BofA SECURITIES

Humana Inc

Fischbeck Focus: HUM's growth and the state of the MA market

Reiterate Rating: BUY | PO: 470.00 USD | Price: 355.36 USD

Guide a disappointment, but a better setup at rebased levels

HUM issued disappointing 2024 guidance, and although 2025 EPS is expected to grow by $6-10 (38-62%), the magnitude of the growth has raised questions even as the implied $22-$26 range is well below its prior $37 target. We think the focus on the 50% EPS growth misses the mark, as there can be significant EPS growth off of a base where margins are sub 1%. In our view, the key to multiple expansion for HUM and the group is beating earnings guidance "the right way" i.e. on medical costs rather than SG&A. While HUM's 2024 guidance was clearly disappointing, we think that it is conservative (particularly the MLR), creating a good set up from these depressed levels. Following the quarter, we are lowering our EPS estimates. Our $470 PO is now based on 18.4x 2025E EPS (vs 15.5x prior) given higher visibility in hitting our rebased estimates. While the near-term results are well below expectations, we reiterate Buy as we see little reason to believe that the business long term is fundamentally different, and we expect at least three years of above-average growth off of these depressed levels.

Debunking some popular bear MA arguments

In our note, we debunk some popular bear theories on MA: 1) MA can't predict trend/it's more volatile (2023 was a perfect storm, incredibly high degree of difficulty to get right that no one (MCOs, hospitals or medtech) predicted would happen), 2) margins are permanently impaired (excluding these trend issues, the margins of the largest MA names have been remarkably consistent and with 1/3rd of the industry losing money in 2023, margins have to move up in 2025), 3) that rate pressures/benefit cuts will pressure growth (historically not true), and 4) that the market is getting aggressive/competitive (most datapoints indicate the opposite).

Fischbeck Focus: HUM's growth and the state of MA

This quarter, we focus on why 2023/2024's problems are not a HUM-specific problem, but an industry problem, which should make it easier to return to the LT trajectory. We do not see HUM's mispricing (or anyone's mispricing) as emblematic of some structural problem, inability to forecast costs, or reach target margins, but rather a function of a rare disruption in utilization post-COVID. Meanwhile, we see little evidence that the market is suddenly irrational (analyzing industry MA margins over time), making it easier to see how HUM's earnings can rebound meaningfully over the next three years.

Estimates (Dec) (US$)	2022A	2023A	2024E	2025E	2026E
EPS	25.22	26.00	16.25	25.50	30.50
GAAP EPS	22.05	19.83	10.03	19.24	24.20
EPS Change (YoY)	22.4%	3.1%	-37.5%	56.9%	19.6%
Consensus EPS (Bloomberg)			27.96	33.26	37.23
DPS	3.09	3.47	4.12	4.67	5.30
Valuation (Dec)					
P/E	14.1x	13.7x	21.9x	13.9x	11.7x
GAAP P/E	16.1x	17.9x	35.4x	18.5x	14.7x
Dividend Yield	0.9%	1.0%	1.2%	1.3%	1.5%

Refer to important disclosures on page 17 to 19. Analyst Certification on page 15. Price Objective Basis/Risk on page 15.
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Timestamp: 26 January 2024 03:05AM EST

26 January 2024

Equity

Key Changes

(US$)	Previous	Current
2024E Rev (m)	107,137.8	111,828.7
2025E Rev (m)	118,562.2	120,423.6
2026E Rev (m)	130,765.7	129,703.1
2024E EPS	26.50	16.25
2025E EPS	30.40	25.50
2026E EPS	34.65	30.50
2024E DPS	3.99	4.12

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Stock Data

Price	355.36 USD
Price Objective	470.00 USD
Date Established	25-Jan-2024
Investment Opinion	B-1-7
52-Week Range	342.69 USD - 541.21 USD
Mrkt Val (mn) / Shares Out (mn)	43,518 USD / 122.5
Free Float	98.7%
Average Daily Value (mn)	700.63 USD
BofA Ticker / Exchange	HUM / NYS
Bloomberg / Reuters	HUM US / HUM.N
ROE (2024E)	12.1%
Net Dbt to Eqty (Dec-2023A)	42.7%
ESGMeter™	High

ESGMeter is not indicative of a company's future stock price performance and is not an investment recommendation or rating. ESGMeter is independent of BofA Global Research's equity investment rating, volatility risk rating, income rating, and price objective for that company. For full details, refer to "BofA ESGMeter Methodology".

See page 14 for abbreviations

iQprofile℠ Humana Inc

Income Statement Data (Dec)

(US$ Millions)	2022A	2023A	2024E	2025E	2026E
Total Earned Premiums	87,712	101,272	108,598	116,960	125,835
Net Investment Income	NA	NA	NA	NA	NA
Total Revenue	**92,488**	**105,305**	**111,829**	**120,424**	**129,703**
Total Cost of Benefits and Claims	(75,690)	(88,394)	(97,224)	(103,832)	(111,083)
S,G & A (Including Commissions)	(12,671)	(13,188)	(12,776)	(13,334)	(14,671)
Total Operating Expenses	**(89,070)**	**(102,361)**	**(110,784)**	**(117,931)**	**(126,498)**
Pre-Tax Operating Earnings	**3,418**	**2,944**	**1,044**	**2,493**	**3,205**
Income Tax Expense	(784)	(836)	(397)	(752)	(926)
Operating Earnings After Tax	**3,200**	**3,231**	**1,983**	**3,066**	**3,589**
Net Income (Reported)	**2,804**	**2,547**	**1,224**	**2,319**	**2,853**
Diluted Shares	127	124	122	120	118
Operating Earnings Per Share	25.22	26.00	16.25	25.50	30.50
Net Income (Reported) Per Share	22.05	19.83	10.03	19.24	24.20

Balance Sheet Data (Dec)

(US$ Millions)	2022A	2023A	2024E	2025E	2026E
Fixed Income Securities	NA	NA	NA	NA	NA
Total Cash and Investments	18,942	21,320	21,026	23,752	0
Total Assets	**43,055**	**47,065**	**50,377**	**52,805**	**0**
Reserves	9,264	10,241	12,813	12,917	0
LT Debt	9,034	10,213	10,213	10,213	0
Total Liabilities	**27,685**	**30,747**	**33,835**	**34,656**	**0**
Total Equity	**15,370**	**16,318**	**16,542**	**18,149**	**0**
Total Equity (Ex FAS 115)	**15,370**	**16,318**	**16,542**	**18,149**	**0**
Book Value per Share (Reported)	121.13	131.30	135.56	150.93	0
Book Value per Share (Ex FAS 115)	NA	NA	NA	NA	NA

Ratios (Dec)

(US$ Millions)	2022A	2023A	2024E	2025E	2026E
Expense Ratio	13.7%	12.5%	11.4%	11.1%	11.3%
Loss Ratio	86.3%	87.3%	89.5%	88.8%	88.3%
Combined Ratio	**100.0%**	**99.8%**	**101.0%**	**99.8%**	**99.6%**
Avg Assets / Avg Eq (Ex FAS 115) Ratio	2.8x	2.8x	3.0x	3.0x	2.9x

Growth Rates (YoY) (Dec)

(US$ Millions)	2022A	2023A	2024E	2025E	2026E
Total Earned Premium	9.9%	15.5%	7.2%	7.7%	7.6%
Net Investment Income	NA	NA	NA	NA	NA
Total Revenue	11.6%	13.9%	6.2%	7.7%	7.7%
Operating Earnings per Share	22.4%	3.1%	-37.5%	56.9%	19.6%
Asset	-2.9%	9.3%	7.0%	4.8%	-100.0%
Reported Book Value per Share	-2.8%	8.4%	3.2%	11.3%	NA

Performance Metrics (Dec)

(US$ Millions)	2022A	2023A	2024E	2025E	2026E
Operating ROE	20.3%	20.4%	12.1%	17.7%	39.6%
Operating ROE (Ex FAS 115)	20.3%	20.4%	12.1%	17.7%	39.6%
Operating Return on Average Assets	7.3%	7.2%	4.1%	5.9%	13.6%
Operating Margin	3.5%	3.1%	1.8%	2.5%	2.8%
Long Term Debt to Cap Ratio (Ex FAS 115)	37.0%	38.5%	38.2%	36.0%	NA
Net Income % Operating Income	87.0%	78.8%	61.7%	75.6%	79.5%
Amtz of DAC % Pretax Profit bef Amtz of DAC	0%	0%	0%	0%	0%

Company Sector

Managed Health Care

Company Description

HUM is one of the largest managed care organizations in the United States, offering health insurance to members in the government and commercial segments. The company has a focus on Medicare Advantage, but also participates in other government programs including TRICARE and Medicaid. The company also has an increasingly large healthcare services business to service its installed base of membership through pharmacy, home care and primary care.

Investment Rationale

HUM is a strong player in the fastest growing market under our coverage. with additional upside potential from share repurchases and several non-healthcare catalysts, margin normalization, and the rebound in risk coding.

Stock Data

Average Daily Volume	2,254,110

Quarterly Earnings Estimates

	2023	2024
Q1	9.38A	5.83E
Q2	8.95A	5.27E
Q3	7.78A	4.76E
Q4	-0.11A	0.40E

Fischbeck Focus: State of the MA market

In the Fischbeck Focus section, we choose a theme to explore in more detail, either in response to recent investor questions or because of an unexpected development in the quarter. This quarter, we focus on why 2023/2024's problems are not a HUM-specific problem, but an industry problem, which should make it easier to return to the LT trajectory. We do not see HUM's mispricing (or anyone's mispricing) as emblematic of some structural problem, inability to forecast costs, or reach target margins, but rather a function of a rare disruption in utilization post-COVID. Meanwhile, we see little evidence that the market is suddenly irrational (analyzing industry MA margins over time), making it easier to see how HUM's earnings can rebound meaningfully over the next three years.

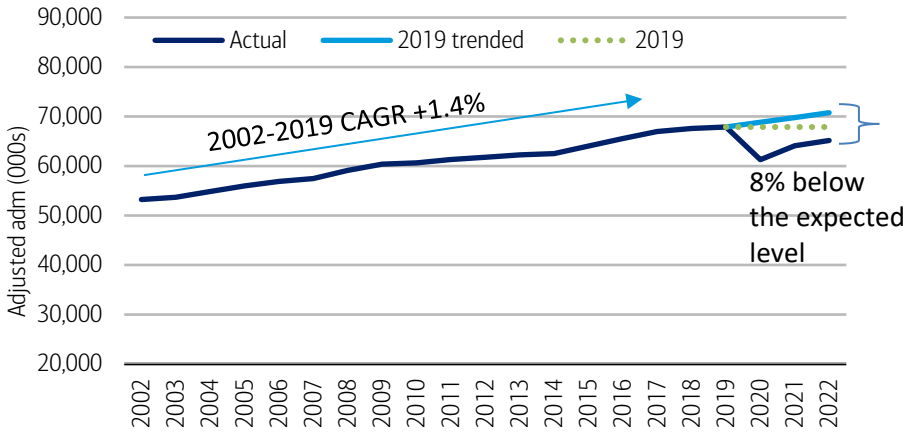
Degree of difficulty for 2023/24 was well above average

There has been a significant amount of surprise around the magnitude of trend issues in 2023/24, so it's important to take a step back and remember how we got here. In 2021, MCOs uniformly said that commercial trend was coming in higher than expected as younger people started to use the system normally, and on top of that was getting COVID. However, Medicare and Medicaid were below trend. Then in 2022, the same thing happened – commercial was above and Medicare/Medicaid were below.

In our view, this likely led MA MCOs to wonder if, after two straight years of below average trend, whether trend would actually be permanently lower going forward post COVID. This likely led to companies pricing to a more aggressive trend assumption in 2023, reducing their margin for error (with some exceptions like ELV who mispriced 2022 – see our 25 January note, so was building in more conservatism than normal into their 2023 pricing).

At the same time, we were estimating that hospital volumes were 8% below the LT trend line in 2022. Since commercial costs were above trend, most of this below average utilization was in the government business. This meant that there was a significant amount of potential trend acceleration, just when companies were pricing a little more aggressively.

Exhibit 1: Hospital volumes were 2019 levels in 2022, 8% below 2019 trended forward
Hospital industry adjusted admissions: 2002-19A; 2021-2022 BofA estimate



Source: BofA Global Research estimates, American Hospital Association, Kaufman Hall

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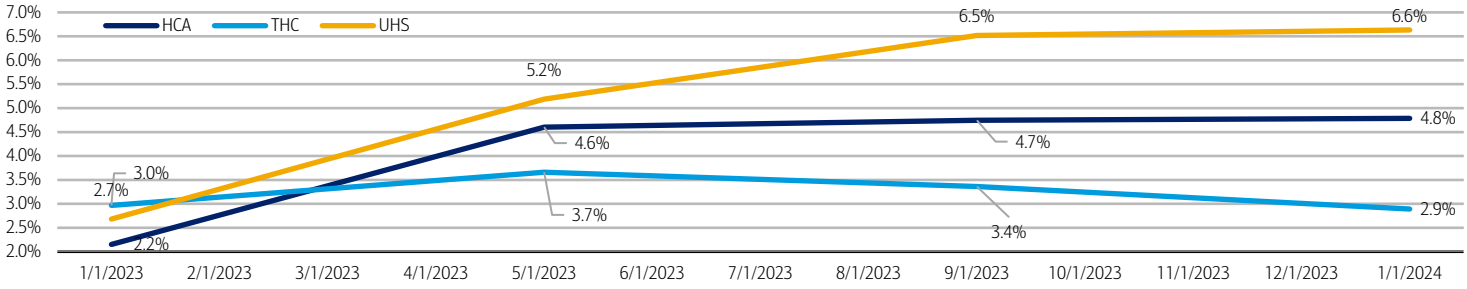
No one got it right

It is important to note that no one got it right in 2023. HUM, UNH and CVS, the three largest names, all got trend wrong in 2023. Meanwhile, CI and CNC are losing money and ELV is operating below target margins. But it is also important to highlight that the increase in volumes was not expected by the hospital companies either, where volumes are likely to come in 2x what they originally guided to. At the same time, no medtech company was guiding to the types of volume growth that they ultimately saw in 2023.

Exhibit 2: Expectations for hospital volumes have doubled since the start of the year
Public Hospital company same store adjustment admissions consensus growth estimates over time



Source: Visible Alpha, BofA Global Research

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It's worth noting only 40-50% of hospital volumes are related to Medicare, which covers elderly adults who are most likely to have seen pent up demand and deferred care during COVID. Therefore, if the volume outperformance at hospitals is mostly related to Medicare (which is where insurers are complaining), the growth rate vs initial expectations on the Medicare population could be >3x higher than expected rather than just 2x on the reported numbers.

As a result, this was a trend issue of unprecedented magnitude, based off of COVID-impacted comps where visibility was low. Therefore, we do not see HUM's mispricing (or anyone's mispricing) as emblematic of some structural problem, inability to forecast costs during normal times or barrier to ultimately reaching target margins, but rather a function of a rare disruption in utilization.

MA margin pressure built through the year

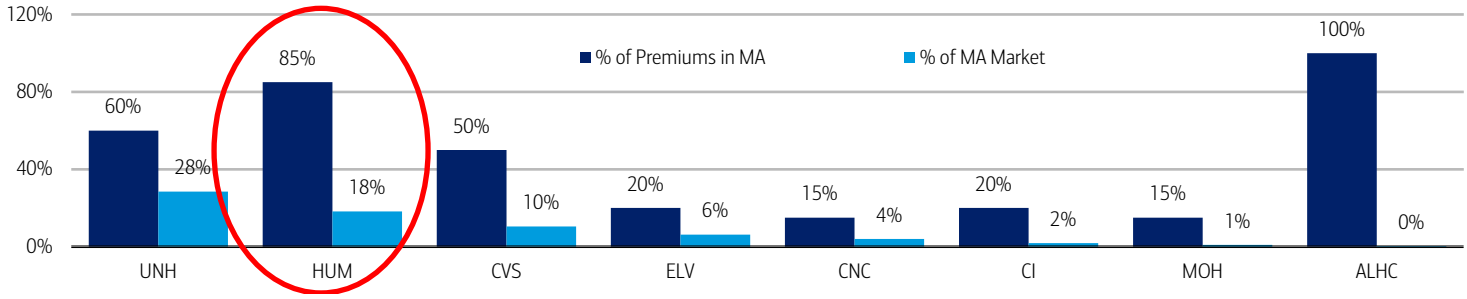
One of the best parts of the insurance business model is that if costs spike unexpectedly, companies can always reprice to target margins the following year. In the case of MA, where repricing happens in June for the following year, a burgeoning cost issue in June may not be fully repriced for the following year and we may have to wait until 2025 before margins fully normalize. However, in a worst case, where there is a large mispricing, companies could decide to reprice over a 2-3 year period.

Unfortunately, this is largely what appeared to have happened in 2023. Insurers initially believed that they caught 2023 trend increases in time for 2024. However, MLR generally continued to disappoint in 3rd quarter and now even 4th quarter, which suggests that to some extent, margins will likely continue to be depressed in 2024.

Magnitude of downside similar across industry

While clearly the whole market is facing margin compression in MA vs. expectations, on the surface, the magnitude of downside revision screens as more acute at HUM vs peers. In part, this is driven by the fact that HUM is by far the most exposed MA insurer of the public companies (with the exception of smaller 'startups' such as ALHC).

Exhibit 3: HUM much more exposed to MA than its larger peers
Medicare Advantage premium mix and market share by MCO, 2023



Source: Company Filings, BofA Global Research

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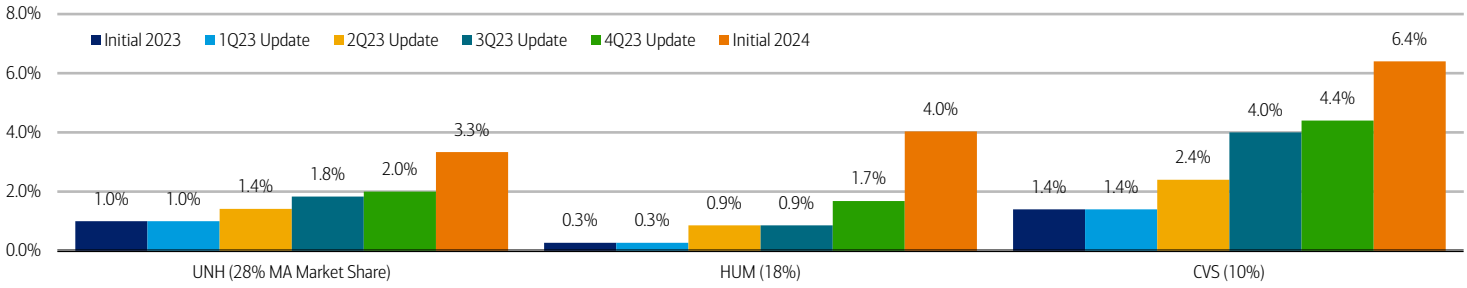
To that end, the three largest MA MCOs have now guided to 2024 MLR somewhere between 330bps and 640bps above 2022 results.

Exhibit 4: For most Medicare Advantage companies, MLR continues to drift upwards past 2022 levels
Difference between most current MLR guidance at time of update versus 2022 results by major MA company



Source: Company Filings, BofA Global Research

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HUM's MLR expectations much higher than peers

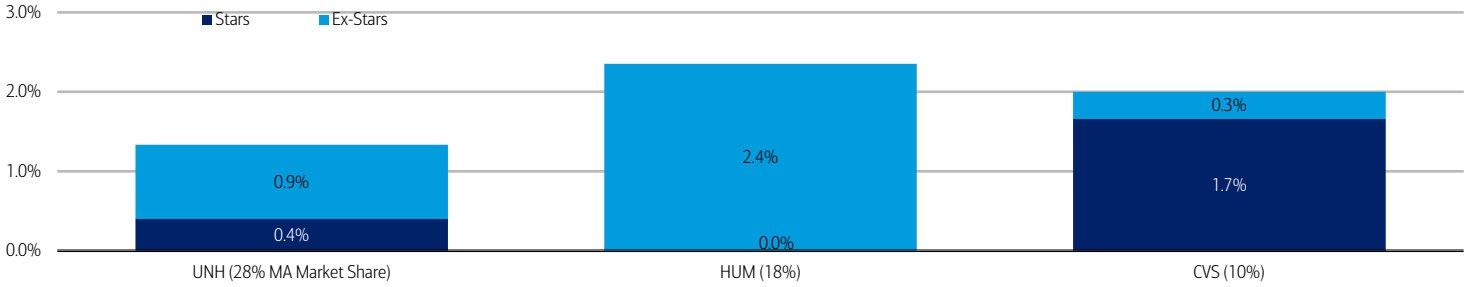
Clearly, companies did not catch the margin pressures experienced in 2023 in time to price 2024 back to targeted margins. To that end, the major MA companies have already guided up MLR, even off of the elevated 2023 base. By far, HUM's was the most significant, with an expected increase of 240bps (they guided +200bps to the insurance segment, but we are dividing by MA premiums to come up with the MA only number). This compares to 130bps at UNH and 200bps at CVS.

When accounting for Stars, the delta is significantly higher

At first, this screens as generally similar. However, both UNH and CVS are facing larger stars headwinds than HUM, and CVS has explicitly said it is absorbing an $800m net headwind which translates to a 170bps of MA MLR. Therefore, if we assume UNH is also absorbing a similar proportion of its reimbursement pressure it implies that UNH is really guiding up 90bps ex-stars and CVS is only guiding up 30bps ex-stars compared to 240bps ex-stars at HUM (HUM doesn't have a stars headwind, so this is the same as the reported change). On top of that, the risk model revision changes which impact industry reimbursement, should also be impacting UNH to a larger degree than HUM, given UNH's exposure to value-based care, making HUM's increase relative to UNH's look even more conservative.

Finally, we note that HUM believes that it cut benefits more than its peers (and its lower membership growth outlook would support that). All else equal, large benefit cuts should mean we would expect HUM to have the lowest MLR headwind, not the largest.

Exhibit 5: HUM's assumed MLR guidance ramp is much more conservative vs. peers, especially after accounting for Stars
Implied y/y MA MLR increases in 2024 by major MA company, breaking out the impact of Stars net reimbursement pressures



Source: Company Filings, BofA Global Research

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Not clear if HUM is conservative, or others mispriced

HUM's guidance includes a number of assumptions which appear conservative: **1)** The company claims it is run-rating the total trend levels it experienced in 4Q23 (the highest trend quarter of the year) into 2024, as well as assuming additional normal trend off the elevated base, **2)** assumes no benefit on 2024 risk adjustment revenue from higher utilization in 2023.

Meanwhile, both UNH and CVS issued MLR guidance before reporting the fourth quarter, giving them somewhat less insight into trend when providing guidance. Since that guidance, both companies had seen continued unexpected trend pressure into 4Q.

HUM and UNH attributed Q4 pressure to different factors…

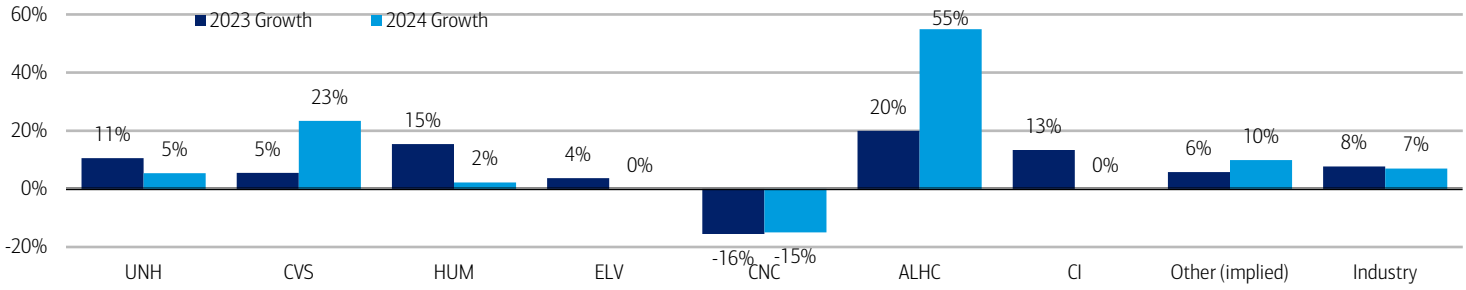
In Q4, both HUM and UNH missed on MA MLR. However, they attributed the miss to very different factors. UNH said their miss was due to seasonal activity (RSV, COVID, and the extra utilization it brought from people who hadn't seen a physician in a while) and core trend was in-line. As a result, UNH thought the "end of Q4 type of small seasonality variation [isn't] really durable or relevant to the rest of the year," and didn't see a need to flow through any of this pressure into their 2024 outlook. Meanwhile, HUM said that seasonal activity was slightly below their guidance, but was more than offset by higher inpatient utilization, particularly in short stay admissions. As such, HUM doesn't see the pressure as 1x, and built that into their 2024 trend baseline.

To some extent, comparing notes between companies is useful, but there is a limit to what can be gleaned because whether something was worse than expected has a lot to do with what the company expected. HUM's Q3 commentary was that they were building in an acceleration in respiratory costs in Q4 into the guidance despite not seeing any pressure in October, in order to be conservative. As a result, that cost coming in better is not a surprise (HUM largely implied that the costs were higher than the October numbers would have implied but still below guidance, which leaves the door open for UNH to have built their respiratory expectation on a lower trend that got worse). It is unclear whether UNH saw pressure from more short stay admissions, but if the reason for it was the implementation of the new "2 midnight rule" for MA plans (essentially requiring MA plans to pay for an admission if the patient is in the hospital for 2 midnights), it is possible that UNH forecasted some pressure at year end (before the policy officially took place Jan 1) and that cost was elevated, but as UNH expected.

Growth rate also suggests conservatism in pricing

Another way of gauging conservatism of bids is by comparing the expected growth rate across MCOs. Historically there has been a correlation between below industry growth and relative margin improvement. In this case, of the big 3 MA insurers, HUM is growing the slowest while CVS (the one that appears to have given the lowest y/y MLR guidance in MA) is growing the fastest by far.

Exhibit 6: Another way of looking at conservatism is based on expected growth
Summary of MCO membership growth commentary, 2024 expected growth vs 2023 by company, alongside industry growth expectation and implied 'Other'



Source: Company Filings, BofA Global Research, CMS

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HUM has had a -70% correlation between membership growth and EPS growth

Looking at HUM's own experience (the only standalone MA company with enough prior history) illustrates the historical relationship between margins and growth. Going back to 2010, there is a -70% correlation between MA membership growth and EPS. In a 4% margin business, growing margins 40bps is as good as growing membership 10%, so growing more slowly to price for margin often leads to faster EPS growth than sacrificing some margin to grow revenue quickly.

Additionally, while earnings have never been as volatile as 2024/2025 are forecasted to be, if you select almost any other five-year period (starting in 2012-2023), the company has almost always on average delivered against both its membership (high single digits) and EPS (mid-teens) growth targets.

Exhibit 7: Typically a strong relationship between membership growth and earnings growth
Highlighting HUM's membership growth and EPS performance over time

Humana results over time	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Year over year growth															
Medicare Advantage Membership	18%	8%	19%	7%	19%	11%	-1%	3%	8%	16%	11%	9%	3%	15%	2%
Adj. Earnings Per Share	14%	20%	-9%	10%	-11%	3%	23%	22%	24%	23%	5%	10%	22%	3%	-39%
5 Year Rolling Average															
Medicare Advantage Membership					14%	13%	11%	8%	8%	7%	7%	9%	9%	11%	8%
Adj. Earnings Per Share					5%	3%	3%	10%	12%	19%	20%	17%	17%	13%	0%

Source: Company Filings, BofA Global Research, CMS

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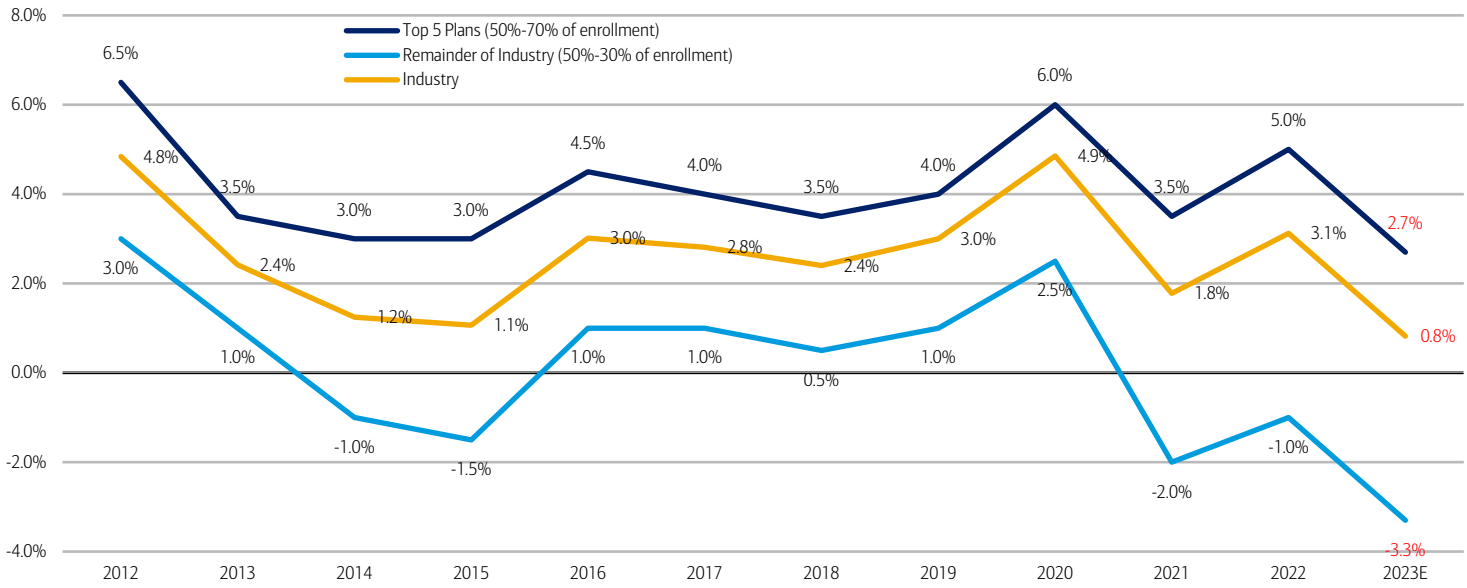
Margins appears to be at all-time lows in 2023/2024

Looking back at a Deloitte study of insurance statutory filings (since insurers don't disclose directly to investors), the underwriting margin of MA MCOs has consistently fluctuated between 1%-5% as an industry, with an average spread of +4% between the top 5 insurers (UNH, HUM, CVS, ELV, Kaiser) which have been shockingly consistent in their competitive positionings since 2012. We point this out as normally if a company doesn't earn a margin, it brings into question if they can do it in the future. However, in this case, the industry has a very long track record (particularly the top 5 insurers) of operating well above the current levels. For example, if we overlay the public company weighted average increase in MLR of 230bps, it implies the industry is now operating at the lowest level on record (0.8%) while the bottom 30% of enrollment is deeply in the red, which is only likely to worsen in 2024.

Exhibit 8: 2023 margins are likely all-time lows, mirroring experiences from ACA implementation, which eventually rebounded
MA underwriting margins over time. Top 5 plans are UNH, HUM, CVS, ELV, Kaiser. 2023 is extrapolated based on MLR guidance updates from UNH, HUM and CVS



Source: Deloitte, NAIC, CADMHC, BofA Global Research

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UNH claims it is still at 'target margin', HUM says just ~1%

That being said, UNH claims that it was able to offset most of the MLR pressure in 2024 with G&A cuts such that it is still earning 'target margin' in MA, though it seems clear to us that margins on an apples-to-apples basis are lower. At their Investor Day, UNH essentially acknowledged that it was above its target in 2023, noting that "we can still be at the high end of our target range in 2024 and be down y/y." Meanwhile, HUM has acknowledged it will be around 0-1% margins in both 2023 and 2024.

2025 margins should be better, because it has to be

On their call, HUM indicated that they believe that this trend pressure is an industry issue and it would expect that everyone reprices to this trend over time. As a result, that should make it easier for HUM to deliver better margins in 2025. The chart above supports that view (30% of the industry is losing money which is unsustainable), and the top names are operating at the lowest margins in well over a decade. Since no company has changed their LT margin targets, we would expect margins to move up.

This is important to reinforce because HUM's margins are in the 0-1% range in MA, and the $6-$10 increase implies another 1-1.5% improvement in 2025, still leaving the company around a 2% type margin in 2025. From there, it would be easy to see how getting to 3.5% in 2026 could push the earnings power well above $30, while still being well below the 4.5-5% type margin that MA ultimately can achieve.

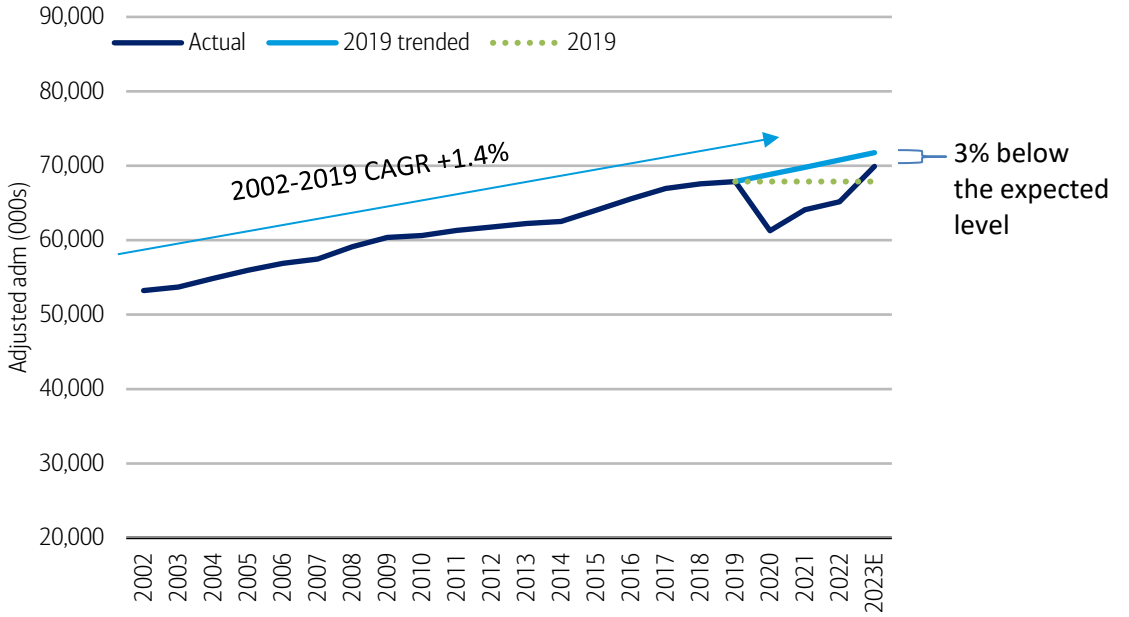
Although we have received a number of questions about the 50% EPS growth HUM is guiding to in 2025, it's important to remember that when margins are under 1%, you don't need meaningful margin expansion to drive meaningful EPS growth. Meanwhile, growing EPS 50% the year average EPS shrinks 40% should not be too difficult. In fact, when looked at from 2023-2025, the guidance is for EPS to be flat to down -15% over that two-year period even though revenue is expected to be up 10-15% over that time. In that context, 2025 EPS of $22-$26 actually looks conservative to us. This is particularly true when the company has signaled that it will price for margin expansion.

It should be easier to reprice correctly now that trend has normalized

In addition to the company signaling that guidance is conservative and they are focused on margin improvement, there is another reason to believe that visibility in 2025 is

higher: trend has largely normalized. Entering 2023, we estimated that hospital volumes were 8% below the LT trend line and then volumes grew well above average. Now, entering 2024, we believe that hospital volumes are 3% below the LT trend line. Although this means volumes are likely to be higher than average in 2024, it means that a repeat of 2023 trend is highly unlikely, and the potential range of outcomes is much more narrow when companies have to price 2025 in June 2024.

Exhibit 9: Hospital volumes are above 2019 levels but still below expected level
Hospital industry adjusted admissions: 2002-19A; 2021-2023 BofA estimate



Source: BofA Global Research estimates, American Hospital Association, Kaufman Hall

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MA is still a good business; competitive fears overblown

The pandemic and subsequent recovery in utilization has created an unusually volatile period for health insurers. Historically, healthcare utilization was predictably growing in the low single digit range, with minimal standard deviation, meaning that if MCOs mispriced, MLR implications were generally in the dozens of basis points. However, COVID disrupted patient behavior at an unprecedented scale, driving a huge upfront drop in healthcare utilization, followed by difficult to predict surges in the recovery back to baseline, causing cycles of MLR beats and misses in the triple digits.

Uncertainty made it difficult for insurers/governments to predict costs

As we noted above, 2023 was unprecedented in terms of forecasting with both large MCOs, hospitals, and medtech companies results coming in vastly different than initially expected. It would obviously be better if MCOs got it right, but it doesn't seem logical to assume that things are permanently broken just because they got them wrong in a year like 2023.

Margin revision may be delayed to 2025 if utilization wasn't caught in time

This normally would argue for a strong setup to 2024 as the industry should have been forced to price conservatively after a year of pressure in 2023. However, it's not clear that insurers as an industry were able to fully capture the higher levels of costs in time for bid submissions. The impact of risk coding changes in 2024 further cloud what would normally be a margin mean reversion story. Therefore, the 'boom' period is more likely to come in 2025, which we think was validated by HUM committing to $6-10 (or 38-62%) EPS growth in 2025.

Even if 2024 MLR is elevated, MCOs can still demonstrate costs under control

That said, even if MLR remains under pressure in 2024, it's not too late to reset investor expectations. UNH, CVS, CNC, and HUM have now all raised Medicare MLR guidance y/y, and even if it means margins are below targets, if MCOs at least show investors they have a handle on forecasting costs (by beating earnings guidance through MLR upside), it should help restore confidence in 2025 pricing, and possible margin improvement. It is worth reinforcing that beating "the right way" (on MLR not G&A), will be the key to demonstrating that they have a handle on costs, which will be the key to multiple expansion. For HUM in particular, we think their 2024 guidance is conservative, so the set up for beats and raises "the right way" is much easier.

Industry-wide margin compression fuels concerns of 'new normal'

Based on company disclosures, unless utilization comes in extremely favorably vs industry expectations, it's clear that MCOs won't be earning target underwriting margins in 2024. Given it is the second year in a row of margin compression, and CVS is aggressive on taking market share, the bear view on MA is that the sector is too competitive and margin compression is the new normal. UNH is facing margin compression (even though it still expects to be at the high end of its target range), both HUM/ELV are below 'target margins' and CVS, CNC and CI will all be operating at a loss in 2024. Additionally, companies like UNH/CVS/HUM/ELV are increasingly building out healthcare service capabilities which can increase 'non-insurance' earnings of an MA member. This creates the fear that MCOs can rationally justify earning a lower margin on the insurance side if it means earning the same amount or more at the enterprise level.

HUM committed to margins over growth in near-term

We note that HUM disagreed with the argument that the market is more competitive than normal, noting that there are usually 1-2 names who get aggressive on growth in a given year, but then they pull back in the following years when they realize that margins are too low. HUM is committed to pricing to trend, noting that winning share on lower pricing is not sustainable.

To analyze this deeper, we looked back at the past 10 years to see what happened to the two fastest growing health plans (excluding UNH) in the two years following their above average growth. Based on our analysis, 55% of the time, those companies grew below average over the next two years, and 40% of the time, those companies actually had negative enrollment growth the following year.

Exhibit 10: A majority of the time, when a company grows fastest in a year, they grow below average in following years

Two companies growing MA enrollment fastest y/y, vs growth the next two years, over time

	Fastest	Faster vs industry next 2 years?	Second fastest	Faster vs industry next 2 years?
2014	MOH	No	CVS	Yes
2015	HUM	No	CVS	Yes
2016	CNC	No	CVS	Yes
2017	ELV	Yes	CVS	Yes
2018	ELV	Yes	CNC	No
2019	CVS	No	ELV	Yes
2020	CNC	Yes	CI	No
2021	MOH	Yes	CNC	No
2022	CNC	No	MOH	No
2023	MOH	No	HUM	No

Source: Centers for Medicare & Medicaid Services, BofA Global Research

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However, there are also signs of prices firming, benefiting incumbents

We note that while there is cause for concern, there are also a number of indications that pricing is firming. First, some of the mid-sized plans with high growth ambitions like CNC are slated to shrink its membership 15%+, while MOH and CLOV have also been talking about having priced for margin. Meanwhile, some companies such as BHG, OSCR and now even CI are on track to exit the MA market entirely as they concluded (after sinking billions of dollars in M&A/statutory capital) that they cannot compete with the more scaled incumbents.

The argument that MA plans may look to use membership as loss leaders to drive volumes and profits to their provider business is a risk long-term but falls flat as a reason for margin compression today. UNH is the only company which is profitable in these businesses, so cutting the MA margin to steer more volume to breakeven/money-losing provider assets does not make sense for companies valued on EPS.

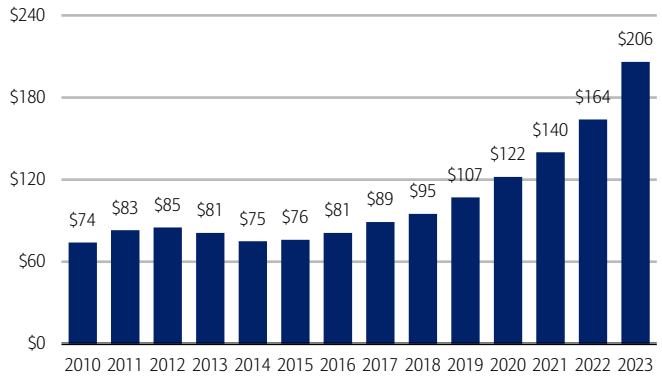
Meanwhile, if this were true, wouldn't UNH and HUM also being growing meaningfully above average in 2024? But even if you believe this thesis, it is all the more reason to own UNH and HUM, who are the most advanced in this strategy and best positioned to monetize the MA membership that they have.

Enrollment growth will slow, but slowly

For a long time, the MA market has been the fastest growing segment of managed care driven by 1) the aging demographic and 2) increased penetration of MA within the Medicare program. The success of the MA program in large part is driven by the ability of insurers to offer differentiated benefit designs and incremental value to seniors versus the Original Medicare program, causing them to increasingly choose MA. Functionally, the way this works is that plans generate savings vs the benchmark using network management (unit discounts), site of care optimization and care management initiatives to help steer more efficient utilization. By underwriting those savings, MA plans submit 'bids' to CMS which are below the proposed benchmark, and CMS will rebate part of the delta between the bid and benchmark back to the plan. The plan then uses these rebates to fund supplemental benefits, so rebates are the best single metric to look at when gauging the value MA plans can offer to seniors.

Below we show the weighted average monthly rebate of MA plans over time and note that HMO plans have the highest rebates due to the fact that they have narrower networks. Interestingly, since 2010 supplemental rebates have increased at a CAGR of 10%. Meanwhile, when accounting for rebate spending relative to general medical spending of beneficiaries, rebates have grown from 8% of MA spending to 16% in 2023.

Exhibit 11: Rebates have materially increased over time…
Medicare Advantage Rebates over time



Source: CMS, BofA Global Research

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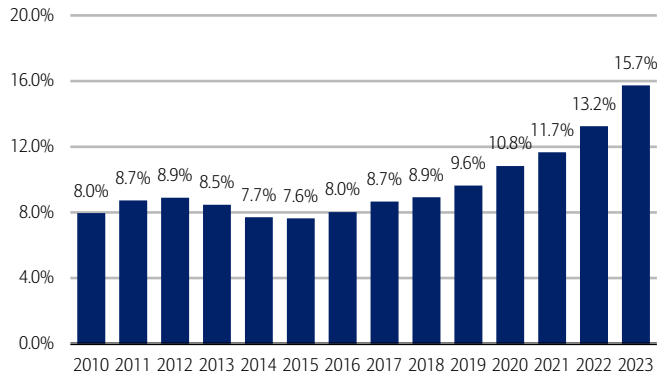
Exhibit 12: … climbing to 16% of MA spend vs 8% in 2010
Medicare Advantage Rebates over time as % of MA spending



Source: CMS, BofA Global Research

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Benefits and enrollment are less correlated

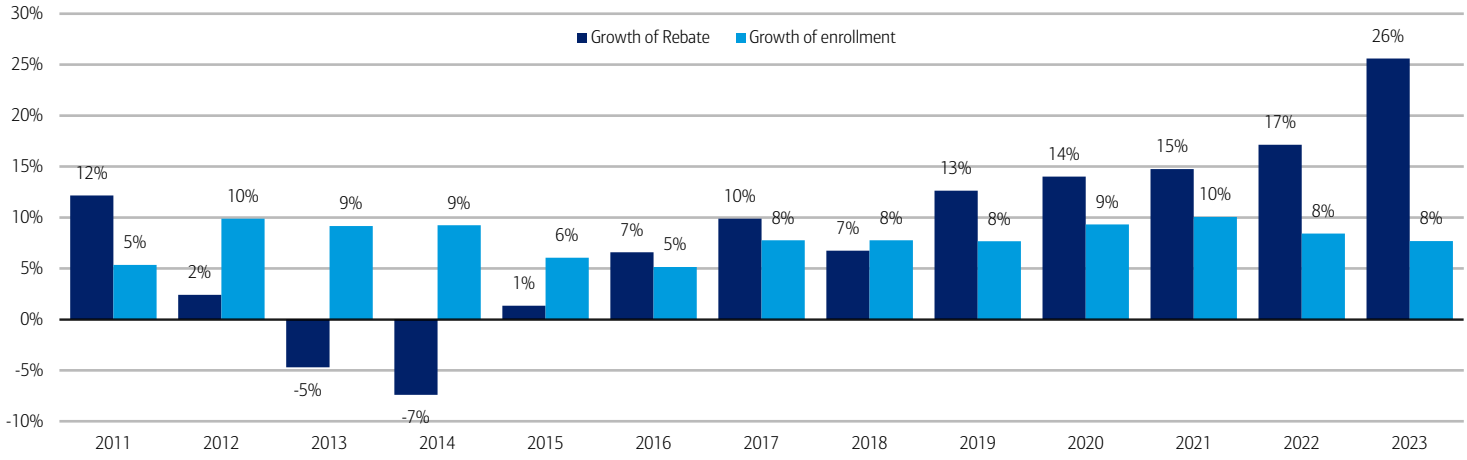
The market has become concerned that MA growth will slow. To some extent this is mathematically true as the demographic trends peak in 2027, and the industry cannot increase penetration forever (we are 52% penetrated today). The CBO forecasts that by 2032, industry growth will be around 2.5%. This directionally makes sense to us, but we note that as membership growth slows, rate growth should increase. Since CMS pays MA plans the average cost of treating someone in traditional Medicare, as more people turn 65, this generally healthier population brings down the average cost of the senior population. But as fewer people turn 65, then the average age of the Medicare population goes up, bringing up the average cost of a Medicare beneficiary. This likely would move pricing from 1-2% today, to 3% by 2032. As a result, even as enrollment slows, MA should be growing revenue 5.5%, which likely will still be the fastest growth of the segments.

Meanwhile, the market is further concerned about a quicker drop in enrollment growth as rate pressure could lead to benefit cuts, and slower enrollment in the near term. We find this argument to be less compelling.

We looked at the relationship between growth in rebates (change in benefits) and overall MA enrollment over time. Surprisingly, while you would expect a relatively strong correlation, we could not find one (Excel suggests 11%). Even during periods of sustained rate pressure and weak benefit improvement (2012-2015), MA enrollment continued to grow at a relatively steady pace. Conversely, even when rebates began to grow faster, MA enrollment did not materially accelerate the pace of growth (though there does appear to be small impacts at the margin.)

Unlike the relationship between rates and benefits, benefits and enrollment do not appear as closely tied. This can be explained by the fact that MA benefits as a whole have become so much stronger than Original Medicare in aggregate (16% better by using the rebate metric) that adjustments at the edges are unlikely to change whether seniors view MA as a superior option.

Exhibit 13: Growth in rebates have not had much of an impact on MA enrollment growth
Comparing growth of MA rebates against MA enrollment growth



Source: CMS, BofA Global Research

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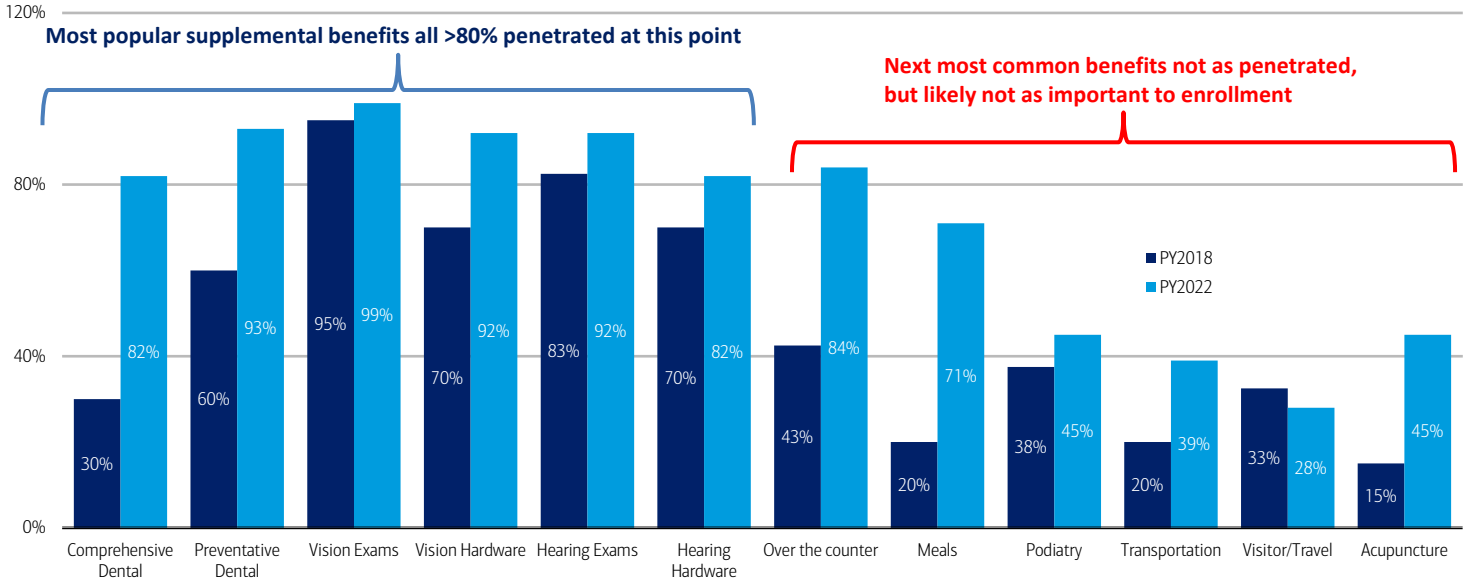
Not all rebate dollars are created equal

If MA rates are pressured for a period of time, and MA plans are forced to cut benefits, the benefits most likely to get cut are the ones that are less critical to the value proposition. For example, the most popular benefits by far in MA are Dental, Vision and Hearing which now penetrate 80-90% of MA enrollment. Now that those benefits are widely available to seniors, when looking to add benefits, MA plans have increasingly offered less compelling benefits on the margin (any rational plan will offer the most

important benefits first, so by definition, incremental benefits are less popular) such as over the counter vouchers, meals, transportation and acupuncture. And while those benefits are certainly better than nothing, if the less popular benefits need to get cut to maintain margins, they are less likely to have an impact on enrollment.

Exhibit 14: In the last 5 years, the most popular supplemental benefits have reached 80-90% penetration, rise in less popular benefits
Illustrating changes in the penetration (percentage of beneficiaries in plans which offer the benefit) of supplemental benefits over time



Source: Milliman, BofA Global Research

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Conclusion: a decent set up from here

This isn't how we wanted to get here, but now that we are, the set up looks relatively good as guidance looks well-rebased, making it easier to beat on MLR (the key to re-instilling confidence and a better multiple). HUM is indicating that a two-year repricing cycle will be necessary, essentially pushing back the path to $37 of EPS by two years, but that type of EPS growth should warrant a premium multiple off of today's depressed guidance.

Meanwhile, we find little credence behind the most common bear theories on MA: 1) MA can't predict trend/it's more volatile (2023 was a perfect storm, incredibly high degree of difficulty to get right that no one (MCOs, hospitals or medtech) predicted would happen), 2) margins are permanently impaired (excluding these trend issues, the margins of the largest MA names have been remarkably consistent and with 1/3rd of the industry losing money in 2023, margins have to move up in 2025), 3) that rate pressures/benefit cuts will pressure growth (historically not true), and 4) that the market is getting aggressive/competitive (most datapoints indicate the opposite). Investors are now asking themselves if it's just easier to own CI or ELV today and not worry about MA trend, which we find ironic. Although we agree that those names show compelling growth/value, they had commercial trend issues in 2021/22, that they repriced over two years and now are viewed as "safer" investments because MA names somehow can't do the same thing? This just goes to show how quickly sentiment can turn in HUM's favor if numbers are as conservative as we believe.

Abbreviations

ALHC = Alignment Healthcare

BHG = Bright Health

CI = Cigna

CMS = Centers for Medicare & Medicaid Services

CNC = Centene

CVS = CVS Health

ELV = Elevance

HUM = Humana

LT = Long-term

MA = Medicare Advantage

MCO = Managed care organization

MLR = Medical loss ratio

MOH = Molina

OSCR = Oscar Health

UNH = UnitedHealth Group

Price objective basis & risk

Humana Inc (HUM)
Our $470 PO is based on 18.4x our 2025 EPS estimate, above its 5-year average of 17.1x, supported by opportunity for future margin improvements.

Upside risks are potential for share repurchase and several non-healthcare catalysts, margin normalization, and the rebound in risk coding.

Downside risks are regular industry sensitivity points (cost trend, MA rates), as well as unknowns from a new administration.

Analyst Certification

I, Kevin Fischbeck, CFA, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

US - Facilities, Hospitals and Managed Healthcare Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
BUY				
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	Addus HomeCare	ADUS	ADUS US	Joanna Gajuk
	Agilon Health	AGL	AGL US	Adam Ron
	Chemed Corporation	CHE	CHE US	Joanna Gajuk
	Elevance Health Inc	ELV	ELV US	Kevin Fischbeck, CFA
	Encompass Health	EHC	EHC US	Kevin Fischbeck, CFA
	HCA	HCA	HCA US	Kevin Fischbeck, CFA
	Humana Inc	HUM	HUM US	Kevin Fischbeck, CFA
	Option Care Health	OPCH	OPCH US	Joanna Gajuk
	Oscar Health	OSCR	OSCR US	Adam Ron
	Privia Health	PRVA	PRVA US	Adam Ron
	Select Medical Corp.	SEM	SEM US	Kevin Fischbeck, CFA
	Service Corp.	SCI	SCI US	Joanna Gajuk
	Surgery Partners, Inc	SGRY	SGRY US	Kevin Fischbeck, CFA
	Tenet Healthcare	THC	THC US	Kevin Fischbeck, CFA
	The Cigna Group	CI	CI US	Kevin Fischbeck, CFA
	UnitedHealth Group	UNH	UNH US	Kevin Fischbeck, CFA
	Universal Health Services	UHS	UHS US	Kevin Fischbeck, CFA
	US Physical Therapy	USPH	USPH US	Joanna Gajuk
NEUTRAL				
	Alignment Healthcare	ALHC	ALHC US	Adam Ron
	AMN Healthcare	AMN	AMN US	Kevin Fischbeck, CFA
	Apollo Medical	AMEH	AMEH US	Adam Ron
	Brookdale	BKD	BKD US	Joanna Gajuk
	Centene Corporation	CNC	CNC US	Kevin Fischbeck, CFA
	Molina Healthcare, Inc.	MOH	MOH US	Kevin Fischbeck, CFA
UNDERPERFORM				
	AdaptHealth Corp.	AHCO	AHCO US	Joanna Gajuk
	Agiliti Health Inc	AGTI	AGTI US	Kevin Fischbeck, CFA
	Cross Country Healthcare	CCRN	CCRN US	Kevin Fischbeck, CFA
	DaVita Inc	DVA	DVA US	Kevin Fischbeck, CFA
	Enhabit Home Health & Hospice	EHAB	EHAB US	Joanna Gajuk
	Pediatrix Medical Group, Inc.	MD	MD US	Kevin Fischbeck, CFA

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Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) × (1 − Tax Rate) + Goodwill Amortization	Total Assets − Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5 Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations − Total Capex	N/A

Quality of Earnings	Numerator	Denominator
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt − Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense

Valuation Toolkit	Numerator	Denominator
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations − Total Capex	Market Cap = Current Share Price × Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price × Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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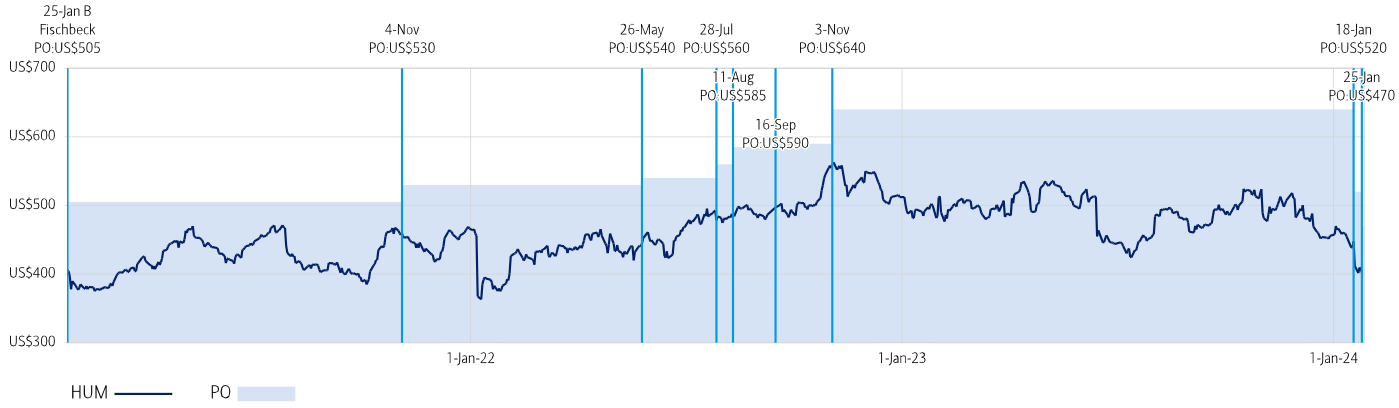
Important Disclosures

Humana Inc (HUM) Price Chart



B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of a date no more than one trading day prior to the date of the report.

Equity Investment Rating Distribution: Health Care Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships [R1]	Count	Percent
Buy	234	60.94%	Buy	115	49.15%
Hold	80	20.83%	Hold	36	45.00%
Sell	70	18.23%	Sell	29	41.43%

Equity Investment Rating Distribution: Global Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships [R1]	Count	Percent
Buy	1895	53.62%	Buy	1083	57.15%
Hold	832	23.54%	Hold	454	54.57%
Sell	807	22.84%	Sell	383	47.46%

[R1] Issuers that were investment banking clients of BofA Securities or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster[R2]
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

[R2] Ratings dispersions may vary from time to time where BofA Global Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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