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WellCare Health: WCG

Peter Galante

Sector: Healthcare
Industry: Managed Healthcare
Current Price: $200.02
Target Price: $251.06

Company Description: WellCare Health Plans Inc. provides managed care services targeted to government sponsored healthcare programs. Services include benefits management and claims processing. The company operates through three segments: Medicaid Health Plans, Medicare Health Plans, and Medicare PDPs. Contracting with 407,000 health care providers and 69,000, WellCare is able to provide quality service to members in all 50 states.

BUY

Current Price:	$200.02
Target Price:	$251.06
Market Cap:	8.91B
Beta:	0.79
Lives covered:	4.4 Million
Cash EBITDA Margin:	8.39%
Revenue Growth:	13.65%
EBITDA Growth:	17.89%
ROIC:	12.17%
WACC:	7.94%

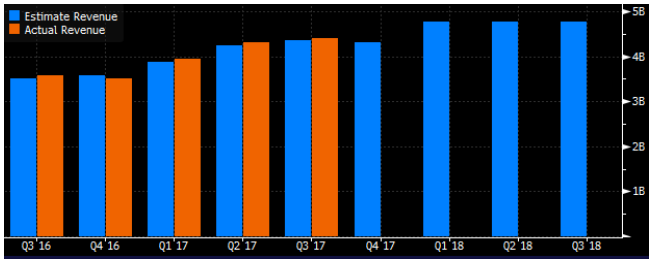
Catalysts:

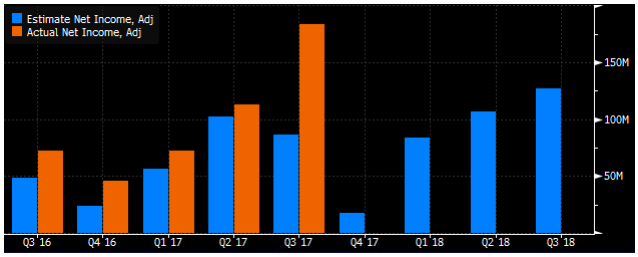
- Short Term (within the year): Successfully integrate new acquisitions, and continue operational efficiency improvements.
- Mid Term (1-2 years): Continue the execution of multi-year growth strategy.
- Long Term (3+): Achieve industry standards for margin while developing a superior product. Take advantage of growth prospects in government sponsored managed care.

Thesis: As a leader in government sponsored healthcare WellCare Health Plans have adapted a growth strategy that will allow them to take advantage of growth opportunities in managing the spend in government sponsored healthcare. Industry growth is expected to be at 6-8% through 2025 and with the improvements to operations and quality, WellCare is a clear Buy recommendation.

Earnings Performance:

WellCare has a history of accurately reporting projected revenues, as seen in the chart below which depicts no large earnings surprises for revenue. In the past five quarters, WCG has beaten estimates by a small margin. As a company that tends to make multiple acquisitions a year, WCG has displayed an ability to successfully integrate their acquisitions. There tends to be a larger variation in reported net income. WCG has beaten net income estimates in each of the last five quarters.





In their earnings call, management was able to raise guidance for 2017 EPS to a range of $8.25 to $8.40. This improved guidance came as a result of revenue growth and improved quality which led to CMS Star Ratings benefits and improved margins.

In the most recent quarter, Medicaid Premium Revenue grew at 15% year over year, with membership growing at 12% year over year. For Medicare premium revenue, there was high growth at 53% year over year and organic Medicare grew by over 10% year over year. Medicare PDP grew at a similar rate to Medicaid, with Revenue and memberships increasing at 15% and 13% respectively year over year. Management believes that through organic growth, successful RFP bids, and a disciplined but aggressive M&A strategy they have positioned the company for long term profitable growth. They foresee strong momentum heading into 2018.

In past earnings calls, management indicated that there was a 2%+ target for their after tax margin. In the most recent quarter they have reached a 2.1% margin. Management indicated that while they have reached the goal, they are not done. Ken Burdick, CEO, stated "So it is not like we feel we have sort of exhausted our playbook, there is more opportunities for improved execution, for innovation. There is plenty of runway ahead of us… we are still in the early stages of creating the high performing, differentiated growth company we envision."

Managed Healthcare Industry Outlook:

State	Medicaid Health Plans	Medicare Health Plans	Medicare PDPs	Total Membership	Percent of Total Membership
Florida	780,000	94,000	28,000	902,000	23.1%
Georgia	571,000	40,000	23,000	634,000	16.3%
Kentucky	440,000	9,000	20,000	469,000	12.0%
New York	137,000	43,000	57,000	237,000	6.1%
Illinois	166,000	16,000	27,000	209,000	5.4%
All other states [1]	450,000	143,000	854,000	1,447,000	37.1%
Total	2,544,000	345,000	1,009,000	3,898,000	100.0%

The government sponsored healthcare programs that WellCare participates in include 35.6 million individuals in Medicaid and 55.3 million in Medicare. Between these two populations, there is an estimated 9.2 million dual eligible lives. According to Centers for Medicare & Medicaid Services (CMS), healthcare is estimated to rise from 17.8% to 19.9% of total GDP by 2025. Health care spend will face inflation in the coming years, driving up costs of service more. This provides an opportunity for managed care organizations to provide value to plans by saving money and creating value. CMS projects that federal, state, and local health spending to grow through 2025 at 5.9% per year. Medicare and Medicaid are projected at 7.1% and 6% respectively through 2025. This organic industry growth plus the growth strategy for WellCare indicate strong prospects for the future.

Business Segments				
For the Fiscal Period Ending	Reclassified 12 months Dec-31-2013	12 months Dec-31-2014	12 months Dec-31-2015	12 months Dec-31-2016
Currency	*USD*	*USD*	*USD*	*USD*
Medicaid Health Plans				
Revenues	5,661.2	7,773.9	9,074.3	9,499.3
Gross Profit Before Tax	733.8	839.2	1,072.4	1,162.8
% Margin	13.0%	10.8%	11.8%	12.2%
Medicare Health Plans				
Revenues	3,071.0	3,963.2	3,898.8	3,876.6
Gross Profit Before Tax	411.5	411.6	428.4	533.9
% Margin	13.4%	10.4%	11.0%	13.8%
Medicare Prescription Drug Plans (PDP)				
Revenues	776.9	1,178.4	901.7	845.0
Gross Profit Before Tax	105.2	71.8	168.2	206.4
% Margin	13.5%	6.1%	18.7%	24.4%

Taking these growth estimates and applying them to the segments of WellCare, both Medicare and Medicaid should continue to see strong revenue growth which signals growth for the company moving forward. Management feels they have developed the right strategy to take advantage of these growth prospects. They operate with similar margins for both of their Medicare and Medicaid segments and they plan on working to expand their presence in both markets.

	12 months Dec-31-2014	12 months Dec-31-2015	12 months Dec-31-2016
Revenues	12,959.9	13,890.2	14,237.1
Operating Profit Befor	148.3	336.1	529.5
EBIT Margin	*1.14%*	*2.42%*	*3.72%*

This is a low margin business, but WellCare has made progress improving their margins in recent years. As they continue to make these improvements as part of the growth strategy, they have plenty of room to catch up to industry averages for margin. The ability to make these improvements is explained below in the explanation of the three part growth strategy.

Growth Strategy:

Management defined their growth strategy as "The Three Bs: Build, Bid, Buy." By building quality service for the members in each of the states they provide, they can be more competitive when new members are being assigned to plans, as well as with new RFP bids to access members. Improving the quality of their service for Medicare Advantage services has increased the CMS Star rating for their service. With 40% of WellCare's members enrolled in 4 star plans, there are material financial implications. Plans with star ratings of 4.0 or higher are eligible for year round enrollment. Lower rated plans have more restrictions and criteria which limits membership growth. WellCare traditionally struggles with this rating system due to the fact that the criteria is not aligned to account for the fact that they generally serve populations with severely low income. Plans with higher star ratings are also provided with additional Medicare revenues, which can be used to offer more attractive benefit packages to members or achieve higher margins. Plans achieving 4 Star performance can receive a bonus of 5% in Medicare income in the following year. These improvements in their quality over time should help their margins reach the industry average. This assumption has been included in the attached Pro-forma valuation by lowing the Operating Cost/Revenue margin down to the industry average of 93.5% which is an improvement from the current margin of 95.8%. Management indicated that while they are excited by these improvements, which were caused by tighter controls on operating procedures, they expect further improvements past the 40% at 4 stars they have already achieved.

Example of the growth strategy in action

The Bid part of the strategy indicates their strategy for making RFP Bids for providing member services then they are up for renewal. Bids are submitted to CMS based on the estimated cost to provide services in designated regions. The winners of the bids are auto-assigned new members. The contracts typically last 1-3 years, so by proving the WellCare provides quality service and identifying the appropriate opportunities, WellCare can create solid revenue growth through these bids. When combined with their buy strategy, and the overall trend of rising healthcare costs, WellCare is capable of continuing the low double digit growth they have displayed in recent quarters. These factors will allow WellCare to grow at the 10-14% rate in the next few years.

Utilization Management to Exceed Industry Standards:

WellCare is currently working to improve the quality of their service through the development of utilization management systems. This is a plan to implement rigorous quality governance that will continue the trend of improving margins. In addition to this plan, the company has been developing and integrating a key component of the care model called Care Central. This is a highly customized care platform that will

provide the internal teams with a complete view of the needs of members served and it will improve the real time coordination of managed care services for these members. This system should improve health outcomes, improve quality of service while reducing costs. In addition to this platform that improves the standard functions of MCOs, the Health Connections model identifies and incorporates a customer's social needs into their care plan. They have catalogued over 185,000 community and social service resources including transportation, food programs, and housing assistance. As these are implemented, costs will decrease with unnecessary utilization and quality will increase. These improvements are vital to exceeding industry standards.

Name (BICS Best Fit)	EBITDA to Net Sales:Q	SG&A Expn as % Tot Sl	Curr Adj Mkt Cap	EBIT/Net Sales:Q
Median	7.36%	8.48	16.42B	6.46%
100) WELLCARE HEALTH PLAN...	5.91%	7.76	8.82B	5.20%
101) MOLINA HEALTHCARE INC	-0.76%	7.83	4.27B	-1.61%
102) TIVITY HEALTH INC	25.67%	7.88	1.38B	25.05%
103) CENTENE CORP	3.62%	8.48	16.42B	2.86%
104) ANTHEM INC	6.66%	14.78	56.70B	5.66%
105) AETNA INC	10.55%	19.16	56.48B	9.48%
106) HEALTHEQUITY INC	35.42%	21.57	3.03B	29.00%
107) HUMANA INC	7.36%	--	33.35B	6.46%
108) UNITEDHEALTH GROUP I...	9.27%	--	203.41B	8.12%

Debt Facility Allows Responsible Flexibility:

Managed care organizations rely on acquisitions to increase revenue and create value. At their shareholders meeting, WellCare identified the existing credit facility that positions them for future growth. After issuing 5.25% $1.2 Billion Notes due 2025. The company also has over $4.8 Billion in cash on their balance sheet, and they have indicated they are willing to utilize it for the right acquisitions.

Capacity for Future Growth	➢ Issued 5.25% $1.2 billion Senior Notes due 2025 – Redeemed 5.75% $900 million seniors notes due 2020 – Paid off remaining $100 million outstanding on credit facility ➢ Increased total capacity of credit facility by $150 million to $1.0 billion

The implementation of their past acquisitions is a testament to their increase in operation efficiency. In their Q3 earnings call, they cited that their acquisitions of two plans in Arizona were vital to their revenue growth. They are currently a year ahead of schedule on the implementation of their Universal American acquisition. The effects of this acquisition helped total revenue for the Medicare Health plan segment improve by 53% year over year, with 10% of that coming from organic growth. In the Q&A portion of previous earnings calls, management indicated that they have a disciplined method for seeking out acquisitions where they have the potential to add value. The Universal American acquisition ($800 million cash) gave WellCare access to a large number of lives, but it is also an opportunity for them to increase the margins of UAM and create value.

What-If Analysis:

Basic what if analysis was utilized to identify how this investment can be effected based on shifts in Revenue growth and Operating Costs. In an optimistic scenario where revenue grows at a rate 2% higher than expected and the operating costs reach a margin of 93.5% in 2019 as opposed to smaller incremental changes until 2022, the one year target price would reach $292.37 which represents a 46.17% return. In a scenario where revenue growth is 2% lower than expected for each year of the forecast and operating costs improve to 95% of revenue by the end of the forecast, the one year price target is $160.30, which represents a -19.86% return. I am comfortable with the sensitivity of this model as the data indicates growth should be on the higher side of the base forecast assumptions, and bearish assumptions do not imply heavy cuts to the value of the company, and the upside is much greater.

Conclusion:

WellCare Health have positioned themselves in the right way to take advantage of the impending industry growth. As a leader in quality for government sponsored managed care, WellCare has improved operational efficiency and quality of service in recent years. Management has identified key areas in which further improvements are possible, and they anticipate sustainable growth and the ability to outperform competitors. With the integration of their utilization management plan, and their care management platform, the quality of service should increase which will give them an advantage in future RFP bids. They have a disciplined yet aggressive approach to acquisitions, and recent acquisitions have been implemented successfully. Between high growth prospects for the industry and an effective strategy moving forward, WellCare is well positioned to display industry leading growth in value creation.

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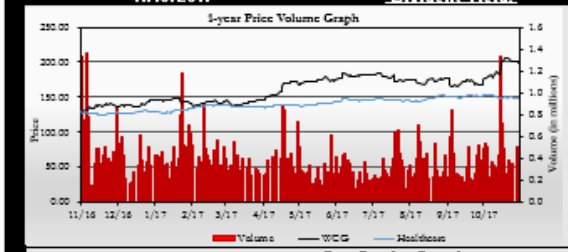
CENTER FOR GLOBAL FINANCIAL STUDIES

WellCare Health Plans, Inc.
(WCG)

BULLISH

Analysis by Peter Galante	Current Price:	$200.02	Intrinsic Value	$240.95
11/19/2017	Divident Yield:	0.0%	Target Price	$251.06

Target 1 year Return: 25.52%
Probability of Price Increase: 86%



Description

WellCare Health Plans, Inc. provides managed care services for government-sponsored health care programs.

General Information

Sector	Healthcare
Industry	Healthcare Providers and Services
Last Guidance	November 3, 2015
Next earnings date	February 7, 2018
Estimated Country Risk Premium	4.91%
Effective Tax rate	40%
Effective Operating Tax rate	40%

Market Data

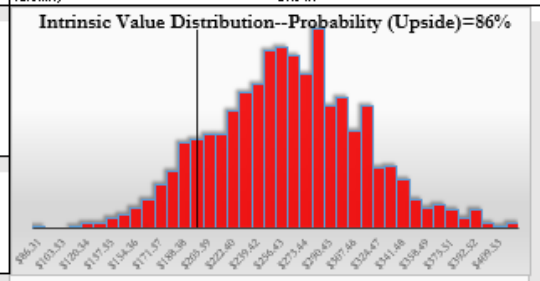
Market Capitalization	$8,905.20
Daily volume (mil)	0.47
Shares outstanding (mil)	44.52
Diluted shares outstanding (mil)	44.88
% shares held by institutions	116%
% shares held by investments Managers	87%
% shares held by hedge funds	8%
% shares held by insiders	0.53%
Short interest	3.69%
Days to cover short interest	4.37
52 week high	$208.89
52-week low	$125.00
Volatility	29.54%

Past Earning Surprises

Quarter ending	Revenue	EBITDA
9/30/2016	2.28%	29.37%
12/31/2016	-0.90%	43.35%
3/31/2017	3.74%	16.89%
6/30/2017	1.87%	7.09%
9/30/2017	1.05%	48.25%
Mean	1.61%	28.99%
Standard error	0.8%	7.8%

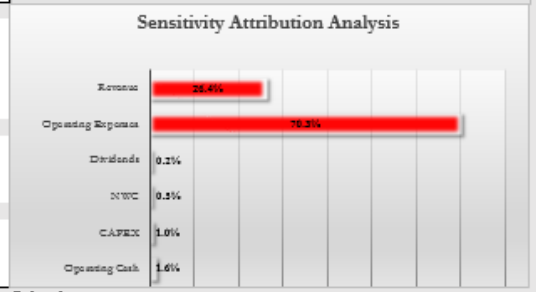
Peers

Molina Healthcare, Inc.
UnitedHealth Group Incorporated
Centene Corporation
Humana Inc.
Cigna Corporation
Aetna Inc.
Anthem, Inc.
Triple-S Management Corporation



Management	Position	Total compensation grant	Total return to shareholders
Burdick, Kenneth	CEO & Director	136.16% per annum over 1y	-4.69% per annum over 1y
Arhor, Andrew	Executive VP & CFO	8.18% per annum over 1y	-4.69% per annum over 1y
Palen, Michael	Executive Vice President of	N/M	0% per annum over 0y
Munran, Kelly	Executive Vice President of	N/M	N/M
Radu, Michael	Executive Vice President of	N/M	N/M
Meyer, Michael	Principal Accounting Officer	N/M	N/M

Profitability	WCG (LTM)	WCG (5 years histurical ave)	Peers' Median (LTM)
Return on Capital (GAAP)	-712.8%	-5.85%	1.37%
Operating Margin	2%	1.39%	2.94%
Revenue/Capital (GAAP)	-360.66	-4.21	0.47
ROE (GAAP)	18.9%	13.4%	15.6%
Net margin	2.1%	1.9%	3.6%
Revenue/Book Value (GAAP)	8.82	7.10	4.32
Invested Funds	**WCG (LTM)**	**WCG (5 years histurical ave)**	**Peers' Median (LTM)**
Cash/Capital	112.7%	95.6%	52.9%
NWC/Capital	-30.8%	-16.3%	-38.9%
Operating Assets/Capital	1.5%	10.1%	55.9%
Goodwill/Capital	16.5%	10.6%	30.1%
Capital Structure	**WCG (LTM)**	**WCG (5 years histurical ave)**	**Peers' Median (LTM)**
Total Debt/Market Capitalization	0.33	0.25	0.40
Cost of Existing Debt	6.0%	4.8%	6.6%
CGFS Rating (F-score, Z-score, and default Probability)	BBB	BB	BB
WACC	9.0%	9.5%	10.9%



Porter's 5 Forces (scores are out of 100)

Valuation

Period	Revenue Growth Forecast	NOPAT Margin Forecast	Revenue to Capital Forecast
Base Year	14%	2.8%	4.89
9/30/2018	14%	2.2%	4.33
9/30/2019	12%	2.5%	4.92
9/30/2020	11%	2.3%	4.88
9/30/2021	9%	2.5%	4.80
9/30/2022	8%	3.2%	4.65
9/30/2023	6%	3.3%	4.31
9/30/2024	6%	3.4%	4.02
9/30/2025	6%	3.5%	3.77
9/30/2026	6%	3.6%	3.55
9/30/2027	6%	3.7%	3.36
Continuing Period	2%	3.8%	3.06

Period	Return on Capital Forecast	WACC Forecast	Price per share Forecast
Base Year	13.7%	9.0%	$242.35
9/30/2018	9.7%	9.4%	$251.89
9/30/2019	12.5%	9.4%	$272.34
9/30/2020	11.3%	9.4%	$293.19
9/30/2021	11.9%	9.4%	$314.64
9/30/2022	14.8%	9.5%	$337.09
9/30/2023	14.2%	9.5%	$361.19
9/30/2024	13.6%	9.5%	$386.99
9/30/2025	13.2%	9.5%	$414.62
9/30/2026	12.8%	9.6%	$444.25
9/30/2027	12.4%	9.6%	$476.04
Continuing Period	11.6%	9.6%	

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