***15.0%***	***14.5%***	Return on Shr. Equity	***14.5%***
15.0%	13.6%	14.8%	14.4%	***14.0%***	***14.0%***	Retained to Com Eq	***14.0%***
2%	1%	4%	8%	***8%***	***8%***	All Div'ds to Net Prof	***8%***
12.5	9.3	8.9	10.0	***Bold figures are Value Line estimates***		Avg Ann'l P/E Ratio	***15.0***
.75	.62	.58	.65			Relative P/E Ratio	***1.00***
.2%	.1%	.4%	.8%			Avg Ann'l Div'd Yield	***.8%***