Aetna 2000

Background

~~Buyer~~ being bought

On March 1st, Aetna, the largest United States health insurer, announced an offer to purchase the company by WellPoint Health Networks and ING America Insurance Holdings in a deal worth $10 billion in cash and stock. Aetna's response to the offer was only that the company would evaluate the proposed transaction in conjunction with a comprehensive review of its present strategy and operations. Prior to the announcement, investors drove up the price of Aetna stock up 31 percent to 53 13/16.

Under the proposed transaction, ING America Insurance Holdings and WellPoint Health Networks would pay roughly $70 per share of Aetna stock. The purchase price would consist of $44 per share in cash and $26 in WellPoint common stock. ING America Insurance Holdings will act as an investment advisor to WellPoint.

Prior to the announcement of a potential merger, Aetna's stock price had floated near a 52 week low of 38 ½ per share on reporting of disappointing earnings in February, well below it's high of 99 7/8.

Aetna

Aetna Incorporated is a Connecticut company based in Hartford. Based on membership, the company is the largest health benefits company and one of the country's largest insurance and financial services organizations.

During the past several years, Aetna rapidly expanded its health operations through acquisitions and divested several other insurance businesses. In July of 1998, the company purchased New York Life Insurance Company's NYLCare health business. In October, Aetna then sold its interest in its individual life insurance business. By August of 1999, the company made another large investment by purchasing The

Prudential Insurance Company's health care business and in October, completed the sale of its Canadian operations.[1] Consolidated financial information can be found in exhibit 1.

As of the end of 1999, Aetna was divided into four areas:[2]

1. **Aetna U.S. Healthcare**: (exhibit 1)

   Health Products

   - Health Maintenance Organizations
   - Point of Service
   - Preferred Provider Organization & Indemnity Products

   Group Life and Disability Insurance

   Long-Term Care Insurance

2. **Aetna Financial Services**: (exhibit 2)

   Financial Services Products

   - Fixed & Variable Annuities
   - Investment Advisory Services
   - Financial Planning Services
   - Pension Plan Advising

3. **Aetna International** (exhibit 3)

   - Life Insurance
   - Health Insurance
   - Financial Services

[1] Aetna 1999 10K
[2] Aetna 1999 10K

4. **Large Case Pensions** (exhibit 4)

   Retirement Products

In January 2000, Aetna announced a restructuring plan that would realign its business units. Under the plan, the company would group both the international and domestic health care within the same division under the name "Global Health." All financial services, including both international and domestic, would be grouped under "Global Financial." The strategy behind the plan was to enable Aetna to share its product expertise and technology between the domestic and international divisions.

As with most insurance companies offering "Managed Care" plans, Aetna is facing several outstanding lawsuits with regards to how it operates its HMO businesses. While a significant impact had yet to come, several states, as well as the federal government, were considering the implementation of an updated strict "patients bill of rights" that may adversely impact the financial operations of a health care company like Aetna.

WellPoint Health Networks

WellPoint Health Networks Inc. is one of the largest publicly traded managed health care companies with over 7.2 million medical members and approximately 30.6 million specialty members. The company offers a wide array of products in several markets including managed care services, underwriting, claims processing, actuarial services, medical cost management, and network access. WellPoint offers these main products, as well as others, to large and small employers, individuals, and seniors. In California, these products are marketed and sold under the name Blue Cross of California and outside California, they are marketed under Unicare. Financial Statistics for WellPoint are summarized in exhibits 7 through 9.

In July of 1998, WellPoint sold its Worker's Compensation Segment to Fremont Indemnity Company in a stock transaction worth $110.0 million. The sale of this segment allowed WellPoint to redirect its focus the state and federal level, may shift a significant cost containment ability from the insurer to the patient. Other possible regulatory measures that might impact the industry would include adding an avenue to bring suit against an insurer if it can be proven that "adequate" care was not provided to the patient. While it has not been passed into law, this too could create a problem for insurers. Other regulatory risks may include, but will not be limited to, a prohibition of incentive plans for physicians designed to limit expenses, mandated coverage levels, increased reserve and capital requirements, changes to licensure or certification requirements, mandatory coverage of experimental procedures or drugs, anti-trust enforcement, mandatory access to specialists, and liabilities for negligent denials or delays in coverage.[3]

Another risk lies in the increased competition among health care insurers. Cost conscious customers may be more willing to leave more expensive coverage for lower premiums. Insurers, to maintain leverage with health care providers, will need a growing base of customers. This may be a difficult task given the ability of competition to continuously lower premiums to gain market share.

In this health care environment of rapid consolidation, Aetna will need to continue to uphold its success in the integration of other health care insurers.[4] Most acquisitions that fail do so for a variety of reasons. Some common possible reasons for acquisition under performance include: relying on unlikely synergies, paying too much, large variations in corporate culture, slow integration of the acquisition, poor due diligence, and a lack of corporate strategy.

[3] Aetna Inc. 1999 SEC Form 10-K405.

Exhibit I

Aetna U.S. Healthcare

Operating Summary

	3 Months Ending September		
	1999		1998
(millions)			
Premiums	$4,935.8		$3,584.1
Net Investment Income	$163.8		$133.3
Fees & Other Income	$478.4		$381.9
Net Realized Capital Gains	($20.1)		$19.2
Total Revenue	$5,557.9	+34.95%	$4,118.5
Current & Future Benefits	$4,205.0		$3,084.5
Operating Expenses	$1,016.8		$725.6
Amortization	$108.6		$99.1
Total Benefits & Expenses	$5,330.4		$3,909.2
Income Before Tax	$227.5		$209.3
Income Tax	$100.1		$95.8
Net Income	$127.4	+12.25%	$113.5

on national expansion of the health care market. Pursuing this strategy, the company purchased the Life and Health Benefits Management Division of Massachusetts Mutual Life Insurance Company and the Group Benefits Operations of John Hancock Mutual Life Insurance Company.

Corporate Issues

In July of 1998, WellPoint entered into an agreement to purchase the insurance company, Cerulean. Through its subsidiary Blue Cross and Blue Shield, Cerulean offered insurance products and administrative support for these products in the state of Georgia.

In September of 1998, policy holders of Blue Cross Blue Shield of Georgia filed a class action lawsuit regarding a conversion of Blue Cross and Blue Shield of Georgia from a "non profit" corporation to a "for profit" entity. The subsequent acquisition is pending and can be terminated by either party.

In September of 1999, the California legislature enacted into law a series of health care reform measures. Effective January 1, 2001, managed care entities must exercise ordinary care in the coverage of medical care requested by policy holders. Managed care organizations may be held liable if it fails to exercise "ordinary care" and the subscriber suffers substantial harm. Substantial harm may be defined as a loss of life, impairment of a limb or bodily function, disfigurement, severe and chronic pain, or significant financial loss. Similar legislative measures were enacted in Texas and have been discussed on the local, State, and Federal levels of government.

Competition in Health Care in the United States

As overall health care expenditures in the United States soar at an alarming rate, competition among health care providers and insurers have increased in an attempt to lower health care costs and maintain a steady revenue stream. Corporations, in order to lower "benefit expenditures" associated with providing health care coverage to employees, have placed an ever-increasing pressure on insurers to maintain or

lower premiums. As a result, it is not unusual to find a company offering several health care plans to its employees. This increase in competition has forced health maintenance organizations like Aetna to focus their attention on health care expenditures attributed to their memberships utilization of their plan.

The critical component to increasing leverage in negotiating contracts with health care providers has been the number of participating members in any given area. Since hospitals are large fixed cost businesses, they primarily depend on volume to maintain solvency. By increasing members within a plan, health insurance companies can control volume and by doing so, significantly increase leverage in negotiating reimbursement contracts with health care providers.

But as health care providers increased their market share over the years, hospitals began to form groups and increase their leverage in key locations. One example of this is Partners Health Care in Boston. Formed in 1995 with the alignment of Massachusetts General Hospital and Brigham and Women's Hospital, over the past five years the organization has added six additional hospitals to the network significantly increasing their contract negotiating leverage with major health insurers in the area.

In late 2000, negotiations between Partners and a major health insurer, Tufts Health Plan, broke off when a contract could not be agreed upon. If unsettled, over a million Tufts Health Plan members would need to change plans or find a new Doctor within six months. A few weeks after the contract stalemate, Tufts and Partners came back to the bargaining table and agreed to the a new contract with price escalators for services. While both entities initially stood their ground, it was ultimately in both of their interests, as well as the participating members, to settle and compromise. These battles however, based on market share leverage, are likely to continue as pressure to control costs and maintain profitability increase.

Risks in Health Care in the United States

Risks in health care in the US come from several angles and each can have a material impact on both insurers and providers of health care. A "Patient's Bill of Rights," currently being discussed at both

Exhibit 2

Aetna Financial Services

Operating Summary

	3 Months Ending September	
	1999	1998
(millions)		
Premiums	$44.2	$38.6
Net Investment Income	$224.8	$278.2
Fees & Other Income	$134.2	$169.2
Net Realized Capital Gains	($11.2)	$1.9
Total Revenue	$392.0 -19.66%	$487.9
Current & Future Benefits	$201.1	$254.2
Operating Expenses	$93.0	$101.9
Amortization	$25.9	$36.2
Total Benefits & Expenses	$320.0	$392.3
Income Before Tax	$72.0	$95.6
Income Tax	$23.7	$29.0
Net Income	$48.3 -27.48%	$66.6

Exhibit 3

Aetna International

Operating Summary

	3 Months Ending September	
	1999	1998
(millions)		
Premiums	$562.0	$376.0
Net Investment Income	$117.0	$102.6
Fees & Other Income	$33.2	$35.4
Net Realized Capital Gains	$43.5	$1.2
Total Revenue	$755.7 +46.68%	$515.2
Current & Future Benefits	$487.9	$337.2
Operating Expenses	$145.6	$98.4
Amortization	$2.3	$2.4
Other	$28.5	$26.9
Total Benefits & Expenses	$664.3	$464.9
Income Before Tax	$91.4	$50.3
Income Tax	$69.3	$9.5
Net Income	$22.1 -45.83%	$40.8

Exhibit 4

Aetna Large Case Pensions

Operating Summary

(millions)	3 Months Ending September 1999	1998
Premiums	$32.8	$31.6
Net Investment Income	$241.1	$278.0
Fees & Other Income	$14.8	$8.9
Net Realized Capital Gains	($5.7)	($0.3)
Total Revenue	$283.0 -11.06%	$318.2
Current & Future Benefits	$248.0	$272.0
Operating Expenses	$7.5	$9.3
Amortization	$0.0	$0.0
Other	$0.0	($68.0)
Total Benefits & Expenses	$255.5	$213.3
Income Before Tax	$27.5	$104.9
Income Tax	$10.4	$40.7
Net Income	$17.1 -73.36%	$64.2

Exhibit 5

Aetna Consolidated Balance Sheets.

(Millions, except share data)	As of December 31 1999	1998
Assets:		
Investments:		
Debt securities available for sale, at fair value (amortized cost $29,409.4 and $30,730.1)	$28,661.60	$32,180.80
Equity securities, at fair value (cost $732.6 and $762.6)	$791.10	$800.50
Short-term investments	$788.20	$942.20
Mortgage loans	$3,238.20	$3,553.00
Real estate	$361.80	$270.30
Policy loans	$541.50	$458.70
Other	$1,394.80	$1,300.30
Total investments	$35,777.20 -9.4%	$39,505.80
Cash and cash equivalents	$2,504.50	$1,951.50
Short-term investments under securities loan agreement	$1,037.50	$753.60
Accrued investment income	$466.50	$537.10
Premiums due and other receivables	$2,751.10	$1,478.10
Reinsurance recoverable	$3,881.10	$3,897.20
Deferred income taxes	$352.00	$46.60
Deferred policy acquisition costs	$2,059.80	$1,768.60
Goodwill and other acquired intangible assets	$9,335.40	$9,143.50
Other assets	$1,341.70	$1,111.90
Separate Accounts assets	$53,332.20	$44,936.00
Total assets	$112,839.00 +7.33%	$105,129.90
Liabilities:		
Insurance liabilities:		
Future policy benefits	$17,599.30	$18,541.10

Unpaid claims	$4,976.50	$3,953.90
Unearned premiums 507.1 '28.9	$507.10	$428.90
Policyholders' funds left with the Company	$15,481.40	$17,632.50
Total insurance liabilities	$38,564.30	$40,556.40
Dividends payable to shareholders	$28.50	$35.20
Short-term debt	$1,887.70	$1,370.10
Long-term debt	$2,677.90	$2,214.50
Payables under securities loan agreement	$1,037.20	$753.60
Current income taxes	$307.60	$444.80
Other liabilities	$4,195.80	$3,007.00
Minority and participating policyholders' interests	$117.40	$148.40
Separate Accounts liabilities	$53,332.20	$44,936.00
Total liabilities	$102,148.60 +9.29%	$93,466.00
Aetna-obligated mandatory redeemable preferred securities of subsidiary limited liability company holding primarily debentures guaranteed by Aetna	-	$275.00
Commitments and contingent liabilities (Notes 3, 5 and 18)		
Shareholders' equity:		
Class C voting mandatory convertible preferred stock ($.01 par value, 15.000.000 shares authorized, 11,61',816 issued and outstanding in 1998)	-	$862.10
Common stock ($.01 par value; 500,000,000 shares authorized; 142,680,694 in 1999 and 141,272,628 in 1998 issued and outstanding)	$3,719.30	$3,292.40
Accumulated other comprehensive income (loss)	($655.60)	$177.80
Retained earnings	$7,626.70	$7,056.60
Total shareholders' equity	$10,690.40	$11,663.90
Total liabilities, redeemable preferred securities and shareholders' equity	$112,839.00 +7.35%	$105,129.90

Exhibit 6

Aetna CONSOLIDATED STATEMENTS OF CASH FLOWS

(Millions)	1999	1998	1997
Cash Flows from Operating Activities:			
Net income	-20.44%, -184.2 $716.90	$848.10	$901.10
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization (including investment discounts and premiums)	$483.00	$451.40	$374.20
Gain related to sale of life business	-	($98.90)	-
Net realized capital gains	($71.90)	($271.80)	($334.20)
Changes in assets and liabilities:			
Decrease in accrued investment income	$63.00	$8.50	$46.00
Increase in premiums due and other receivables	($260.40)	($92.60)	($245.80)
Increase in deferred policy acquisition costs	($410.60)	($278.90)	($302.40)
(Increase) decrease in income taxes	($93.90)	($91.20)	$323.30
Net (increase) decrease in other assets and other liabilities	$245.00	($262.20)	($193.00)
Increase in other insurance liabilities	$969.60	$598.40	$656.40
Other, net	$28.40	($2.20)	$4.90
Net cash provided by operating activities	$1,669.10 +35.64%, $438.6	$808.60	$1,230.50
Cash Flows from Investing Activities:			
Proceeds from sales and investment maturities of:			
Debt securities available for sale	$17,918.60	$20,254.60	$16,247.80
Equity securities	$588.60	$833.40	$961.40
Mortgage loans	$77.50	$90.40	$1,078.80
Real estate	$13.70	$136.50	$626.80
Other investments	$739.80	$639.10	$924.70
Short-term investments	$19,603.20	$21,229.10	$19,957.00
Life business	-	$1,000.00	-

Investment maturities and repayments of:			
Debt securities available for sale	$3,739.70	$2,849.40	$3,913.90
Mortgage loans	$485.60	$918.40	$1,726.50
Cost of investments in:			
Debt securities available for sale	($21,609.80)	($20,602.60)	($21,310.10)
Equity securities	($533.90)	($481.50)	($626.10)
Mortgage loans (480.3) (319.2) (255.3)	($480.30)	($319.20)	($255.30)
Real estate (58.8) (38.5) (66.8)	($58.80)	($38.50)	($66.80)
Other investments (812.5) (4,127.6) (1,033.5)	($812.50)	($4,127.60)	($1,033.50)
Short-term investments (18,924.8) (21,126.0) (20,291.7)	($18,924.80)	($21,126.00)	($20,291.70)
Acquisitions:			
NYLCare health care business	($48.80)	($1,080.60)	-
Prudential health care business	($512.50)	-	-
Other	($212.20)	($84.50)	($473.00)
Increase in property and equipment	($123.50)	($123.20)	($92.40)
Other, net	($9.40)	($97.40)	$83.00
Net cash (used for) provided by investing activities.	($159.80)	($130.20)	$1,371.00
Cash Flows from Financing Activities:			
Deposits and interest credited for investment contract.	$2,503.30	$2,046.40	$1,872.50
Withdrawals of investment contracts	($3,345.40)	($3,150.90)	($3,481.10)
Issuance of long-term debt	$2.00	$25.70	$4.70
Repayment of long-term debt	($33.30)	($153.00)	($34.30)
Net increase (decrease) in short-term debt	$519.40	$1,122.30	($46.70)
Common stock issued under benefit plans	$44.80	$39.60	$134.70
Common stock acquired	($512.50)	($394.90)	($523.10)
Redemption of mandatory convertible preferred stock	($275.00)	-	-
Dividends paid to shareholders	($153.50)	($170.90)	($174.90)
Other, net	$32.80	-	-
Net cash used for financing activities	($1,217.40)	($635.70)	($2,248.20)

Effect of exchange rate changes on cash and cash equivalents	($0.50)	($5.80)	($10.10)
Net increase in cash and cash equivalents	$291.40	$36.90	$343.20
Cash acquired from the NYLCare health business	-	$108.80	-
Cash acquired from the Prudential health business	$261.60	-	-
Cash and cash equivalents, beginning of year	$1,951.50	$1,805.80	$1,462.60
Cash and cash equivalents, end of year	$2,504.50	$1,951.50	$1,805.80

Exhibit 7

WellPoint Financial Statistics
As of April 2000

Share Price and Volume

52 Week Low	$48.25
Current Price	$71.81
52 Week High	$97.00
Beta	0.94
Daily Volume	407,100
Market Capitalization	4.45 Billion
Shares Outstanding	61.9 Million
Float	34.1 Million

Exhibit 8

WellPoint Financial Statistics
As of April 2000

Per Share Information

Book Value	$20.63
Earnings	$4.36
Sales	$109.34
Cash	$49.51
Price/Book	3.48
Price/Earnings	16.49
Price/Sales	0.66

Exhibit 9

WellPoint Financial Statistics
As of April 2000

Financial Summary

Sales	7.49 Billion
EBITDA	614.1 Million
Income Avail to Common	297.2 Million
Profit Margin	4.00%
Operating Margin	7.30%
ROA	6.69%
ROE	22.23%
Current Ratio	1.51
Debt/Equity	0.27
Total Cash	3.26 Billion

Suggested Questions for Students

1. How well positioned in the market is Aetna?
2. What would you consider is Aetna's strengths and weaknesses?
3. What is Aetna's most profitable segment and why?
4. Should Aetna be focusing on health care?
5. Why is Aetna the target of a takeover attempt?
6. Why might Aetna reject the offer?
7. Is the offer the right price for Aetna?
8. Would Aetna be better off merging with a large American health insurer?
9. If this is the case, why is this the only offer on the table?
10. Are Aetna's problems a result of the industry? Is WellPoint the right partner to solve these problems?
11. What is the correct price for Aetna?
12. Given the potential changes in the "regulations" of this industry, how would you value these potential issues?
13. What synergies does WellPoint bring to the table? Should these be used to value Aetna?
14. Should Aetna accept WellPoint's offer? If you were on the Board, how would you vote?