INDUSTRY TIMELINESS: 58 (of 98)

As 2012 heads into the history books, investors have chosen to cycle out of the Medical Services Industry in droves. Prospects for the sector remain bright, but for the near term there is a large amount of uncertainty stemming from the sweeping reform that will begin January 1, 2014. The recent reelection of President Obama secured the fact that his Affordable Care Act will persevere and kick in on that date.

Heading into the election, many stocks in this space were up considerably, and it's likely that many investors took profits heading into 2013, a year that will probably be marked by substantial changes in the way many medical services companies do business. Consolidation should hit a few fields, while cost cutting will be the name of the game for the rest. When the dust settles, we think this sector will be in good shape and be poised to post handsome growth characteristics out to late decade. Still, for the coming year we think much of the cloudiness still hanging overhead has jarred investors that were already spooked with a bevy of variables floating in the stock market. With that, this industry's ranking has fallen considerably in the *Value Line* standings.

Hospitals Will Likely Win Big

Currently, utilization is running well below historic norms. The general belief is that people are putting off any form of surgery that is not vital. Postponing such operations until the onset of Obamacare will probably prove to be a wise move on the consumer's part, but for now, results at some hospital operators are feeling the pinch.

Looking further out, however, the consensus call is that some 30 million more Americans will have coverage beginning in 2014 and that alone will cure many of the ills that have hurt the hospital arena over the course of the last decade. Bad debt and caring for the uninsured should no longer be the sizable burdens they have been in the past.

Many hospitals, *Health Management Associates* for example, are acquiring facilities in order to get their bed counts up in anticipation of the wave of volume increases expected once reform begins. Such purchases are unfortunately adding to the hospital subsector's already enormous debt. We believe those entities that service these covenants best over the coming years will distance themselves from the pack.

Specialty Operators Get A Boost

The companies that are prospering at the moment are those that patients cannot take for granted due to the critical services. Examples of such include *DaVita HealthCare Partners*, a major player in the kidney dialysis field, and *MEDNAX*, which has a sizable position in neonatal care, coupled with a growing presence in behavioral/psychiatric medicine.

Lab Volumes Are A Sizable Concern

When a potential patient decides to put off going to the doctor for a visit, one of the side effects is fewer people heading to laboratories for testing on the doctor's recommendation. Add to this the catastrophic storms experienced in the eastern part of the U.S. during 2012, and an even smaller number of people are coming to the two major players in this subsector, *Laboratory Corporation of America* and *Quest Diagnostics*. With that in mind, top- and bottom-line expectations from this duopoly have come down considerably. So, too, have their share prices.

On that note, *LabCorp* remains in the headlines as a play for private-equity firms. Such a maneuver makes sense from a number of perspectives, especially when considering the dampened expectations for 2013 brought on by the aforementioned dip in utilization. Elsewhere, *Quest* has recently upped its dividend by a wide margin, which has kept its share price from falling too far.

HMOs Are In An Adjustment Phase

Unemployment remains significantly above its historic average. In that vein, membership tallies for many of the prominent health maintenance organizations (HMOs) leave much to be desired. Moreover, Obamacare will place spending floors on each individual account. This will lead to alterations in these companies' medical cost ratios. To get out ahead of this concern, significant cost trimmings are already in full swing. Also, to compensate for any gains that may be erased by these loftier layouts, HMOs are building up their cash balances to leave room for share-buyback activity. *Aetna* has followed this blueprint thus far.

It is also worth noting that *UnitedHealth Group* has been added to the illustrious Dow Jones Industrial Average. The selection of this company highlights the medical services industry's growing prominence as a piece of the U.S. economy. It also shines a spotlight on the HMO field during these times of immense change.

Conclusion

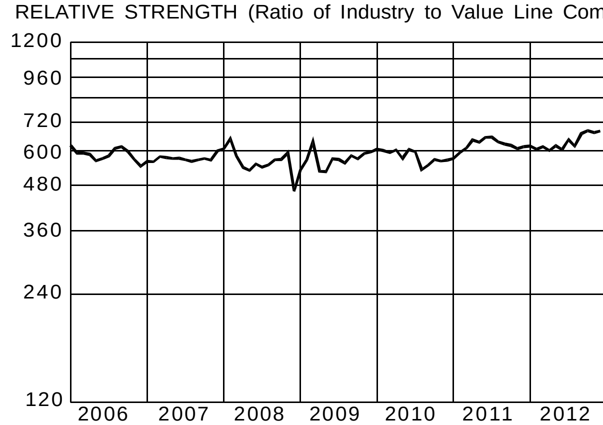
The next 12 months should be a tumultuous period for the Medical Services field. Adjustments will need to be completed successfully, and alterations to the way many firms have done business for years are undoubtedly in the works. Still, for the pull to 2015-2017, there are numerous strong investment plays in this industry that can be used to capitalize on the winds of change. That said, certain niche players are also on our recommended list for the year ahead.

We recommend all potential suitors thumb through each of the following pages before deciding which is the best selection for them to commit funds.

Erik M. Manning

Medical Services

RELATIVE STRENGTH (Ratio of Industry to Value Line Comp.)



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