We believe Humana is among the best-positioned managed care organizations to capitalize on the long-term structural growth of Medicare Advantage enrollment given management's renewed focus on profitability over growth at any cost.

Today, roughly 65 million Americans are enrolled in Medicare[1], the US government-sponsored health insurance program for retirees and people with disabilities. Medicare enrollment has grown at a steady clip for decades, but, in recent years, that growth has been concentrated in Medicare Advantage (MA)—the highly popular, private plan alternative to traditional Medicare.

Managed care organization (MCO) Humana is the #2 carrier of Medicare Advantage plans, and the industry's most prominent pure play on the proliferating segment. Covid-19 created unusual volatility around medical utilization patterns, particularly among seniors, ultimately resulting in softer plan pricing. While this degree of mispricing is atypical for the Medicare Advantage industry, it is a familiar dynamic in short-tailed insurance markets (e.g., property and casualty insurance), and such periods are invariably followed by harder pricing and restored profitability. Despite a structurally attractive Medicare Advantage end market, Humana's stock has languished on temporary pricing headwinds that we believe investors are over-emphasizing, resulting in a compelling valuation today.

THE MEDICARE ADVANTAGE MARKET

Americans who qualify for Medicare coverage (and are not employed) have three options: traditional Medicare (fee-for-service), Medicare with supplemental coverage (Medigap), and Medicare Advantage. Medicare is the preferred option for participants who have generally low utilization and aren't concerned with catastrophic risk (no out-of-pocket maximum), whereas Medigap provides the same coverage/provider access as Medicare, with expenses capped, but comes with somewhat hefty premiums. Medicare Advantage offers a logical third option: zero premiums, fully capped out-of-pocket expenses, and complementary supplemental benefits such as vision, dental, and others.

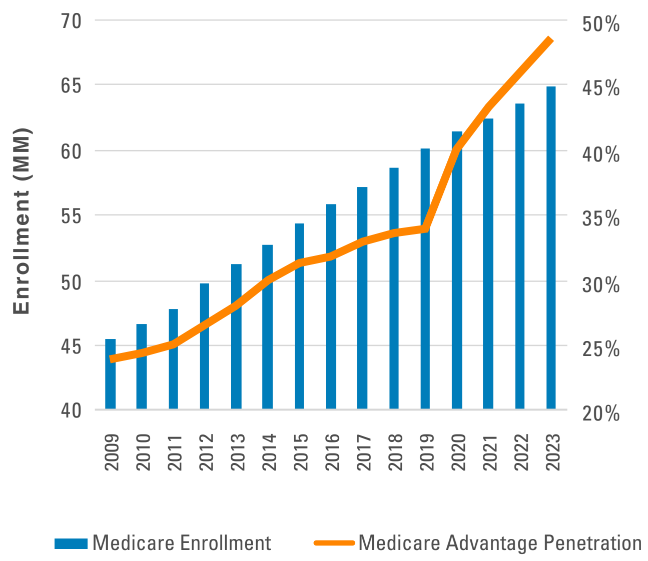
1. Bloomberg

		Earnings Per Share			Price/Earnings		
	Price	FY 24E	FY 25E	Normal*	FY 24E	FY 25E	Normal*
Humana	$373.65	$16.39	$20.31	$58.61	22.8x	18.4x	6.4x

Fiscal year-end June 28.
**Pzena estimate of normal earnings.*
Source: FactSet, Pzena analysis. Data as of June 28, 2024.

The US government's Centers for Medicare and Medicaid Services (CMS) outsources management of Medicare Advantage plans to private insurers, with the top four— UnitedHealthcare, Humana, Elevance, and CVS (Aetna)—controlling roughly 60% of the market. This is out of necessity, as the government is unable to effectively manage all the health plans of a growing US senior population while simultaneously improving care and keeping costs down—core competencies of private MCOs like Humana. Because Medicare Advantage is especially popular among a crucial voter demographic, any US administration is heavily incentivized to keep funding the program, which is why it has displayed consistent growth over the past several decades, resulting in healthy profits for Humana and peers (Exhibit 1).

Exhibit 1: A Growing End Market

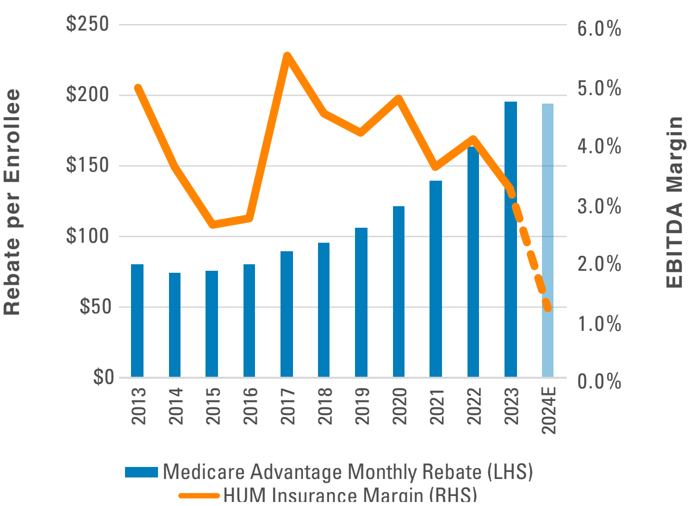


Source: Bloomberg

THE DOWNTURN

The Covid-19 pandemic's impact on the global health care system has been well documented, and its aftermath also upended the entire Medicare Advantage industry. US hospital admissions initially fell by ~20%[1] amid the 2020 lockdowns, and 2021-22 saw only a modest rebound in utilization. At the same time, CMS approved relatively generous Medicare Advantage rate increases in light of rising health care costs, which the MCOs mostly reinvested into supplemental plan benefits (or rebates, in industry parlance) to drive penetration growth, operating under the assumption that plan utilization in 2023 would look similar to 2022. Needless to say, that assumption did not play out. In the second half of 2023, seniors returned to hospitals in droves for elective procedures, while supplemental benefits were utilized much more than expected—a dynamic that has persisted into 2024. Consequently, Humana, as well as its peers, wound up having underpriced their plans (rebates were too high and premiums too low) for what turned out to be an abnormally high utilization year in 2023 and so far in 2024, eating into margins and sending shares lower (Exhibit 2).

Exhibit 2: Industry Rebates vs. Humana Margins



Source: MedPAC analysis of data from CMS on plan bids; company filings, Pzena analysis

To exacerbate Humana's profitability woes, CMS' 2025 rate increase announced this past April was highly disappointing to the industry—particularly in the context of rising medical costs. As a result, Humana's medical loss ratio (MLR), a key metric that shows total benefit costs as a percentage of premium income, is expected to come in at 89.5% for FY24[2] —the highest level on record.

MEDICARE ADVANTAGE INDUSTRY PROFIT NORMALIZATION

After eight consecutive years of Medicare Advantage rate increases following the Obama Administration's ACA rate cuts, CMS has started taking a parsimonious stance towards the MCOs. The government is effectively challenging the industry to scale back their plans' supplemental benefits, which have surged amid the MCOs' growth push, if they want to boost their margins. Encouragingly, each of the major players, including Humana, has collectively acknowledged that greater pricing discipline is paramount to achieving their target margins. In theory, benefit cuts would boost MCOs' margins at the expense of enrollment growth. However, with all the Medicare Advantage-exposed insurers experiencing pain, and the entire industry shifting from a growth to profit mindset, it's unlikely that Humana or any single insurer would shed market share, while Medicare Advantage's value proposition to seniors should remain intact even after benefit cuts. In fact, between plan years 2012 and 2016, rebates per enrollee declined, but Medicare Advantage penetration rose from 27% to 32% (roughly 4.5M net adds).[3]

HUMANA'S EDGE

While we expect the broad Medicare Advantage insurance industry to benefit from concerted cost reduction efforts, Humana is particularly well-positioned to capitalize on this structurally attractive (and growing) end market. What mostly differentiates Humana from peers is the fact that it's a vertically integrated, quasi-monoline insurer,

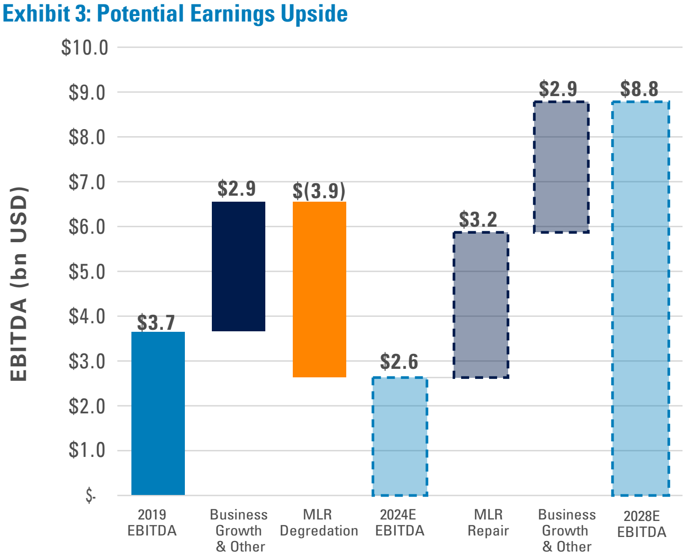
1. Annual equivalent admissions of HCA Holdings, Tenet Healthcare, Community Health Systems, and Quorum Health between 4Q19–1Q21. Source: Bloomberg

2. FactSet
3. MedPAC, Bloomberg, Pzena analysis

meaning it predominantly offers only a single type of coverage, with 84% of its premium/service revenue directly or indirectly generated via US government contracts.[1]

Humana is poised to become even more singularly focused on its core Medicare Advantage business going forward, as management looks to fully exit its non-core employer-sponsored lines this year. Competitors like CVS (Aetna) and Cigna are more horizontally integrated, with large commercial plans and other ancillary businesses. Humana's outsized exposure to Medicare Advantage simplifies the investment case to raising premiums/cutting benefits and managing utilization; and in that regard, management isn't sitting still. Beyond making blanket supplemental benefit cuts, such as to gym memberships, vision, hearing, transportation, etc., Humana will look to exit loss-making plans altogether, which are more prevalent in subscale markets. We expect management's self-help initiatives to materially repair Humana's MLR while the underlying Medicare Advantage market continues to grow, resulting in appreciable EBITDA[2] growth from today's depressed level (Exhibit 3).

Exhibit 3: Potential Earnings Upside



Source: company filings, Pzena projections
MLR degradation: 86.4% in 2019 to 90% in 2024; MLR repair: 90% today to 87% in 2028

THE BENEFITS OF VERTICAL INTEGRATION

Humana's vertical integration stems from its Centerwell (health care services) business, which includes pharmacy solutions, in-home/hospice care, and senior primary care, whereby it operates 296 facilities serving 300,000 patients across the country.[3] Centerwell accounts for roughly 25% of Humana's normal EBITDA, by our estimation, but the business also has implicit value to the company's core Medicare Advantage insurance unit that we believe investors are overlooking. Besides generating an average margin roughly 400 basis points above that of the insurance business[4], Centerwell's primary care network enables Humana to extract savings by closely coordinating between the providers and payors. Via Centerwell, Humana also has access to troves of data and insights into clinical practices that can be deployed more broadly in utilization management—a crucial part of keeping medical costs down and improving its record high MLR.

CONCLUSION

As the US population continues to age, government spending on Medicare is expected to balloon to $1.8 trillion per year by 2031, up from about $1 trillion today.[5] What's more, CBO projects ~62% Medicare Advantage penetration by 2033, up from 50% today. Put simply, Humana operates in a very attractive and growing space, and a material earnings rebound is largely predicated on management improving the economics of its plans, which reset annually. With shares trading at just ~6.4x our normal earnings estimate, we believe the market is pricing in elevated utilization in perpetuity, with little to no improvement in plan pricing and a lack of support from the government, which we view as highly unlikely.

1. Company filings, FY23
2. Earnings before interest, taxes, depreciation, and amortization
3. Company filings
4. 8% Centerwell vs. 3.9% Insurance avg. annual EBITDA margins 2020-23
5. NHE projections

FURTHER INFORMATION

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Humana was held in our Focused Value, Global Focused Value, Global Value, Large Cap Focused Value, Large Cap Value, Mid Cap Focused Value, and other strategies during the second quarter of 2024.

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