Strategic Report for Aetna, Inc.

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Executive Summary

More money is spent on health care in the United States than in any other country in the world. In addition, health care spending is consistently outpacing GDP growth. Nevertheless, 15.4 percent of the American population was uninsured in 2008. On March 23, 2010 President Obama signed the Patient Protection and Affordable Care Act in the hope of enabling more Americans to afford adequate health care and coverage.

Aetna is one of the largest health insurance companies in the United States, serving nearly 19 million members in 2009. The company started in 1850 as a life insurance company, and over the years has expanded into the fields of health care, group insurance, and large case pensions. Its health insurance segment offers life insurance, disability insurance, and long-term care insurance, as well as retirement savings and specialty health products such as dental and pharmaceutical insurance.

The past few years have been challenging for the economy as a whole, and Aetna is no exception. Despite increased membership, the company has experienced less economic growth in 2008 and 2009 than in previous years. It faces increased expenses and decreased revenue, as well as a thirty percent reduction in net income. To respond to these challenges, Aetna has quickly adjusted its operations. Furthermore, it has used this time to position itself for expansion. The company has begun to acquire some domestic companies and has also started to expand overseas. Because of its strategic maneuvering throughout the recession, analysts are confident that the company will recover.

Aetna’s main strategic challenge is to ensure that its existing insurance options and operational policy conform to the standards set forth by the new federal legislation. However, while the legislation poses challenges, it also creates opportunities by expanding the customer base for health insurance.
Vector Strategy Group recommends the following strategies to Aetna:

1. In the next six months, Aetna should adjust rates and premiums in anticipation of the effects that health care legislation will have on the company’s operations.

2. Aetna should expand its market share and service territories by acquiring small insurance companies that are unable to stay solvent under the changing insurance regulations.

3. Aetna should expand its Medicare and Medicaid market segments. Due to membership growth from 2006-2009, Medicare accounted for nearly 85 percent of the increase in industry gross profits. Medicaid has also grown rapidly since its inception in 1965, and the new health care legislation intends to increase the number of citizens eligible for Medicare and Medicaid.

4. Most of Aetna’s health care insurance is employer-based, and the new legislation incentivizes growth within this field. Any company with more than 50 employees must soon offer health insurance to its workers. Also, young adults up to the age of 26 are allowed to stay on their parents’ insurance. Not only will these changes cause an increased demand for employer-based health insurance, but working-age citizens and young adults tend to be the healthiest members of the population. Thus, this is a desirable market segment to pursue.

5. Aetna should discontinue or sell some of its products that are not core to its health insurance business. It has already begun to implement this strategy, and the continued reevaluation of its product offerings will enable the company to have flexibility to acquire other firms.

The new legislation will produce many changes in the health care market. There are six months of grace time before any of the reforms are implemented, and Aetna is well-positioned to take advantage of the increasing and changing customer base. Aetna continues to offer a premium health care system that enables even more Americans to achieve health and financial security. Vector Strategy Group looks forward to the opportunity to provide continued support for Aetna Inc. as it moves into a new era of health care insurance.
History

In 1850, Aetna Insurance Company organized an Annuity Fund to sell life insurance. The name was inspired by Mt. Etna, the most active volcano in Europe at the time. Three years later the Annuity department branched off and was incorporated as Aetna Life Insurance Company.

In 1861, Aetna began offering participating life insurance policies. Aetna launched its new product with an aggressive promotional effort, which included higher commission rates for agents. With the outbreak of the Civil War, Aetna’s strategy of expansion was somewhat unconventional. However, to the benefit of the company, the devastation of the battlefields combined with a prosperous wartime economy sparked a surge in life insurance purchases.

By the end of the Civil War, Aetna was one of the nation's leading life insurers. It had increased its volume of business by 600 percent from 1861 and had also increased annual premium income nine times. In 1865, Aetna’s annual income topped $1 million.

Aetna issued its first farm mortgage loan in 1867. The company rose to become one of the two largest national firms in the farm mortgage field. By 1924, Aetna had 43 percent of its assets — $94 million — invested in the breadbasket of the country.

In 1868, Aetna radically altered its business practices. Aetna was one of the first two companies to abandon the half-note premium system.

Aetna issued its first accident policy in 1891, a move that signaled Aetna’s evolution into a company that offers a variety of coverage. In 1899, Aetna became one of the first stock insurance companies to enter the health insurance business.

As the nation's industrial base and the Progressive social reform movement grew, Aetna responded by organizing an Accident and Liability department to handle employers' liability and workmen's collective insurance. By 1907, Aetna was the largest life insurer in the world, offering accident, health and liability coverage.
In 1906, the San Francisco earthquake hammered the insurance industry. Two hundred and forty-three insurance companies paid out over $225 million in claims. Twenty companies completely failed. Nonetheless, Aetna paid every claim in full, totaling almost $3 million.

In 1907, Aetna began to offer automobile coverage. In 1913, Aetna became one of the first insurers to write group coverage for businesses. Around this time, the company also began its first national advertising campaign.

During World War I, Aetna used its financial strength to provide huge amounts of insurance to bond contractors involved in government construction. The company also helped to fund the country's war effort by purchasing and selling millions of dollars of Liberty Bonds.

By 1922, Aetna’s assets had increased from $25.7 million in 1879 to $207 million, and premium income rose more than twenty-fold. However, in 1926, Aetna’s affiliate, the Automobile Insurance Company, nearly went bankrupt. Aetna’s president moved quickly by replacing the top management of the company and recapitalizing the organization with Aetna Life money so that its financial stability could be restored.

At the turn of the century, over 40 percent of the company’s assets were in farm mortgages. However, the post-war agricultural sector collapsed, and land values plummeted. Aetna was forced to foreclose an increasing number of mortgages. Aetna took the aggressive step of entering the farm management business. The company fixed up properties, leased them to tenants, and waited for prices to rise before reselling them. After eighty years in the business, Aetna eventually withdrew from the farm mortgage field in 1947.

Aetna managed the stock market crash of 1929 by withholding dividend payments to shareholders from late 1932 to early 1934, reducing the workforce through attrition, and cutting salaries by ten percent. Aetna employees survived the Depression in relatively good shape; there were no layoffs, and the companywide pay cut was more than offset by a deflationary cycle that increased purchasing power. In 1930, Aetna became the first multiple line insurer in
America to pay out $1 billion in claims.

Throughout the 1930s, Aetna assisted with government bonds used to fund the construction of many national projects, including Hoover Dam and the National Archives Building in Washington, D.C.

Aetna entered the international insurance arena in the early 1960’s by acquiring a Canadian life insurer, Excelsior Life Insurance Company. In 1966, Aetna partnered with Italy’s Assicurazioni Generali to form an international insurance network that would market insurance products in over 70 countries. In 1968, Aetna expanded its international business by acquiring a majority interest in Producer's and Citizen's Cooperative Assurance Company, an Australian-based entity, for a negotiated price of $10 million.

In 1963, Aetna insured the lives of the first seven American astronauts, and in 1966, Aetna paid the first Medicare claim.

A few years later Aetna abandoned its traditional individual company identities in favor of a single public image — Aetna Life & Casualty. In 1967, Aetna acquired the Participating Annuity Life Insurance Company (PALIC). Aetna's acquisition of PALIC was part of a strategic plan to grow its financial services. Aetna was listed on the New York Stock Exchange for the first time on September 24, 1968 under ticker symbol “AET”. In 1969, Aetna launched a new diversified investment strategy.

Aetna expanded its international presence in the 1980’s when it acquired a forty percent interest in two Chilean companies, a pension and a life enterprise. Soon to follow were ventures in England, Spain, Hong Kong, Taiwan, Indonesia and Korea.

In 1982, the company reentered the managed care industry with the introduction of its first formal health management organization (HMO), Choice HMO in Chicago. Around the same time, Aetna joined with Voluntary Hospitals of America (VHA) to form Partners National Health Plans, an alternative delivery health care joint venture. Aetna entered the 50-50 joint venture to begin
Aetna, Inc.

marketing HMOs, preferred provider organizations (PPOs) and other competitively priced products. By 1987, Partners National Health Plans' total membership topped $1 million.

That same year Aetna sold the industry's first employer group long-term care plan. A year later Aetna acquired Human Affairs International, Inc., a leading provider of employee assistance programs and managed mental health plans.

In 1990, Aetna stopped selling individual health policies, and in 1996, Aetna sold its property-casualty operations to Travelers Insurance Group for $4 billion. That same year, Aetna merged with U.S. Healthcare, beginning a new era — Aetna as a health and financial services company. The health business became Aetna U.S. Healthcare. Aetna also combined its financial service business units into Aetna Retirement Services, and Aetna Life & Casualty was renamed Aetna Inc.

In 1997, Aetna Retirement Services purchased Financial Network Investment Company, a leading financial planning company. That same year, Aetna completed its acquisition of NYLCare Health Plans for $1.05 billion. In 1999, Aetna completed its acquisition of Prudential HealthCare for $1 billion, making Aetna the country’s largest provider of health benefits with more than 21 million members.

Aetna also continued its overseas expansion. It opened its first offices in China in 1993 and formed an insurance joint venture in Thailand in 1998. A year later, Aetna International launched a joint pension venture in Poland with the country’s sixth largest bank.

In 2000, Aetna completed the sale of its financial services and international businesses to ING for $7.7 billion and spun off the health business to its shareholders. This sale helped Aetna redefine itself as an independent health and group benefits company. The following year, Aetna launched Aetna HealthFund®, an innovative health care product that marked the company's first foray into consumerism by a national, full-service health benefits company.

In 2002, Aetna broke new ground when its President, John Rowe, called on the
health insurance industry to support legislation and consider adopting guidelines for access to genetic testing, genetic counseling and the appropriate use of test results. The guidelines, reflected in Aetna’s own comprehensive policy for coverage policy decisions, have become the industry standard.

In 2004, Aetna adopted a new, industry-leading approach to end-of-life care through Aetna Compassionate Care, a comprehensive new program of expanded benefits, nurse case management and information.

After achieving a new high-water mark in stock price in 2004, Aetna declared a two-for-one split of the company’s common stock effective March 11, 2005. Aetna completed a series of strategic acquisitions that allowed the company to strengthen its base of products and services while reaching new customer segments. These acquisitions included: Strategic Resource Company (SRC), an administrator of group benefit products for part-time and hourly workers; ActiveHealth Management, a clinically focused, technology-driven health management and health care data analytics company; and HMS Healthcare, a regional health care network operating in Michigan, Colorado and other states. Aetna also launched a pioneering transparency program that allowed consumers in selected areas to see the cost of physician services online before going to the doctor's office. Aetna also acquired the disability and leave management business of Broadspire, a leading provider of disability and casualty claim management services.

In 2007, Aetna acquired Schaller Anderson, a leading provider of health care management services for Medicaid plans, headquartered in Phoenix, Arizona. Aetna also acquired Goodhealth Worldwide, a leading managing general underwriter for international private medical insurance offering expatriate benefits around the world.

In 2009, Aetna had a $1.3 billion profit and was ranked third in Fortune 500’s Insurance and Managed Care list, after UnitedHealth Group and WellPoint.¹
Health Care Reform

In 2007, the United States spent $2.2 trillion on health care. This was roughly 16.2 percent of GDP, a proportion greater than that of any other country in the world.

Furthermore, the level of national health expenditure (NHE) has been rising steadily over the past three decades, and on average, outpaces GDP growth annually.

http://www.kff.org/insurance/upload/7670_02.pdf
Aetna, Inc.

Average Annual Growth Rates for Nominal NHE and GDP for Selected Time Periods

http://www.kff.org/insurance/upload/7670_02.pdf

Despite the increased spending on health care, many people still lack health insurance. In 2008, 84.6 percent of Americans had health insurance, while the remaining 46.3 million Americans were uninsured.4

Coverage by Type of Health Insurance, 2008

On March 23, 2010 President Barack Obama signed the Patient Protection and Affordable Care Act (Pub. L. No. 111-148) into law. This legislation is meant to “give families the relief they need from skyrocketing health insurance costs, and will ensure Americans have secure, stable, affordable health insurance.” The federal government hopes to enable 30 million new customers to receive health insurance, insurance companies face opportunities to expand membership. It is estimated that more than half of the newly insured will be under the age of 35, and about 80 percent will be in good to excellent health. Companies will be required to provide health plans to their employees if they employ more than 50 people, and children up to the age of 26 will qualify as dependents on their parents’ insurance policies. Significant new opportunities for health insurers also exist in Medicaid and Medicare plans, both of which have been expanded to include more Americans.

There are new standards for the amount an insurance company must pay out in benefits. This will go into effect in 2011. Insurance companies will be required to give money back to consumers if they do not meet those standards. In addition, requested premium increases will be made publicly available, and in 2014, plans that have previously raised rates arbitrarily may not be able to participate in the new health insurance exchanges. In September of 2010, all new individual market health plans must provide coverage for preventive services. Recommended prevention and vaccination services will be covered without any deductibles or co-payments. Insurers will be prohibited from placing lifetime limits on what they pay for medical care, and will only be able to apply restricted annual benefit limits. Insurers will no longer be able to arbitrarily cancel insurance policies when policy holders get sick, except in cases of fraud. Beginning in 2014, reform will create state-based health insurance exchanges that pool small businesses and their employees, which are intended to spark competition and increase buyer power. The exchange will offer the same types of private insurance choices available to government officials.

Furthermore, the current economic downturn and subsequent restoration of the economy will create a changing demand for health insurance. According to the Kaiser Family Foundation, “for every one percent increase in the unemployment rate, an estimated 1.1 million become uninsured and another 1 million become
eligible for Medicaid or the State Children’s Health Insurance Program.”

Therefore, in the near future individual health insurance enrollment may decrease, while Medicaid membership is likely to increase.
Competitive Analysis

<table>
<thead>
<tr>
<th>Force</th>
<th>Strategic Significance</th>
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<tbody>
<tr>
<td>Internal Rivalry</td>
<td>high</td>
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<tr>
<td>Entry and Exit</td>
<td>medium</td>
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<tr>
<td>Buyer Power</td>
<td>low</td>
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<tr>
<td>Supplier Power</td>
<td>medium</td>
</tr>
<tr>
<td>Substitutes and Complements</td>
<td>high</td>
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</table>

Aetna operates in the health care industry under SIC codes 63- Insurance carriers, and, more specifically, 6324- Hospital and medical service plans. It is one of the largest health insurers in the US, offering life, disability, and long-term care insurance, as well as retirement savings products. Its Health Care division offers managed care plans, health savings accounts, and traditional indemnity coverage, along with dental, vision, behavioral health, and Medicare plans. Aetna's Group Insurance segment sells life, disability, and long-term care insurance nationwide, and its Large Case Pensions segment offers pensions, annuities, and other retirement savings products.

<table>
<thead>
<tr>
<th>2008 Sales</th>
<th>in millions</th>
<th>% of total</th>
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<tbody>
<tr>
<td>Health care</td>
<td>$ 28,775.00</td>
<td>93</td>
</tr>
<tr>
<td>Group insurance</td>
<td>$ 1,710.70</td>
<td>5</td>
</tr>
<tr>
<td>Large group pensions</td>
<td>$ 465.00</td>
<td>2</td>
</tr>
<tr>
<td>Total</td>
<td>$ 30,950.70</td>
<td>100</td>
</tr>
</tbody>
</table>

source: Hoovers

Outside its core medical plan offerings, Aetna provides a number of specialty health insurance products. It is one of the largest dental insurance providers in the country. Aetna Specialty Pharmacy unit delivers high-tech medications to
patients with chronic diseases. Another subsidiary, The Chickering Group, specializes in health programs for college students. The company also offers special coverage for expatriates through its Aetna Global Benefits (AGB) group, which handles its international business. Aetna’s subsidiary, ActiveHealth, uses technology and data analytics to provide disease management programs, clinical decision support, and other services that identify at-risk plan members and provide preventative health care services. Aetna also offers Medicare prescription drug coverage nationwide and has expanded Medicaid services to about a dozen states.

In recent years, Aetna has expanded into many international partnerships and acquisitions. It has begun to sell insurance in various countries around the world, most recently China.

**Internal Rivalry**

The healthcare industry is highly competitive, primarily due to a large number of competitors. Aetna’s plans mainly compete with other large commercial health benefit insurance companies, such as CIGNA, WellPoint, and UnitedHealth Group. Aetna also faces competition from Blue Cross/Blue Shield plans, Health Maintenance Organizations (HMO) such as the Kaiser Foundation, and various specialty service providers including pharmacy benefit providers, integrated health care delivery organizations, health information technology companies, and for certain plans, programs sponsored by the federal or state governments. Furthermore, since Aetna offers such a wide array of insurance products, it also faces competition from companies that specialize in only one type of insurance, such as Delta Dental Plans.

Health insurers compete over membership, prices, and offerings. All three have been affected by the current health care legislation as the government has created incentives to increase insurance membership numbers. However, the government has also placed limitations on the prices insurance companies can charge, as well as requirements on the types of health offerings available. Additionally, not only is the quantity of membership important, but the demographic composition is an important factor as adverse selection strongly
affects the health insurance industry. In terms of medical costs, from an insurance point of view, the most attractive customers are the young and healthy members of the population who need very little medical care. This demographic pays for insurance, and the insurance company faces only minor expenses. However, these people are the least inclined to buy health insurance. Instead, high risk individuals are more likely to buy health insurance because they anticipate higher medical costs and will benefit more from having health insurance because those costs are then passed onto the insurer. Adverse selection applies to these high-risk individuals. When adverse selection occurs, the insurance company loses money and must raise its premium to remain in business. However, as premiums are increased, more low-risk individuals drop out as the cost outweighs the benefits. This, in turn, exacerbates the problem. Ordinarily, insurance companies are reluctant to raise their premiums in anticipation of this effect. Instead, they impose restrictions on use or higher premiums for people they can identify as higher risk.

However, due to the current health care reform, many restrictions have been placed on health insurers. They can no longer deny coverage due to pre-existing conditions, and there are limitations to the premiums that insurers can charge members. These specific changes, along with general pressure to alter products to meet the new requirements, will exert great pressure on insurance companies. Some of the smaller companies are unlikely to remain profitable when faced with these changes.

**Entry and Exit**

New entrants into the marketplace, as well as significant consolidation within the industry, have contributed to the competitive environment. Although there are few capital costs associated with providing insurance, there are substantial barriers to entry.

The first barrier is access to a network. Current health insurance providers already have extensive networks of physicians and hospitals. Thus new entrants would have to build their own networks in competition with existing ones.

Another barrier is reputation. Safety, stability, and reliability are significant factors in the decision of an insurance provider. In general, reputation is one of a
health insurance company’s most important assets. Aetna has over 150 years of experience and has built a name for itself in the industry. Customers would probably be hesitant to entrust their health care to an unknown entity. Nevertheless, the reputation of commercial health benefit insurance companies as a sector is currently at risk due to the general discontent regarding health care organization and costs. Aetna points out, “The risk of negative publicity is especially strong now as the health care industry and insurance system is in the public eye with the debate over health care legislation.”

Buyer Power

Aetna serves approximately 36.1 million people. Customers include employer groups, individuals, college students, part-time and hourly workers, health plans, governmental units, government-sponsored plans, labor groups and expatriates. While individual buyers do not have a large amount of market power, homogenous groups do. Aetna states:

“Our customers generally, and our large customers particularly, are well informed and organized and can easily move between us and our competitors.... Failure to anticipate changes in customer preferences or to innovate and deliver products and services that demonstrate value to our customers can affect our ability to retain or grow profitable membership which can adversely affect our operating results.”

While individuals do not have significant market power, much buyer power is protected through government regulation, which mandates customers’ rights with regard to price and coverage.

Supplier Power

The primary suppliers to the health insurance industry are the doctors and hospitals that provide the care. Aetna contracts with physicians, hospitals, and other health care providers for services to their customers. The health care providers who participate in Aetna’s networks are independent contractors and are neither employees nor agents of Aetna. Aetna’s provider network includes
more than 952,000 participating health care providers, including over 539,000 primary care and specialist physicians and over 5000 hospitals. Other suppliers to Aetna are freestanding health facility providers such as laboratories, imaging, and urgent care. These are usually paid under fee-for-service arrangements. Aetna’s expenses are largely dependent on the cost of service charged by these providers, especially those of physicians and hospital care as they account for the largest share of national health spending.

**Distribution of National Health Expenditures, by Type of Service, 2007**

http://www.kff.org/insurance/upload/7670_02.pdf

**Substitutes and Complements**

Aetna’s principal health care products and services are targeted specifically to large, multi-site national, mid-sized and small employers. There are also a lot of substitute products offered due to the large variety of healthcare options. Competitors have an array of marketing and pricing for healthcare products and services, and there is a proliferation of competing products. Furthermore, new products are continually being introduced into the market. These products vary according to the quality of service, the comprehensiveness of coverage, premium and out-of-pocket costs, financial stability, geographic scope, number and variety of providers, and member support and care management. Customers may elect
to self-insure or to reduce benefits in order to limit increases in their benefit costs. Such elections may result in reduced membership and/or lower premiums in Aetna’s more profitable Insured products.\textsuperscript{23} Aetna has developed and maintained its products and service offerings to assist existing and new customer markets through organic growth and acquisitions.\textsuperscript{24}

On the other hand, one important complement is government policy. As legislation requires more people to be insured, this creates greater demand for Aetna’s insurance products. Furthermore, government funding of programs such as Medicare and Medicaid enable Aetna to offer more products and serve more customers.

Another complementary good is technological innovation. As technology improves, it enables more medical services to be available at lower costs and with increased efficiency, as well as with higher levels of accuracy and success rates. Technology has also allowed Aetna to expand its product offerings by enabling the development of products such as Personal Health Record. Personal Health Record provides members with online access to personal information, including individual personalized messages and alerts, detailed health history based on available claims data and voluntarily submitted information, and integrated information. It also offers resources to help members make informed decisions about their health care.\textsuperscript{25}
Financial Analysis

Aetna’s Recent Financial History

Aetna has seen steady revenue growth over the past few years, which was driven by the Health Care business segment. The Health Care segment has seen increases in membership levels as well as premium rates. These increases have occurred both organically, within Aetna, as well as through recent acquisitions. However, the increase in membership also produced an increase in operating expenses due to higher general and administrative expenses as a result of higher employee-related costs and other expenses associated with higher membership and higher selling expenses. This resulted in the steady decrease of Aetna’s net income and net profit over the same period of time. Aetna has tried to lessen these costs and, as evident in the change in employee count, Aetna reduced its number of employees in 2009 as a way to accomplish that goal.

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<thead>
<tr>
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<tbody>
<tr>
<td>Revenue</td>
<td>$34,764.10</td>
<td>$30,950.70</td>
<td>$27,599.60</td>
</tr>
<tr>
<td>Net Income</td>
<td>$1,276.50</td>
<td>$1,384.00</td>
<td>$1,831.00</td>
</tr>
<tr>
<td>Total Operating Expenses</td>
<td>$5,761.60</td>
<td>$5,479.50</td>
<td>$4,787.80</td>
</tr>
<tr>
<td>Net Profit</td>
<td>3.7%</td>
<td>4.50%</td>
<td>6.60%</td>
</tr>
<tr>
<td>Employees</td>
<td>34,891</td>
<td>35,500</td>
<td>35,200</td>
</tr>
</tbody>
</table>

Source: hoovers.com

Aetna’s entire operation contracted in 2008, and slowly started to recover in 2009. The largest decreases were in noncurrent assets and liabilities. However, it is especially interesting to note the increase in current assets. Aetna has spent the past year streamlining its operations, and has started to position itself to acquire smaller firms. The presence of current assets will enable Aetna to continue acting in this manner over the next year and thereby adapt its customer base and product offerings to succeed under the new legislation.
CIGNA has been the leader in health care stock performance over the past year, while Aetna’s stock experienced less growth than that of its competitors. There does not seem to be any significant cause for this discrepancy. Rather, it appears that CIGNA stock was doing very poorly a year ago, and over the course of the year the company has worked to improve its business. They have undergone cost-cutting measures, have expanded into some Asian markets, and have elected a new CEO and head of their Pharmacy Management division. Aetna, on the other hand, was performing very strongly in past years but did not perform as well in 2009. This is especially true of its administrative products (ASC), an area in which Aetna maintains a higher level of exposure than its peers. Aetna has tried to address this by re-pricing its business, and this has given investors confidence that margins will improve in 2010, though perhaps not as aggressively as previously believed.
This past year, Aetna’s stock has underperformed the market as a whole and has been much more volatile over the same period. The volatility is largely due to the industry-wide effect that health care legislation uncertainty has produced. Another cause of Aetna’s volatility specifically is the interplay between the optimism of traders and the conservative financial reports released by Aetna. Throughout 2009, Aetna kept announcing low forecasts for its FY 2009 EPS, which caused its stock to fall. At the same time, Aetna completed some acquisitions and cost-cutting decisions, which caused its stock to rise. Despite these changes, however, the management of Aetna held fast to its forecasts for FY 2009 EPS, and with each release of these figures the stock fell again.
Despite the poor performance of Aetna’s stock over the past year, analysts believe that Aetna will show stronger performance in 2010. Such improvements are already evident. In the past month Aetna’s stock has seen the highest growth compared to its peers, especially in the period after the Health Reform Legislation was passed. This indicates that investors might view Aetna as being in a better position to benefit from the legislation. One reason for this is that Aetna has less exposure to Medicare than its competitors. Medicare is going to receive less government overspending, with increases of 2 percent or less each year instead of the annual 4 percent increases seen in the past.27
Furthermore, when examined in a longer time frame of five years, Aetna’s stock has kept pace with its major rivals. It appears that although Aetna’s stock performance was relatively weak this past year, it has demonstrated positive performance relative to its peers over this period. The company has undertaken measures that will improve earnings in the next few years, and analysts are optimistic that these measures will be successful.
Aetna, Inc.

**Stock Chart (Aetna v. CIGNA v. UnitedHealth v. WellPoint) Five Year Trailing**

![Stock Chart](www.finance.yahoo.com)

**Key Financial Performance Indices**

<table>
<thead>
<tr>
<th>Valuation Ratios</th>
<th>Aetna</th>
<th>CIGNA</th>
<th>WellPoint</th>
<th>UnitedHealth</th>
</tr>
</thead>
<tbody>
<tr>
<td>P/E Ratio (TTM)</td>
<td>12.38</td>
<td>7.82</td>
<td>6.61</td>
<td>10.22</td>
</tr>
<tr>
<td>Price to Sales (TTM)</td>
<td>0.45</td>
<td>0.55</td>
<td>0.48</td>
<td>0.45</td>
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<tr>
<td>Price to Book (MRQ)</td>
<td>1.59</td>
<td>1.88</td>
<td>1.17</td>
<td>1.63</td>
</tr>
</tbody>
</table>

Source: hoovers.com

Despite Aetna’s weak stock performance this past year, its valuation is above that of its peers. This is further evidence that investors are confident that Aetna will do well after it emerges from the economic slump.
SWOT

Strengths
- Aetna offers a wide variety of insurance plans and health insurance options.
- Its large size and long history give Aetna legitimacy and power in the industry, especially compared to smaller insurers.
- The company played an active role in health reform debates and has closely monitored the formation of policy.
- Aetna has increased its current assets, which will enable it to acquire small insolvent companies that will enhance Aetna's membership base and product offerings.

Weaknesses
- The company has faced financial strain due to the economic downturn. This is an issue that has plagued other firms as well, and Aetna has responded to it by raising rates and decreasing its employee count in order to cut costs and increase revenue.
- Aetna has some discontinued products, such as its Large Case Pensions and some Group Insurance offerings, for which it has stopped soliciting or enrolling customers but for which it continues to manage the accounts of existing customers. The Large Case Pensions have been discontinued since 1993. Aetna is trying to transition the Long-Term Care to other carriers.

Opportunities
- There is an opportunity for consolidation and acquisition of small insurers who are unable to stay solvent due to health care reform. This provides a chance for Aetna to expand its product offerings and increase its market share.
- Health care legislation is expected to extend insurance to 20-30 million more Americans, thereby increasing the customer pool.
- Health care legislation has created significant incentives to increase demand for Medicaid plans. This not only means demand for Medicaid will rise, but
also that some of the premiums will be paid by the government, thereby ensuring payment for these accounts.

- Aetna’s principle products and services are targeted to employers. This segment will become an expanding customer base due to the new legislation that will require all firms with over 50 employees to provide insurance to their workers.

**Threats**

- Health insurance legislation sets limits on premiums, meaning that insurance companies will not be able to adjust their premiums to cover the risks of insuring their customer base.

- It is unclear what the composition of new customers for health insurance will be. Health care reform is encouraging enrollment of young adults and workers, groups that are traditionally healthy and thereby beneficial for insurance companies to insure. However, legislation also provides support for those who are already ill to purchase health insurance, which will be an expensive group to insure.

- Health care legislation does not address hospital and physician costs, or make these costs more visible to consumers. Insurance companies’ costs of coverage depend not only on the volume of medical care and services by its customers, but also on the costs of those services. Since 1970, average health care spending has increased by 9.6 percent per year. If insurance companies are not able to raise premiums to reflect higher costs, their revenue will not be able to cover their expenses.

- Employers may change the insurance options for their employees based on the new health care legislation. This may be an opportunity for Aetna, as companies with over 50 employees are required to provide insurance. However, it may also be a threat. Some tax incentives, such as those for pharmacy insurance, were discontinued in the new legislation, and companies might drop this coverage.
Strategic Recommendations

In general, Aetna is a strong company, maintaining positive profit margins during the recession and responding rapidly to keep costs low and revenue high. Given its current position with projected cash inflows for the next few years, Aetna should review the various segments of its business to determine how to best position itself to prepare for the effects of the new health care reform. Some areas to consider are:

- Within the next six months, before the first health care reforms are implemented, Aetna should anticipate the effect of health care reform on its projected costs and revenues and adjust its rates and premiums accordingly.
- Aetna should look into the acquisition of small insolvent insurance companies that will give Aetna a broader exposure to new markets and geographic locations, or serve to strengthen Aetna’s existing market shares.
- Aetna should expand its Medicare and Medicaid market segments. Due to membership growth between 2006-2009, Medicare accounted for nearly 85 percent of the increase in industry gross profits. This is mostly due to membership growth rather than margins, but the new health care legislation intends to increase the number of citizens eligible for Medicare so membership growth is projected to continue. As it only accounts for 7.3 percent of Aetna’s EBITDA, this is a market segment that Aetna should pursue. Medicaid has also grown rapidly since its inception in 1965, and the new health care legislation encourages continued growth of both Medicare and Medicaid.
- Aetna’s principal health care products and services are targeted specifically to large, multi-site national, mid-sized and small employers, and the company should continue to focus on this group. The new health care legislation mandates that any company with more than 50 employees must offer health insurance to its workers, and young adults up to the age of 26 are allowed to stay on their parents’ insurance. Not only will these changes cause an increased demand for employer-based health insurance, but the growth in demand will be from a segment of the population that is desirable from an insurance perspective. Working-age citizens and young adults tend to be the healthiest members of the population, so their membership would enable Aetna to better spread risk among the various population segments it insures.
Aetna should discontinue or sell some of its products that are not core to its health insurance business. It has already begun to implement this strategy. Aetna discontinued its Large Case Pension products, though it still accepts deposits from existing customers and manages the run-off of the existing business. It has also stopped soliciting or accepting new Long-Term Care Insurance Products and is looking into selling its Pharmacy Benefits Management Package. This would enable Aetna to have flexibility to acquire other firms that better relate to the rest of Aetna’s operations.

The new legislation will produce many changes in the health care market. There are six months of grace time before any of the reforms are implemented, and Aetna is well-positioned to take advantage of the increasing and changing customer base. Aetna continues to offer a premium health care system that enables even more Americans to achieve health and financial security. Vector Strategy Group looks forward to the opportunity to provide continued support for Aetna Inc. as it moves into a new era of health care insurance.
# Appendix

## Balance Sheet

<table>
<thead>
<tr>
<th>Assets</th>
<th>Dec 09</th>
<th>Dec 08</th>
<th>Dec 07</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Assets</strong></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Cash</td>
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<td>Net Receivables</td>
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<td>Inventories</td>
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<tr>
<td>Other Current Assets</td>
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<tr>
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<td><strong>Net Fixed Assets</strong></td>
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<td><strong>Total Assets</strong></td>
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<td><strong>Liabilities and Shareholder’s Equity</strong></td>
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<td></td>
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<tr>
<td><strong>Current Liabilities</strong></td>
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<td>Accounts Payable</td>
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<td><strong>Long-Term Debt</strong></td>
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<td><strong>Total Liabilities</strong></td>
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<td>27,666.1</td>
<td>40,686.3</td>
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<td><strong>Shareholder’s Equity</strong></td>
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<tr>
<td>Preferred Stock Equity</td>
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April 15, 2010
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<th>2010</th>
<th>2011</th>
<th>2012</th>
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<tr>
<td>Common Stock Equity</td>
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<td>Total Equity</td>
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<td>10,038.4</td>
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<td>Shares Outstanding (mil.)</td>
<td>431.0</td>
<td>431.0</td>
<td>431.0</td>
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</tbody>
</table>

Source: Hoovers
Aetna, Inc.

**Income Statement**

<table>
<thead>
<tr>
<th></th>
<th>Dec 09</th>
<th>Dec 08</th>
<th>Dec 07</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>34,764.1</td>
<td>30,950.7</td>
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<td>Cost of Goods Sold</td>
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<td>Gross Profit</td>
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<td>8,226.5</td>
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<td>Gross Profit Margin</td>
<td>24.8%</td>
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<td>29.2%</td>
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<td>SG&amp;A Expense</td>
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<td>Depreciation &amp; Amortization</td>
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<td>Operating Income</td>
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<td>Operating Margin</td>
<td>5.5%</td>
<td>7.2%</td>
<td>7.0%</td>
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<td>Nonoperating Income</td>
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<td>254.1</td>
<td>1,076.2</td>
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<tr>
<td>Nonoperating Expenses</td>
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<td>(236.4)</td>
<td>(180.6)</td>
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<td>Income Before Taxes</td>
<td>1,901.2</td>
<td>2,174.2</td>
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<td>Income Taxes</td>
<td>624.7</td>
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<td>Net Income After Taxes</td>
<td>1,276.5</td>
<td>1,384.1</td>
<td>1,831.0</td>
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<tr>
<td>Continuing Operations</td>
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<td>1,831.0</td>
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<td>Discontinued Operations</td>
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<td>0.0</td>
<td>0.0</td>
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<tr>
<td>Total Operations</td>
<td>1,276.5</td>
<td>1,384.1</td>
<td>1,831.0</td>
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<tr>
<td>Total Net Income</td>
<td>1,276.5</td>
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<td>1,831.0</td>
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<tr>
<td>Net Profit Margin</td>
<td>3.7%</td>
<td>4.5%</td>
<td>6.6%</td>
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</tbody>
</table>

| Diluted EPS from Total Net Income ($) | 2.84 | 2.83 | 3.47 |
| Dividends per Share             | 0.04 | 0.04 | 0.04 |

Source: Hoovers
Bibliography


3 Kaiser Family Foundation. *Health Care Costs: A Primer*.


10 Aetna 10k pg. 7

11 Aetna 10k pg. 8

12 Aetna 10k pg. 7

13 Aetna 10k pg. 81

14 Aetna 10k pg. 44

15 Aetna 10k pg. 44

28 Aetna 10k pg 10
