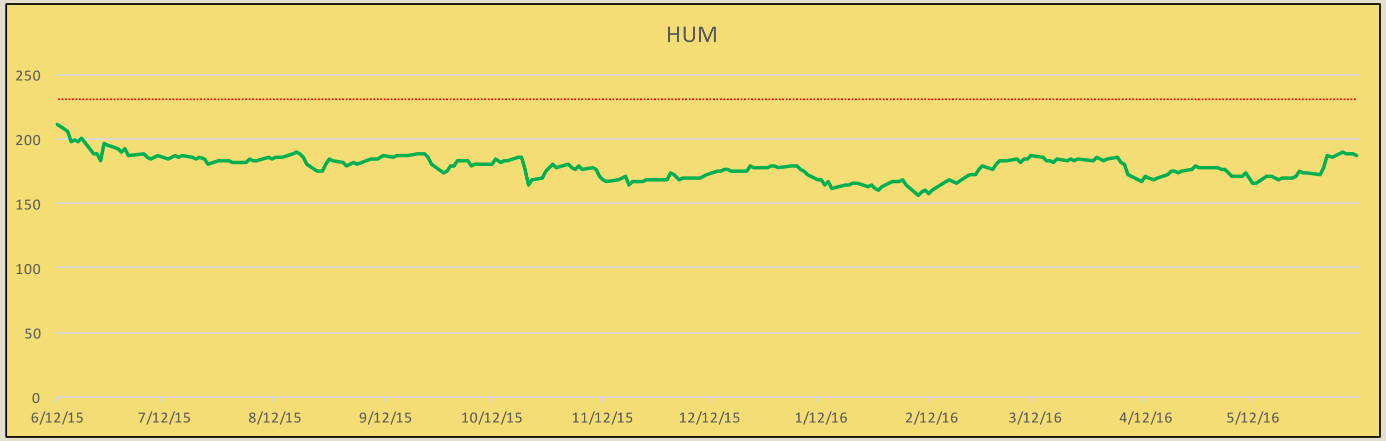
Humana (NYSE: HUM) - M&A Arbitrage

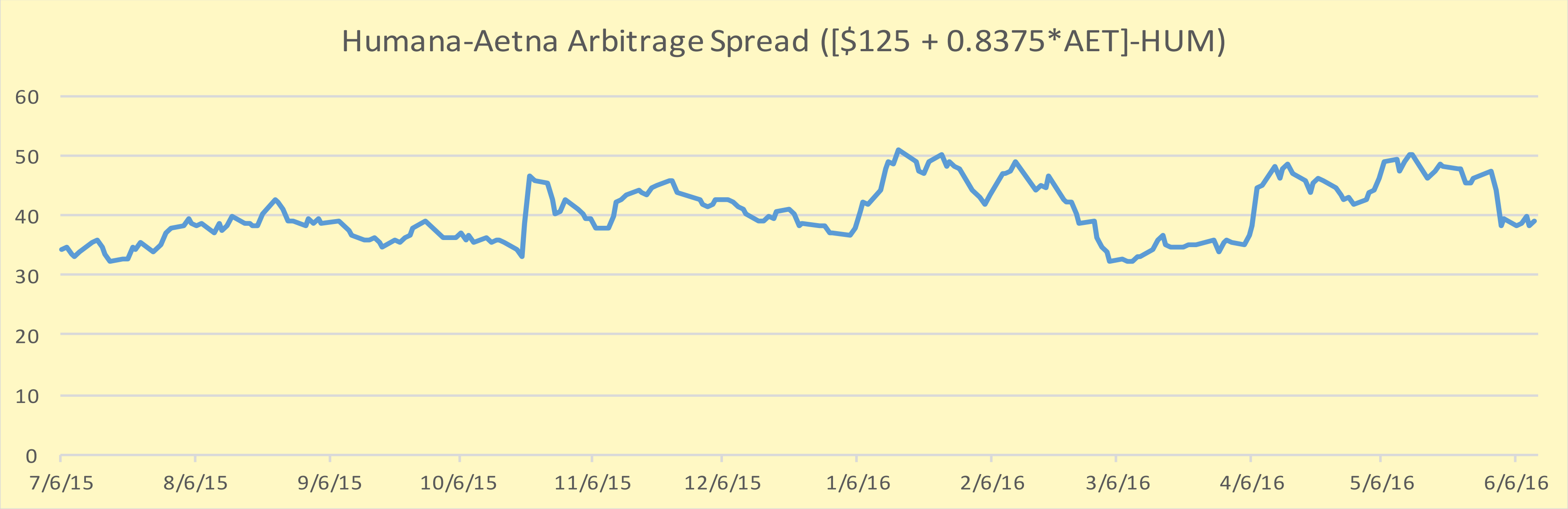
Elkington

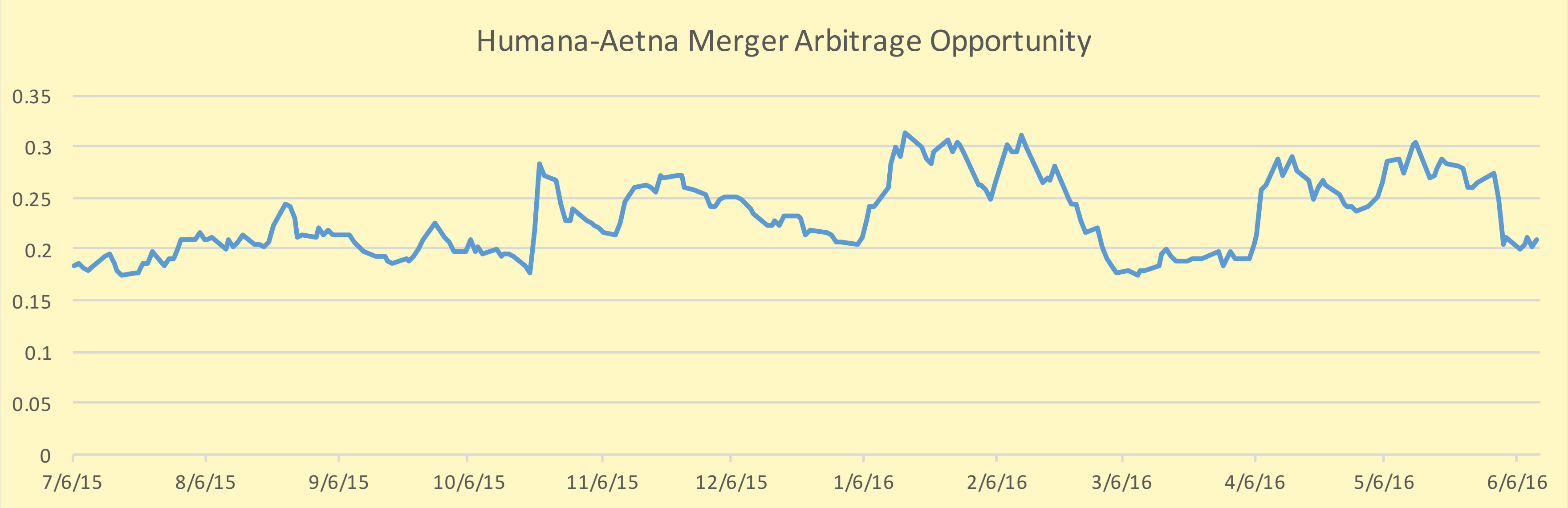
On July 3rd 2015, Aetna and Humana announced a merger where Aetna will acquire Humana for a combination of cash and stock valued at $37 billion or approximately $230 per Humana share.



Humana®

The Humana-Aetna Merger Spread



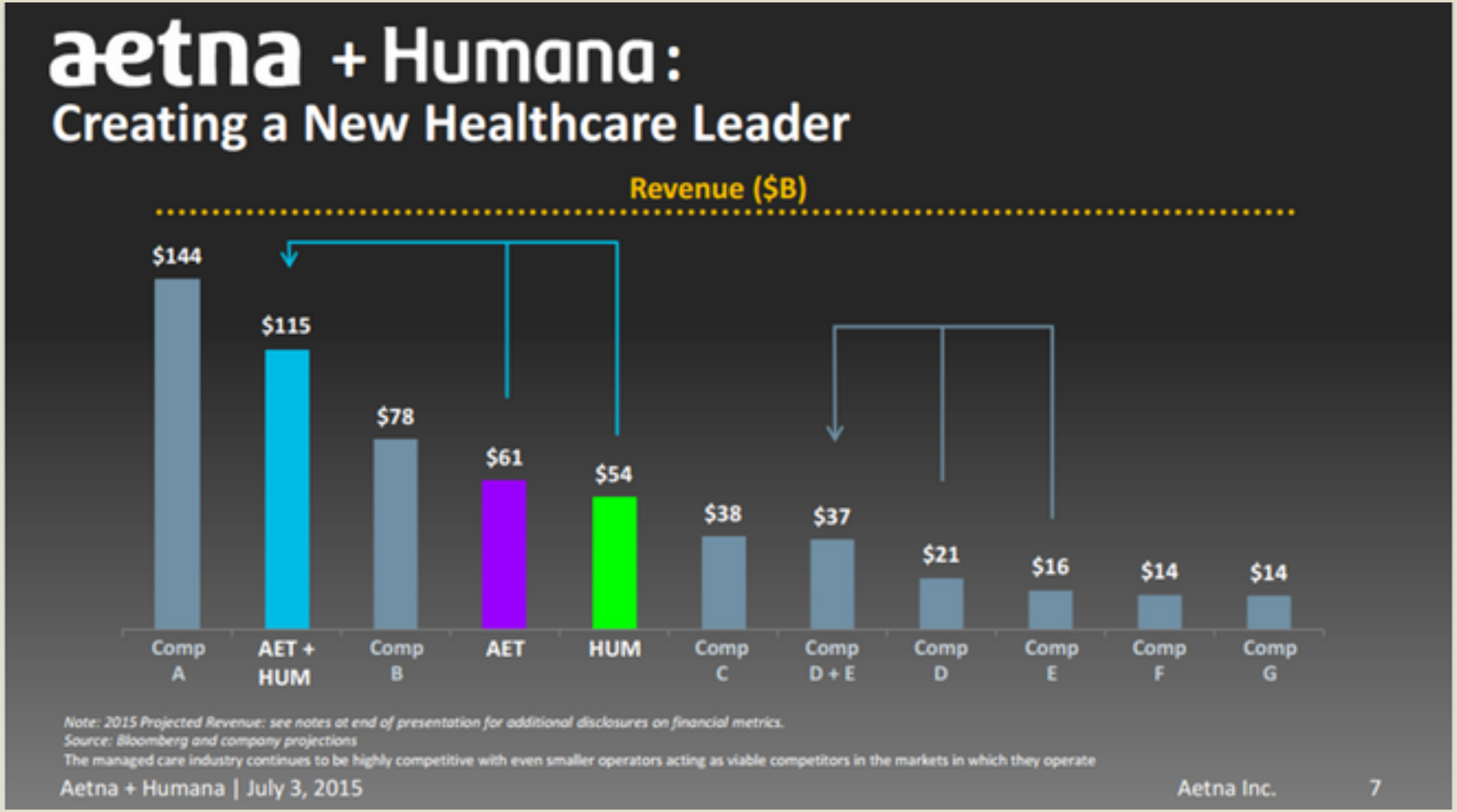


The spread is so large due to antitrust risks

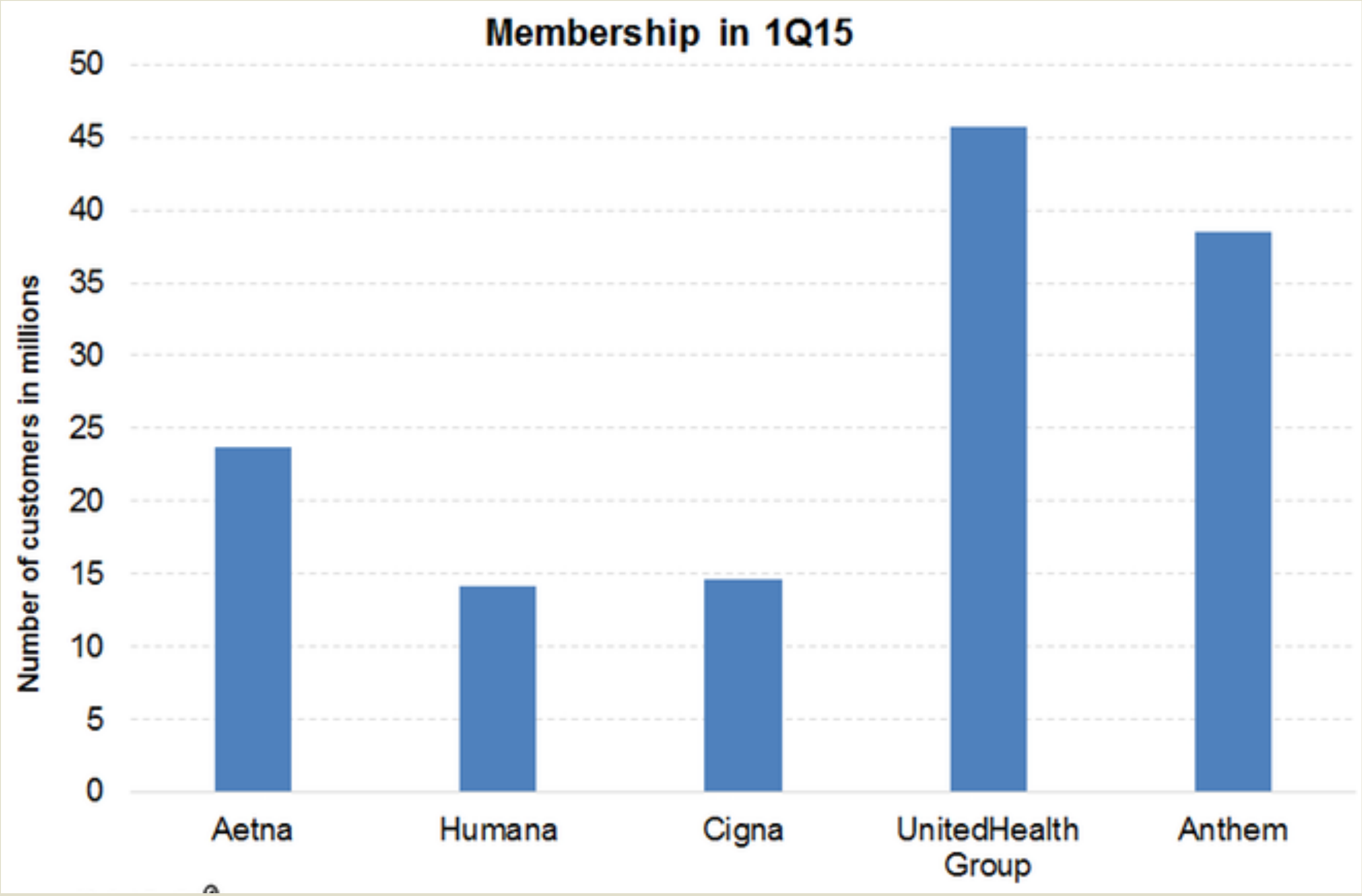
- The health insurance market is dominated by six companies:

1. UnitedHealth
2. Humana
3. Kaiser
4. Aetna
5. Anthem
6. Cigna

After the merger, the combined Aetna and Humana company will be the second largest health insurer in the U.S



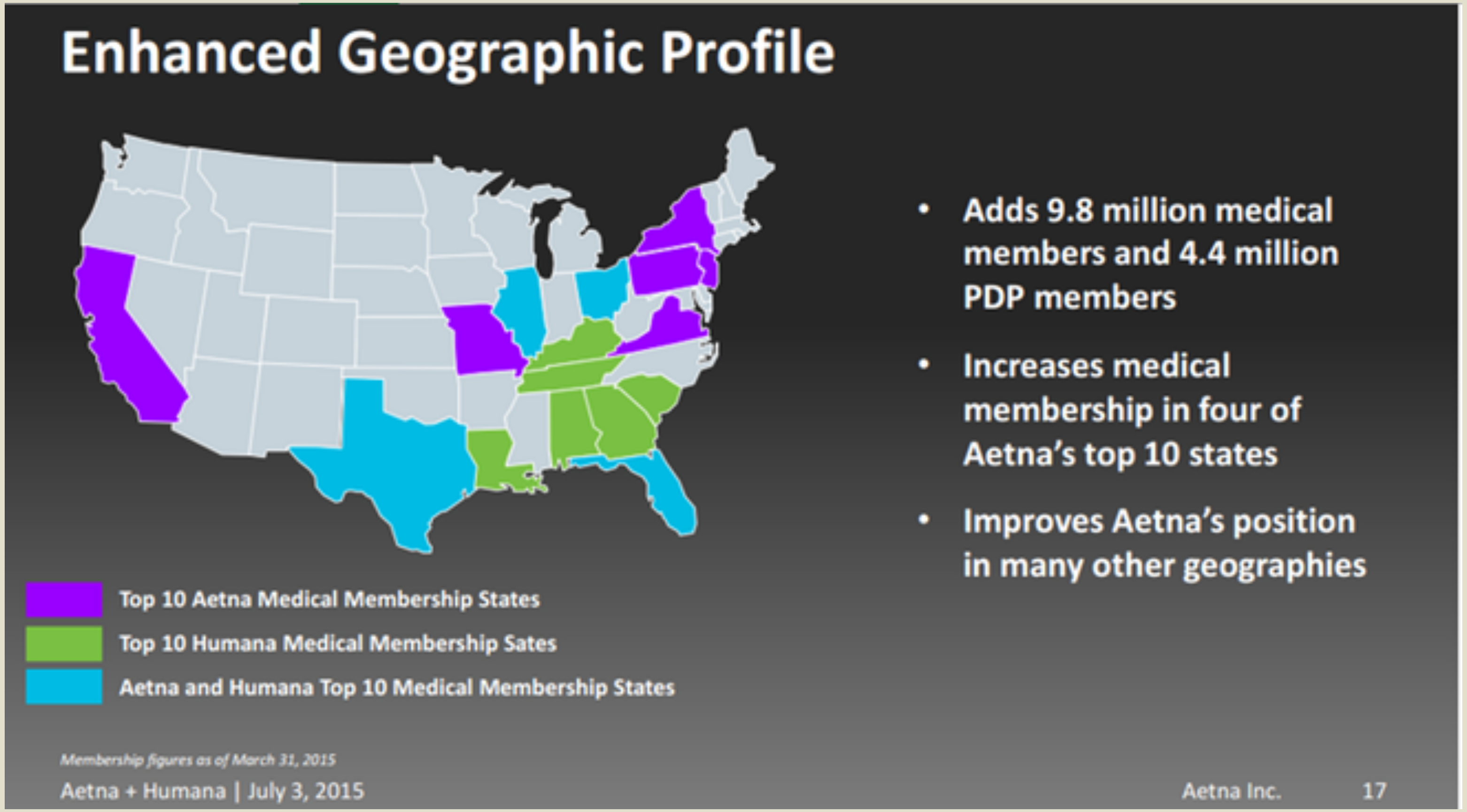
The merged company will have the second largest membership cohort



Antitrust analysis

- U.S regulators will focus on individual markets and how the merger affects competition.
- The regulators will listen to the views of healthcare providers. To note, many providers are wary of this merger and its potential effect on healthcare coverage and prices.
- It’s estimated that the combined company would have a 75% market share in Medicare Advantage in 180 counties. The merged company would have 75% market share in a total of 68 counties, primarily in the South and Midwest. However, this is not as big of an issue for antitrust issues because health insurance is already a highly regulated market.
- The companies are guiding for the second half of 2016 for the deal to complete. Moreover, Anthem is guiding for the end of 2016 for its deal with Cigna.

There are geographic synergies between Humana and Aetna



Creating a more stable healthcare provider in a decreasing margin environment

Recent news

- John Huff (Director of the Missouri Department of Insurance):

If Aetna's $37 billion takeover of Humana goes through, the two health insurers “shall cease and desist from doing business” throughout the entire state with regard to certain products. Specifically, Aetna and Humana would no longer be able to sell individual, small group and employer-based Medicare Advantage plans in Missouri.

- Dave Jones (California’s insurance commissioner):

“I am skeptical in light of past studies,” referring to pasting studies showing health insurance mergers often don’t benefit consumers.

- DaVita Healthcare Partners, one of the largest kidney care companies in the U.S., which provides care for a large number of Medicare beneficiaries, submitted a letter to Jones registering its concerns about the proposed merger:

“Left unchecked, health insurance consolidation creates risks for the chronically ill patients we care for, including loss of access and increased cost,” wrote Jeremy Van Haselen, vice president of state government affairs for DaVita. “Health insurers have begun to use a variety of tactics to exclude chronically ill patients from their plans.”

Risks

- Proposed merger will be denied over antitrust issues
- There has been push back from healthcare providers and state regulators
- Obama administration may not want to allow merger and risk potentially hurting Obamacare exchanges
- However, competition within states is actually not as big of an issue. For example, the combined company would cover less than 2 percent of California's Medicare beneficiaries and both companies cover unique geographic areas

Conclusions

- There is a ~20% merger arbitrage opportunity in HUM
- The spread is near a low since the merger announcement
- The antitrust risks are not as large as believed by the market
- **The trade would be to buy a call in that expires in Q3/Q4 of 2016 as a way to gain optionality on the merger and reduce the antitrust risks**