The past three months have not been as kind as most expected to the Medical Services Industry. Shortly after our last review, with most of the equities in this space climbing higher, the enrollment phase of the Affordable Care Act (ACA) began. The Web site setup by the government has had a number of technical snafus and errors, but now seems to be working through some of them.

The larger problem, however, was that concerns with usage on the site opened the door to severe criticism of the reform as a whole. Too, early enrollment figures came in low. But it remains hard to gauge if such figures were due to a lack of interest or simply the result of people being unable to sign up. Regardless, the fervent enthusiasm that once was behind ACA has indeed waned a good bit. With that, a number of stocks under our coverage have taken a breather.

Bears were already beginning to surface due to the historically low utilization figures being posted by some hospitals and laboratories. Too, political-based criticism is not hard to find. Still,if the technical problems are rectified we believe that additional Americans with health coverage will be a boon to many of the entities in this field. Even still, momentum has taken a hit, and this sector has fallen by a number of notches in our industry rankings as 2013 draws to a close.

Labs May Well Consolidate

Before reform became the buzz word of this industry, the duopoly of *Laboratory Corporation of America* and *Quest Diagnostics* were the high flyers in this arena. Visions of higher profits danced in investors' heads because of new esoteric testing for advanced diseases that would reap sizable margins. All that talk has been shifted from the chimney to the back burner of late, as doctors' visits, and therefore trips for lab testing, have fallen off dramatically.

On top of this, a troubling trend of hospitals purchasing physician groups has resulted in more screenings remaining in network, but we do not expect this phenomenon to last. In fact, longer term we see a shakeout in this field with the duopoly gaining even more market share. Much of the new business beginning in 2014 will be of the lower-margin variety. Smaller operators will certainly feel a financial pinch, and many probably will not be able to stay afloat. At that time, look for the aforementioned industry leaders to become buyers.

Hospitals Gear Up For Reform

For years, bad debt and caring for the uninsured have submarined results at hospital chains. But now, many are taking an aggressive stance to capitalize on the droves of patients expected to be looking for services starting January 1st. *Community Health* and *Tenet Healthcare* are making two of the larger moves by acquiring sizable operators that will vastly increase their bed counts and locations. Both are picking up somewhat distressed assets at reasonable prices, and we believe both will prove profitable as time goes on.

Community has agreed to purchase *Health Management Associates* for roughly $4 billion. HMA has a rural base that adds a whole new dimension to the acquirer's operations. The deal was originally scoffed at by the board of the acquired, but since the initial forays that company's finances have taken a bit of a hit, and some legislation is pending against it. This likely nudged it onto the auction block. Elsewhere, *Tenet* is buying Vanguard Health Systems for $4.3 billion, which includes the assumption of a good bit of debt. Almost all hospitals are heavily leveraged at this juncture, so we see no harm in making this move, especially given the long-term potential it holds if reform goes off as planned.

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More deals like this may well be in the cards in the coming quarters. Utilization will almost certainly climb over that span, and those that are able to cash in on the new clientele will almost immediately distance themselves from the pack.

HMOs Making Tough Decisions

Health maintenance organizations were initially the least thrilled about the forthcoming changes, and now we are getting a clearer picture as to why. Most companies have significantly trimmed their profit expectations for 2014, citing the alterations that need to be made to get in line with new regulations. Spending floors for each individual account and various taxes set to be put in place have drawn the most ire from this subsector.

Reimbursements are set to be sliced considerably, particularly on the Medicare Advantage front. Companies such as *Aetna* and *UnitedHealth Group* have dropped their 2014 calls by such a wide number, we think they are being too conservative in hopes of then clearing the lower hurdles being set. Currently, Earnings Predictability here is cloudy to say the least

Conclusion

The future for the Medical Services Industry remains bright, but the road to those profits may prove to be bumpy. The risk inherent in many of these shares has certainly been ratcheted up in the near term; however, there are still some attractive options for Timeliness. Many more boast impressive total return potential out to 2016-2018.

More so then ever, we advise subscribers to peruse each of the following pages to see which possible investment best suits their needs.

Erik M. Manning