

Welcome, josephine!



Top of Form



Bottom of Form



2829;sz=120x60;ord=68399246?" BORDER=0 WIDTH=120 HEIGHT=60 ALT="Click Here"></A> </NOSCRIPT>

**UnitedHealth Group Inc**

**UnitedHealth’s narrow moat should allow it to thrive in the face of seismic industry changes.**



**by** [**Vishnu Lekraj**](http://srt.morningstar.com/analyst/stock/authorBio?t=UNH&region=usa&culture=en-US)

**Analyst Note** 04/19/2016

Despite the many headwinds United has had to contend with over the past few years, the firm has performed admirably, from our perspective. We believe management’s decision to effectively exit the public exchange market highlights this fact. From what we have gathered, most plans offered on the public exchange are yielding losses, which is likely to continue until the market fully matures. Thus, United’s decision to exit several state exchanges and stop actively seeking new membership in others is prudent. This strategy will allow the firm to preserve profitability and give it an opportunity to re-enter the market when profit headwinds have dissipated--benefiting shareholders.

On a positive note, management stated that the client retention rate for its OptumRx pharmacy benefit management operations remains in the high 90% range despite the large-scale merger with Catamaran. We believe this is a highly positive sign and runs counter to integration issues faced by Express Scripts and CVS when both firms closed their own large-scale acquisitions. We will watch how this trend develops over the next few years, but the common legacy operating platform used by both United and Catamaran seems to have smoothed the initial transition. After factoring in these latest developments, we are reiterating our $116 fair value estimate.

**Investment Thesis** 07/27/2015

Even with what is sure to be a more difficult operating environment for its core managed care business, we believe UnitedHealth possesses material competitive advantages that should allow it to produce outsized economic profits over an extended period. While the profit outlook for U.S. health insurers is uncertain, United has built itself into a powerful all-around healthcare player through acquisitions and by leveraging its large and diverse membership book.

United has also built its OptumRx division into the third-largest PBM in the United States. With the recent acquisition of narrow-moat Catamaran, United now processes approximately 1 billion prescription claims annually. This dynamic allows the firm the ability to obtain significant supplier pricing and centralized cost advantages. From our perspective, OptumRx will be a strong value driver for United over the next several years.

The firm has also moved to become a major player within the healthcare IT market through its other Optum lines. United is a major participant within the patient population and provider infrastructure management markets. We believe these business lines offer significant growth opportunities for United and should allow it to offset a significant portion of the headwinds it faces within its MCO operations.

The MCO industry will now encompass a significantly greater degree of transparency, competition, and costs. With capped gross profitability through mandated medical loss ratios, or MLRs, only players with large and sufficiently diverse membership bases will be able to earn economic profits. UnitedHealth’s approximately 46 million total medical members give it the ability to scale its fixed costs, maintain underwriting expertise, gain pricing leverage with providers, and solidify a robust member/provider network.

**Economic Moat** 07/27/2015

Given several positive factors, we believe UnitedHealth possesses a narrow economic moat and will continue to be one of the best-performing health care services firms over the next several decades. The firm has historically been the top performer within the MCO sector and we expect this trend to continue well into the future. Additionally, through a series of acquisitions and organic growth, United has become one of three major PBMs as it now processes approximately 1 billion prescription claims annually. These variables have endowed United with the ability to churn out long-term economic profits.

Through the leveraging of its large and diverse membership base, United has established the gold-standard MCO. It has a solid lineup of products and participates in most major MCO markets (individual, group, government). This diversification shields United from adverse developments within one specific risk pool. The firm also operates a top-tier PBM with its recent acquisition of narrow-moat Catamaran. The firm now has the ability to negotiate highly favorable drug pricing with all players along the pharmaceutical supply chain. This factor gives it the advantage of growing its client base by providing low-cost products, while at the same time preserving its gross margins. Scale is also a source of competitive advantage as each additional claim processed is more profitable than the previous. Centralized and technology system costs are able to be spread across the entire level of claims, which clearly gives an advantage to larger PBMs. We believe these competitive advantages form the solid bedrock of a narrow economic moat.

[**Valuation**](http://quicktake.morningstar.com/StockNet/StockValuation.aspx?Country=USA&Symbol=UNH&culture=en-US) 03/15/2016

We're increasing United's fair value estimate to $116 from $105 per share after incorporating the firm's 2015 results, 2016 outlook, and Catamaran acquisition. United has doubled the number of prescription claims it processes annually and will now be able to obtain top-tier supplier pricing discounts. We believe the firm will not only be able to increase its prescription claims over time but also the probability of each claim as it gains the upper hand with suppliers. We have incorporated a 18% CAGR for gross-profit-per-claim over our five-year explicit forecast to reflect this dynamic. We also model in a gradual scaling of centralized fixed costs as United integrates the Catamaran assets over the next few years. As a result, we believe the confluence of greater supplier pricing discounts, growing scale advantages, and a favorable purchase price of the Catamaran assets is a positive for United's overall equity valuation. Although we model moderate revenue growth for the firm's MCO operations as it implements a prudently cautious public exchange strategy, we also factor in a moderation in operating margin erosion over our explicit period as we believe the firm will execute its underwriting activities better than most if its peers. Additionally, given our slower public exchange membership growth assumption, revenue mix will not skew as dramatically toward lower margin MCO operations. Overall we believe ACA mandates and greater competition because of the exchange market will pressure United's MCO business over the long term; however, offsetting these negative variables are the excellent prospects that the firm's Optum segment represents. Over our five-year explicit forecast, we project operating revenue (revenue excluding investment income) to grow at an 9.4% compound annual rate, which includes revenue from the Catamaran PBM assets. We also model operating margins to average 6.2%, and compares with an 12.2% operating revenue CAGR and a 7.6% average operating margin over the past five years. We have factored in moderate per-member premium growth along with increasing per-member medical costs, which will pressure gross margins. Offsetting this anticipated negative trend is a positive scale trend for selling, general, and administrative costs.

**Risk** 07/27/2015

The uncertainty permeating the MCO industry is thick as the U.S. implements an overhaul of its entire healthcare system. Increased regulation, transparency, and competition will pressure industry players for some time to come. Decreasing payment rates for government-sponsored medical programs add to the heightened uncertainty for MCOs. However, even with the large amount of risk it faces, we believe UnitedHealth is positioned to work through these headwinds. In fact, there is a large growth opportunity given ACA-mandated expansion of medical coverage to most U.S. residents, which lessens some of the uncertainty for quality MCOs. UnitedHealth should be able to leverage its narrow economic moat and profitably take advantage of changing industry dynamics.

**Management** 07/27/2015

We believe UnitedHealth has a top-tier management team that has delivered excellent results. The firm has consistently outperformed most of its peers over the past several years and has built a strong reputation among providers, regulators, and customers. United is the largest health insurer in the U.S. with approximately 46 million medical members and one of the largest PBMs with approximately 1 billion annual prescription claims. The firm's strategy of building a strong core membership base has given its a solid base to operate from. Apart from its core MCO operations, the firm's management team has also built United into a health care services powerhouse through its Optum division. Driving a good amount of value is the firm's OptumRx PBM which is now one of the largest payers within the pharmaceutical industry. Through the acquisition of narrow-moat Catamaran, management has moved OptumRX into the top-tier of pharmaceutical players and has given its shareholders another source of significant long-term value creation as a result.

**Overview**

Profile:

With about 46 million medical members and 1 billion annually processed prescription claims, UnitedHealth is one of the largest MCOs and PBMs in the United States. The firm provides health insurance services to its members through products for every major insurance market--individual, group, and government sponsored. The firm also provides back-office services to providers through its Optum segment. UnitedHealth has a large nationwide operation and competes in most major U.S. geographies.

S&P 500 index data: S&P 500 Copyright @ 2016

All data from Morningstar except U.S. intraday real-time exchange quotes, which are provided by BATS when available. End-of-day quotes for Nasdaq, NYSE, and Amex securities will appear 15 minutes after close. Graph times are Eastern Standard. @ Copyright 2016 Morningstar, Inc.

**Morningstar's Take**

**UNH**

* Analyst

|  |  |  |
| --- | --- | --- |
| Price 05-13-2016  | Fair Value Estimate | Uncertainty   |
| 129 USD | 116 USD | Medium |
|  |
| Consider Buy   | Consider Sell   | Economic Moat   |
| 81.2 USD | 156.6 USD | Narrow |
|  |
| Stewardship Rating   |
| Standard |
|  |
|  |  |
| Bulls Say |
|  |
| • | UnitedHealth has the largest and most diverse membership base within the MCO market, which gives it significant competitive advantages. |
|  |
| • | The firm’s diversification into high margin healthcare IT services niche gives it the opportunity to increase its bottom line through a high growth market niche. |
|  |
| • | As United solidifies its major PBM operations, it will reap significant long-term economic profits from the 1 billion annual prescription claims it now possesses.  |
|  |

|  |  |
| --- | --- |
|  |  |
| Bears Say |
|  |
| • | The overhaul of the U.S. healthcare market has built unprecedented uncertainty into the operating environment for UnitedHealth.  |
|  |
| • | Increased transparency and competition will pressure pricing and profits for MCOs. |
|  |
| • | MA rates will be under a steep downward trend, pressuring one the largest sources of revenue for UnitedHealth.  |
|  |

[More...](http://financials.morningstar.com/competitors/industry-peer.action?&t=XNYS:UNH&region=usa&culture=en-US&cur=)

**[Competitors](http://financials.morningstar.com/competitors/industry-peer.action?&t=XNYS:UNH&region=usa&culture=en-US&cur=)**

**[UNH](http://financials.morningstar.com/competitors/industry-peer.action?&t=XNYS:UNH&region=usa&culture=en-US&cur=)**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Name**  | **Price**  | **% Chg**  |  | **TTM Sales $ mil**  |
|  |
| UnitedHealth Group Inc  | $129.00  | -0.57  |  | 165,878   |
| [CVS Health Corp](http://quotes.morningstar.com/stock/CVS/s?t=0P000000ZP&culture=en-US)  | $103.67  | -1.13  |  | 160,173   |
| [Express Scripts Holding Co](http://quotes.morningstar.com/stock/ESRX/s?t=0P0000021S&culture=en-US)  | $72.01  | -0.83  |  | 101,644   |
| [Anthem Inc](http://quotes.morningstar.com/stock/ANTM/s?t=0P000005W9&culture=en-US)  | $135.51  | -0.42  |  | 80,394   |
| [Aetna Inc](http://quotes.morningstar.com/stock/AET/s?t=0P00000072&culture=en-US)  | $107.90  | -0.64  |  | 60,936   |
| [Cigna Corp](http://quotes.morningstar.com/stock/CI/s?t=0P0000019K&culture=en-US)  | $128.36  | 0.23  |  | 38,293   |

[Compare These Stocks](http://screen.morningstar.com/Compare/Stock/StockCompareResults.html?CriteriaList=%7EAET%7EHUM%7EUNH%7E)

[More...](http://www.morningstar.com/cover/videocenter.aspx)

**[Video Reports](http://www.morningstar.com/cover/videocenter.aspx)**

**[UNH](http://www.morningstar.com/cover/videocenter.aspx)**

[Healthcare Slump Is a Buying Opportunity](http://www.morningstar.com/cover/videocenter.aspx?id=741317)