SageGroup

Revolutionizing Corporate Strategy

PacifiCare®

Strategic Report

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Executive Summary

PacifiCare Health Systems, Inc. (PacifiCare) offers managed care and other health insurance products to employer groups, individuals and Medicare beneficiaries throughout the United States. The company is currently in good financial condition, although compared to competitors within the industry, PacifiCare's operations are limited in terms of market share and profitability. Furthermore, PacifiCare's revenue stream is highly reliant on Medicare, a highly regulated body, posing a possible source of risk.

It is SageGroup's consensus that PacifiCare must focus on expanding its commercial enrollment while maintaining a steady flow of revenue from Medicare. Towards this end, PacifiCare may consider acquiring smaller firms to move into geographic regions where performance has been sluggish; consolidation will provide the company with a broader network with local hospitals and physicians, more pricing leverage with corporate clients, and a spreading of the PacifiCare brand. Alternately, the company may seek to dispose some segments which show no signs of profit potential.

PacifiCare must capitalize on upcoming Medicare reforms; particularly the new drug benefit program starting January next year. This reform will increase the role that insurers play in prescription drug circulation; PacifiCare's drug segment has been quite strong in the past and will likely continue to do so, increasing revenues from next year.

In the long run, PacifiCare must be sensitive to downward pressures on prices. It is likely that the US government will implement policy to spur competition between care providers; for example by computerizing patient records or importing drugs from Canada. PacifiCare must take an investing initiative now to establish the technology and human capital that will be demanded, and hasten to expand its total enrollment so as to raise revenue even in thinner profit margins.

Background

Company Description

PacifiCare Health Systems, Inc. (PacifiCare) offers managed care and other health insurance products to employer groups, individuals and Medicare beneficiaries throughout the United States. These products include health insurance, health benefits administration and indemnity insurance products, such as Medicare Supplement products offered through health maintenance organizations (HMOs) and preferred provider organizations (PPOs). PacifiCare also offers specialty managed-care products and services that employees and individuals can purchase as a supplement to the PacifiCare's basic commercial and senior medical plans or as stand-alone products. These products include pharmacy benefit management (PBM) services, behavioral health services, group life and health insurance, and dental and vision benefit plans.

Commercial Products

PacifiCare's commercial HMO, PPO and self directed health plan (SDHP) products are offered on a stand-alone basis or are bundled with its specialty products and services. PacifiCare's HMO plans provide healthcare benefits to commercial members through a defined provider network, in which members typically pay a fixed co-payment for services accessed. As of December 31, 2004, PacifiCare's network included approximately 700 hospitals and 68,000 primary care and specialty physicians.

The company's PPO network supplements its existing HMO network with additional healthcare providers. The PPOs enable members to have a broad selection of providers in any given geographic area. PacifiCare's SDHP product, introduced in 2004, offers its members a self directed account (SDA) that covers certain healthcare expenses coupled with a PPO plan for expenses incurred that are outside of the coverage of the SDA and after the applicable deductibles have been met. Unused amounts in the SDA can roll over from year to year and accumulate for future use (up to a plan maximum).

PacifiCare also offers an exclusive provider organization (EPO) product that combines all of its networks in each state where it offers PPOs. This allows members to receive more cost-effective benefits on an in-network basis, as long as they receive services from a contracted EPO provider. PacifiCare offers commercial products in customer segments ranging from individuals and small groups to large employers. It also has contracts with the United States Office of Personnel Management (OPM) to provide HMO services to members under the Federal Employee Health Benefit Program (FEHBP) for federal employees, annuitants and their dependents.

Group Life and Health Products

PacifiCare is licensed to issue life and healthcare insurance in 47 states, the District of Columbia and Guam. By marketing its commercial healthcare product line in conjunction with supplemental insurance products, PacifiCare is able to offer multi-option health and financial benefit programs. Other supplementary benefits offered to employer groups include basic life insurance, group term-life insurance, and indemnity dental and indemnity behavioral health benefits. Indemnity dental and behavioral health benefits are specialty products.

Senior Products

PacifiCare offers eligible Medicare beneficiaries access to Medicare Advantage and Medicare Supplement products through its Secure Horizons programs. PacifiCare contracts with the Centers for Medicare and Medicaid Services (CMS) under the Medicare Advantage program to provide health insurance coverage in exchange for a fixed monthly payment per member that varies based on geography and risk factors. The firm is licensed in 48 states to offer group and individual senior supplement products. These products are designed to fill gaps left by traditional Medicare coverage. The Individual Supplement products pay for hospital deductibles, physician copayments and coinsurance, for which an individual enrolled in the traditional Medicare program would otherwise be responsible for. The Senior Supplement product provides employer groups with similar coverage options for their Medicare-eligible retirees.

Specialty

PacifiCare offers specialty products and services in conjunction with its commercial and senior products to its existing employer group and senior clients. These specialty products and services include PBM, behavioral health services, group life and health insurance products, and dental and vision services. It also sells its specialty products and services to unaffiliated health plans, union trusts, third party administrators and employer groups.

PacifiCare provides behavioral healthcare services, including managed behavioral health, employee assistance, care management and chemical dependency benefit programs. Managed behavioral health and chemical dependency services are offered as a standard part of most of the company's commercial health plans. PacifiCare provides dental and vision insurance and discount services to individuals and employer groups. Commercial plans include dental HMO, dental PPO, dental fee-for-service, vision PPO, and dental and vision discount programs. The company provides its commercial dental and vision products to small, mid-size and large employers, regardless of their existing medical carrier.

Company History

PacifiCare was formed in 1975 as a not-for-profit health care corporation by the Lutheran Hospital Society. LHS was one of the largest health care systems in the Los Angeles area. Physicians outside California resisted health maintenance organizations (HMOs), and the plans were illegal in some states well into the 1970s. By 1978 they had been legalized nationally; that year PacifiCare began operating as a federally qualified HMO. Lutheran Hospital Society converted PacifiCare to a for-profit corporation in 1984 and took the company public in 1985, retaining a 66% interest in the new company. LHS later merged with another LA area provider, the Healthwest Foundation, forming UniHealth, now UniHealth Foundation. In the late 1980s the company expanded rapidly, through purchases and acquisitions in states such as Oklahoma, Texas, and Indiana. In 1991 PacifiCare began operations in Northern California, the home turf of rival Kaiser Foundation Health Plan.

PacifiCare continued to grow, and also moved into new fields within the health care industry, forming a subsidiary to offer centralized billing and account services to multistate employers, opening staff-model pharmacies and buying Execu-Fit, a wellness and health education provider. PacifiCare pursued alliances with other healthcare-related companies and increased the amount of business it did with government agencies. UniHealth decreased its ownership of PacifiCare stock to allow the company to offer stock for new purchases. In 1993 its ownership of PacifiCare fell below 50%. Also in 1993, PacifiCare purchased a Miami-area HMO; the company then won a Civilian Health and Medical Program for the Uniformed Services (CHAMPUS) contract to provide care to military personnel and dependents in 19 Northeastern and Midwestern states.

In 1994 PacifiCare forged an alliance with Liberty Mutual Insurance to provide managed care for injured workers. Industry apprehension of federal intervention discouraged many health care companies. PacifiCare used the opportunity to snap up companies to strengthen its membership base, geographic reach, and operations over the next two years. In 1997 the firm bought rival FHP International in 1997. To control some unprofitable operations, PacifiCare left some markets, including Florida, Illinois, New Mexico, and Utah. It cut employees by 9% and signed more capitation contracts with care providers to reduce risk. The company also suffered a $124 million loss related to merger problems, but by 1998 it had largely recovered.

PacifiCare announced in 1999 that it would sell its benefits administration subsidiary to focus on health insurance. It then reorganized its operations as its Medicare HMO came under increasing pressure from reimbursement cutbacks; it announced some 450 job cuts the next year. In 2000 the firm strengthened its presence in such states as Colorado and Texas by purchasing troubled plans there, but it announced its exit from the Medicare HMO business in Ohio and Kentucky. The company also established SeniorCo., a majority-owned subsidiary as an Internet provider of information and products for senior citizens. Early in 2002, the company reduced its workforce by nearly 15% to cut costs.

Competitive Analysis

Pacificare Health Systems operates in three SIC classifications: 6324 - Hospital And Medical Service Plans, 8093 - Specialty Outpatient Facilities Not Elsewhere Classified, and 8099 - Health & Allied Services Not Elsewhere Classified. Operations extend to 48 states, Guam, and the District of Columbia.

Industry

PacifiCare Health Systems faces competition in both geographic and product markets. Geographically, commercial and Medicare membership are highest in California, Florida, Texas, Arizona, and Oklahoma. Although PHS operates in other states, their market share falls far behind that of Kaiser Foundation, UnitedHealth Group, WellPoint, and Aetna. PHS makes an effort to differentiate their products from those of its competitors by promoting better and newer health techniques, tailored life and health insurance policies. Patients tend to be loyal to a specific hospital and costs may vary across hospitals. The magnitude of Medicare enrollment in PHS's operations limits, to an extent, the premiums that the company can gain off of its clients. There are a large number of insurance providers, but the managed health care industry has a select few strong firms.

Top 10 Companies ranked by HMO enrollment:

1. Kaiser Permanente, with 8.4 million enrolled
2. Blue Cross Blue Shields Assn., 5.5
3. UnitedHealth Group Inc., 4.8
4. Aetna Inc., 3.9
5. WellPoint Health Networks Inc., 3.6
5. Health Net, 3.6
7. PacifiCare Health Systems Inc., 2.7
8. Humana Inc., 2.3
9. Anthem Inc., 1.9
10. CIGNA Corp., 1.5
10. Coventry Health Care Inc., 1.5

Substitutes and Complements

Health care is a growing necessity in modern times, and its proportion of GDP continues to rise. Home practitioners and over-the-counter drugs may be negligible substitutes for general health care. An interesting consideration is the potential of health foods and exercise as a substitute, any activity that promotes a healthy body could be considered a substitute. The obvious complement to health care is insurance, which PHS is involved in. There may be many providers of insurance or different coverage policies, but cannot be substituted as an aggregate.

Buyer and Supplier Power

Buyers include patients, companies, physicians, and other insurers. Medicare is the most important buyer to PHS, and has substantial power over its operations. Guidelines for medical loss ratios and government policy can easily alter revenues. Patients tend to have loyalties to specific hospitals or insurance providers and may be difficult to steer away from a competitor. PHS has recently focused on increasing their commercial enrollment. Provided companies have a variety of providers to choose from, they have substantial buyer power. If the market is regional, growing companies or new commercial enrollments may occur in the hometown. In this case, PHS may not be strong enough in the areas where entrepreneurship and business development occur (San Francisco, New York, etc.).

The main suppliers to consider are physicians, nurses, pharmaceutical companies and health equipment providers. The physician recruitment market is mostly national, and PHS has hospitals nationwide, making replacement relatively simple. More specialized radiologists, anesthesiologists and pathologists may be harder to find and must usually be paid more. Unions of such medical professionals may increase their supplier power. Growing R&D costs for pharmaceutical and biotech equipment may increase their supply costs, but a trend of generic production or importing from Canada or elsewhere counters these.

Entry

There are significant barriers to entry due to federal and state regulation and economic realities. Establishment of hospitals and hiring of physicians requires large amounts of capital, especially the more complicated or advanced the specialized field. Permits for practice and providing insurance are necessary, both for the firm and the underwriting personnel. Although there is a continuous stream of new physicians graduating from medical school or finishing their residency, preparation for medical practice takes many years, which adds to their high costs.

Financial Analysis

PacifiCare Health Systems (NYSE: PHS) is in good financial health, reporting increased revenues for fiscal year 2004, as well as a fairly positive outlook for the foreseeable future. Positive macroeconomic issues include a trend of health care increasing as a percentage of GDP, a rapid graying of the population, and Bush's persistence in the privatization of Medicare—PacifiCare's primary revenue source. Analysts project a 25% increase in company value over a five year horizon due to consequences of reform. In January 2005, PacifiCare announced its projection of a 15% increase in revenues for fiscal year 2005.

As of April 15, 2005, PacifiCare's stock price stands at $54.34 with a market capitalization of approximately $4.73 billion. The chart above shows historical price data for the past five years. After April 2002, PacifiCare's share value has continued to increase relative to the market (proxy by the S&P 500), and the widening of the gap is expected to persist.

Enrollment in both senior and commercial provisions continues to increase, although there have been some fluctuating quarters. Also, there is some doubt regarding the optimism of Medicare reform, as there may be inertia for seniors to change providers. As Medicare constitutes a significant portion of PacifiCare's operations, it is also true that government regulation can quickly alter the state of the company. Local and state jurisdiction differences also pose some problems as PacifiCare expands its operations in more of the Midwestern and eastern states.

The chief threat to PacifiCare's future is its relationship with its competitors. Its primary competitors include Aetna, Co., the Kaiser Foundation, and WellPoint. The following chart summarizes various key indicators of financial performance for PacifiCare, two of its competitors, the industry, and the overall market.

Key Numbers	**PacifiCare**	**Aetna**	**WellPoint**		
Annual Sales ($ mil.)	12,276.80	19,904.10	20,815.10		
Market Cap ($ mil.)	5,573.40	**22,638.20**	17,609.50		
Profitability	**PacifiCare**	**Aetna**	**WellPoint**	**Industry[2]**	**Market[3]**
Pre-Tax Profit Margin	4.02%	**9.54%**	7.00%	7.31%	9.61%
Net Profit Margin	2.47%	**11.28%**	4.61%	5.38%	6.22%
Return on Equity	13.90%	**24.70%**	14.10%	19.70%	11.70%
Return on Assets	5.80%	5.30%	**6.80%**	4.00%	2.00%
Return on Invested Capital	9.40%	**21.00%**	11.50%	15.50%	5.60%
Valuation	**PacifiCare**	**Aetna**	**WellPoint**	**Industry[2]**	**Market[3]**
Price/Sales Ratio	**0.45**	1.14	0.85	1	1.44
Price/Earnings Ratio	20.1	**10.76**	20.8	19.13	22.77
Price/Book Ratio	2.55	**2.49**	2.59	3.64	2.7
Price/Cash Flow Ratio	18.37	**10.09**	17.9	18.53	12.37
Per Share Data ($)	**PacifiCare**	**Aetna**	**WellPoint**	**Industry[2]**	**Market[3]**
Revenue Per Share	141.66	135.23	**149.98**	81.79	20.85
Dividends Per Share	0	**0.04**	0	0.12	0.46
Cash Flow Per Share	3.5	**15.25**	7.09	4.4	2.43
Long-Term Debt Per Share	12.13	10.94	10.95	6.01	11.81
Book Value Per Share	25.25	**61.7**	49	22.38	11.12
Total Assets Per Share	60.31	**286.27**	101.86	110.94	66.49
Growth	**PacifiCare**	**Aetna**	**WellPoint**	**Industry[2]**	**Market[3]**
12-Month Revenue Growth	11.50%	10.70%	**24.10%**	10.20%	6.50%
12-Month Net Income Growth	24.90%	**140.40%**	24.00%	40.60%	23.90%
12-Month EPS Growth	5.30%	**142.00%**	11.90%	34.80%	21.10%
12-Month Dividend Growth	--	**0.00%**	--	0.00%	4.50%
36-Month Revenue Growth	0.90%	-7.80%	**25.90%**	1.70%	6.10%
36-Month Net Income Growth	**146.10%**	--	41.10%	37.10%	66.30%
36-Month EPS Growth	**120.40%**	--	22.50%	37.50%	69.40%
36-Month Dividend Growth	--	**0.00%**	--	4.50%	3.50%

([1] Data unavailable. [2] Industry: Health Care Plans [3] Public companies trading on the New York Stock Exchange, the American Stock Exchange, and the NASDAQ National Market.)

Within the industry, PacifiCare seems to be somewhat behind some of its competitors. The immobility and inertia of client enrollment tend to favor larger, nationally established providers. Regionally, PacifiCare is fairly strong in Southern California and Southwestern states, but still has less market share in terms of enrollment.

PacifiCare's expansion strategies will be key to its success in the near future. At the same time, it must minimize SG&A expenses. Initiating operations in new markets tend to create excessive overhead and inefficiencies; it should be PacifiCare’s goal to increase efficiency within the company. The company’s medical loss ratios show better profit margins, its commercial and private MLRs are down about one percent from the previous year to 83.6% and 82.6%, respectively. The government sector MLR has increased over 300 basis points, perhaps a reflection of tighter regulation; Medicare MLR for 2005 is 150-200 basis points worse than 2004.

	4Q 2003	3Q 2004	4Q 2004 (expected)	4Q 2004	%change Q/Q	%change
Commerical Yield Increase	16.70%	9.40%	7.70%	7.70%	-170 bp	-900 bp
Commerical MLR	85.10%	84.00%	84.20%	83.60%	-40 bp	-150 bp
Private Sector Commerical MLR	84.20%	83.50%	83.40%	82.90%	-60 bp	-130 bp
Private Sector Sr (Grp&Med Supp) MLR	54.20%	69.10%	72.00%	65.60%	-350 bp	1140 bp
Total Private Sector MLR	83.80%	83.20%	83.20%	82.60%	-60 bp	-120 bp
Govt Sector Senior (Medicare) MLR	83.40%	84.90%	85.80%	86.60%	170 bp	320 bp
Consolidated MLR	83.60%	84.10%	84.40%	84.50%	40 bp	90 bp
SG&A ratio	14.20%	12.40%	12.70%	12.80%	40 bp	-140 bp
EBITDA margin	3.40%	4.70%	4.10%	4.10%	-60 bp	70 bp
Tax rate	37.60%	38.10%	38.90%	38.60%	50 bp	100 bp

Simple Discounted Cash Flows Model

The SageGroup team has built a simple valuation model based on a discounted cash flow basis. The assumptions regarding growth rates in revenues, expenses, free cash flows, and other factors reflect the team’s absorption of past performance, estimates by third-party financial analysts, expectations of future macroeconomic conditions, and a random component. An excerpt from the annual report provided by PacifiCare is given below. This income statement guides the DCF model framework.

	Year Ended December 31, 2004	Year Ended December 31, 2003	Year Ended December 31, 2002
	(Amounts in thousands, except per share data)		
Revenue:			
Commercial	$ 5,686,373	$ 5,043,257	$ 4,782,973
Senior	5,810,247	5,395,265	5,887,603
Specialty and other	691,367	498,668	421,439
Net investment income	88,817	71,321	64,487
Total operating revenue	12,276,804	11,008,511	11,156,502
Expenses:			
Health care services and other:			
Commercial	4,786,830	4,270,329	4,205,376
Senior	5,007,852	4,540,301	5,104,275
Specialty and other	379,097	255,164	176,050
Total health care services and other	10,173,779	9,065,794	9,485,701
Selling, general and administrative expenses	1,561,247	1,452,542	1,370,160
Impairment, disposition, restructuring, Office of Personnel Management and other charges (credits), net	—	—	3,774
Operating income	541,778	490,175	296,867
Interest expense, net	(48,041)	(100,531)	(74,904)
Income before income taxes	493,737	389,644	221,963
Provision for income taxes	190,583	146,896	82,792
Income before cumulative effect of a change in accounting principle	303,154	242,748	139,171
Cumulative effect of a change in accounting principle	—	—	(897,000)
Net income (loss)	$ 303,154	$ 242,748	$ (757,829)
Basic earnings (loss) per share[1]:			
Income before cumulative effect of a change in accounting principle	$ 3.60	$ 3.26	$ 1.98
Cumulative effect of a change in accounting principle	—	—	(12.73)
Basic earnings (loss) per share	$ 3.60	$ 3.26	$ (10.75)

The DCF model is given below (2003 numbers are actual):

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Term. Val.
REVENUES													
Senior	$5,395	5665	5948	6245	6558	6886	6954	7024	7094	7165	7237	7309	
Commercial	5,043	5245	5455	5673	5900	6136	6320	6509	6639	6772	6908	7046	
Net Investment Income	71	71	71	71	71	71	71	71	71	71	71	71	
Specialty & Other	499	494	489	484	479	475	470	465	460	456	451	447	
Total Revenues	11,008	11474	11963	12473	13008	13567	13815	14069	14265	14464	14667	14873	
OPERATING EXPENSES													
Senior	4,540												
Commercial	4,270												
Specialty & Other	256												
Selling, General and Administrative	1453												
Total Operating Expenses and Cost of Revenue	10,519	10835	11160	11494	11839	12194	12560	12937	13325	13725	14137	14561	
EBIT	489	640	803	979	1168	1372	1255	1132	940	739	530	312	
EBIT (1-t)	305	399	500	610	728	855	782	705	586	461	330	194	
+ Depreciation & Amortortization	45	46	47	47	48	49	50	51	52	53	54	56	
- Capital Expenditures	-52	-52	-51	-51	-50	-50	-49	-49	-48	-48	-47	-47	
- Change in Working Capital	-82	-81	-80	-80	-79	-78	-77	-76	-76	-75	-74	-73	
FREE CASH FLOW	215	311	415	527	647	777	706	632	514	391	263	130	1,654
Present Value of FCF		$289.31	$358.55	$423.00	$482.87	$538.41	$454.60	$378.20	$286.07	$202.39	$126.55	$57.94	$738.71

Sum of FCF	$4,336.61
+ Market Value of Cash	$951.69
- Market Value of Debt	-$620.20
Market Value of Equity	$4,668.10
Number of Shares Oustanding	87.11
Predicted Price Per Share	**$53.59**
True Price as of 4-19-05	**$54.95**
Market Capitalization	$4,786.69

DuPont Analysis	
Net Profit Margin	2.50%
Total Asset Turnove	2.5
Total Assets	5,227
Total Equity	2,188
Equity Mulitplier	2.39
ROE	**14.93%**

The weighted average cost of capital was calculated to be 7.60%, with a beta of 0.824. A simple inference is that the health care industry tends to be slightly less volatile to macroeconomic shocks relative to the entire market. A required rate of return of 7.60% is quite low, reflecting PacifiCare's financial strength, balanced equity and debt financing and solvency. The SageGroup team's best estimate yields a predicted share price within $1.50, roughly 3%, of the true share price as of April 19, 2005. Growth assumptions were relatively generous up through 2007, with senior and commercial revenues increasing 5% and 3% per annum, respectively. After 2008, these were moderated to a more conservative estimate.

The Dupont analysis model predicts a return on equity close to 15%, contrasted to the firm's announced ROE of 14%. Referring to the competitive landscape illustration earlier in this section, this figure seems to be below the industry average. WellPoint had a comparable ROE for 2004, yet Aetna boasts a much higher figure. This estimate was unable for the Kaiser Foundation, which is a non-profit organization.

Key Issues

PacifiCare has a broad spectrum of healthcare and insurance products, yet a majority of its earnings is derived from Medicare clients. This dependency on a specific client, as described in the section discussing buyer power, could pose as a risk factor for the firm's future. First of all, Medicare is highly regulated by government guidelines; target medical loss ratios are increasing, showing thinner profit margins. Although President Bush's advocacy of Medicare privatization is likely to sustain a steady flow of income, it is true nonetheless that a large portion of PacifiCare's profits depends on its relationship with the government. Beginning January 2006, a rise in Medicare funding and increased drug benefit program will be initiated, helping to maintain positive expectations about PacifiCare's government revenue stream.

While maintaining it strength in Medicare enrollment, PacifiCare has been focusing on expanding its commercial operations, as can be seen in the acquisition of American Medical Security Group, Inc. (AMS) which completed at the end of 2004. This allowed an expansion of the company's group life and health product line and specialty operations targeted at employer groups and their dependent retirees. Consolidation has been an increasing phenomenon even in the health care industry, roughly a third of the smaller firms had been acquired by the end of 2002. This provided more pricing leverage to the remaining firms when negotiating with their corporate clients. There seem to be strong economies of scope and scale issues in this industry.

There is a great deal of attention and media coverage on rising health care costs for companies to sustain employees and retirees, as well as the burden of Social Security and Medicare on the federal budget deficit which continues to reach record levels. There is a general consensus among both Democratic and Republican parties that reform is necessary in this industry, and historically the White House has been active on such overheating industries. Many economists expect that in a foreseeable future, there will be more implementation of reforms aimed at lowering prices. In particular, issues being debated include a standard computerization of patient records and importing pharmaceuticals from Canada.

Computerized patient records would spur competition between health care providers as they would be able to address patients who are being overcharged or treated inefficiently, or better advertise procedures that they have a comparative advantage in performing. This is a plausible yet painful reform and many debates for issues such as the right to privacy and job protection will delay the process.

Importing pharmaceuticals from Canada or other foreign generic pharmaceutical suppliers would require much more time, as the devastation on American pharmaceutical companies is unimaginable—much lobbying will occur. In some ways, this suggestion also seems to counter a necessary American institution of promoting research and development and protecting patents and intellectual property rights.

Strategic Direction

PacifiCare's ongoing interest is its expansion of commercial enrollment while maintaining a guaranteed stream of revenue through Medicare programs. It must be able to capitalize on Medicare and general health care industry reforms that are destined to occur in the short run and long run. Towards this end, there are several ways of approaching this issue.

PacifiCare currently operates in most areas of the United States, including Guam and the District of Columbia. However, its operations are heavily unbalanced and oriented towards the Western states. It may be wise for the company to expand its marketing and product offerings in some of the weaker states, or even dispose some geographic segments. As there seems to be some inertia for seniors to switch between health insurance providers and tend to be loyal to specific hospitals, this poses to be a more difficult target audience to convince. PacifiCare should focus on new Medicare enrollment and its commercial audience. These targets are more likely to be apprehensive of healthcare costs and efficient benefit provision; if PacifiCare can provide a suitable benefit plan at a relatively low cost, it has substantial leverage in enhancing its enrollment.

Geographic and market expansion can be accomplished through a few ways. Acquisition of more smaller firms can assist in providing more local knowledge and networking with hospitals and physicians, while enhancing the power to leverage price negotiations with commercial clients. Companies are weary of increasing health care costs; though slashing prices is not the desirable way of attracting clients, a combination of lower prices with more product options, broader network of health care providers at a local level, and good negotiating can lock in commercial enrollment. Thus PacifiCare must look into its human capital base and determine if its employees are truly maximizing return. PacifiCare should not hesitate to decrease operations in weaker areas; these are likely more rural areas, where people may still buy traditional indemnity insurance.

Towards maintaining its Medicare line, PacifiCare must capitalize on the new Medicare drug benefit program scheduled for January 2006. Furthermore, on April 5, 2005, PacifiCare announced that it received notice from the Center for Medicare and Medicaid Services (CMS) that its Secure Horizons Medicare Advantage plans will receive an overall county rate increase of 6.5 percent to 7 percent beginning January 1, 2006. PacifiCare expects to realize increased revenues in 2006, which it will utilize to expand Medicare Advantage benefits and membership.

The new Medicare drug benefit program will increase the role of insurance providers when beneficiaries purchase prescription drugs. Instead of a discount coupon-like system which it will replace, the new program utilizes insurance to lower copayments by Medicare subscribers. PacifiCare's drug benefit program to date is fairly strong and will likely be able to bring this reform to its advantage.

In the long run, PacifiCare should prepare for thinner profit margins and tighter regulation of health care in general. The government will soon likely implement policy advocating competition and creating an incentive to lower prices. In geographic regions where non-profit organizations and mutually-owned insurers are predominant players, this price reduction may be more severe or happen earlier. These include Pennsylvania, New Jersey, Florida, Texas, Illinois, and others. As these states have relatively large populations and business activity, it is important for PacifiCare to establish a strong presence in these markets to obtain a pricing leverage. Even if premiums decrease on a per capita basis, if total enrollment expands, revenues may still increase. Similarly with computerized patient records, PacifiCare must not lag in the technology to search these records for comparative advantages and opportunities, as well as build human capital of its personne. PacifiCare must take the initiative to invest in protection mechanisms from future price declines.

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