OPPENHEIMER

EQUITY RESEARCH

INDUSTRY UPDATE WITH CHANGES

July 27, 2015

ANTM Acquiring CI; Follow-Up After the Call

HEALTHCARE/HEALTHCARE SERVICES

SUMMARY

After a recent intense takeover battle, Anthem has agreed to acquire Cigna in a cash/stock deal totaling $53B, or $181/shr for CI based on ANTM's Friday closing price of ~$151. The deal price represents 20x our most recent 2016 Cigna EPS estimate of $9.30 (model unadjusted for pre-announcement). ANTM continues to believe the deal, driven by nearly $2B in synergies, will be more than $3.00/share accretive (20%+ vs. $14 in projected EPS) in Year 2 (2018). ANTM will reach 49% debt-to-cap, which it expects to reduce to the low-40% range two years post-close. We view the deal favorably as it is not only highly accretive, but also broadens ANTM's footprint in Medicare and Large Group and provides more PBM options given CI's significant membership base. Meanwhile, we are removing our Outperform rating and $142 price target for Cigna as the stock is no longer trading on fundamentals.

KEY POINTS

- **Transaction Overview:** Anthem announced it will acquire Cigna in a cash/stock deal valued at $181/share. CI shareholders will receive $103.40 in cash and 0.5152 ANTM shares. The transaction is expected to close in 2H16, pending a rigorous review by legislators (see page 2). Joseph Swedish will remain chairman and CEO, while David Cordani will be president and COO. CI will also get five board members (including Cordani) to add to ANTM's current nine.
- **Mgmt Expects $2B Synergies**: Mgmt believes run-rate synergies could approach $2B within two years of closing (ex-PBM), which will drive $3.00+/20%+ accretion in 2018 vs 10% in 2017 (all net of $0.50/shr implementation costs in Years 1 and 2). ANTM expects '18 EPS of $17.00+, based on their original $14.00/share target and $3.00+ in accretion. Please see our attached pro forma analysis, which suggests $4.00+ in accretion (CI estimates unadjusted).
- **Q2 Results Pre-announced:** ANTM previewed strong 2Q15 results, expecting adj. EPS of $3.10, vs. our estimate of $2.75 and Street consensus of $2.68, and raised '15 EPS guidance to $10+ (from $9.90+). Meanwhile, CI pre-announced 2Q15 adj. EPS of $2.50+ (GAAP: $2.21+) vs. our estimate and Street consensus of $2.24, and raised '15 EPS guidance to $8.30-$8.60 from $8.15-$8.50.
- **Valuations**: If the deal gets done, ANTM's stock looks attractive. Assuming $17.00 in '18 EPS and ANTM's/industry's historical multiple of 12.7x/13.6x (discounted two years), ANTM would be worth $180/$193. As for CI, based on a standalone value of $132 (post-break-up fee) and an implied value after acquisition of $181, we believe CI's stock implies only a ~27% chance of a deal going through.
- **Conclusion**: Overall, we view this deal favorably as the acquisition price appears reasonable considering the significant potential accretion benefits and improved capabilities gained in the Medicare and Large Group businesses. Now most questions will be pointed toward whether or not regulators will be comfortable with the move from five to three large diversified players.

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Rating/PT Changes

Companies with Updates: Summary										
		12-18-Month Price Target		Rating			2015		2016	
Company	Ticker	Prior	Curr	Prior	Curr	FYE	Prior	Current	Prior	Current
Cigna Corporation	CI	$142	n/a	O	NR	Dec	$8.39	$8.39	$9.30	$9.30
Anthem, Inc.	ANTM	$166	$166	O	O	Dec	$10.04	$10.04	$11.10	$11.10

Source: Oppenheimer & Co. Inc. Note: All figures in U.S. dollars unless otherwise noted.

O, Outperform; P, Perform; U, Underperform; NR, Not Rated.

Transaction Overview

After an intense takeover battle, ANTM has finally agreed to acquire Cigna for a total transaction value of $53B, equating to $181 based on ANTM's Friday closing price of ~$151. The transaction price equates to 20x our FY16 EPS estimate of $9.30 (unadjusted for pre-announcement), above the diversified names' average forward P/E multiple of 17x. Anthem will pay 0.5152 shares of ANTM per CI share (~45%) and $103.40 per share in cash (~55%) for each share of Cigna. ANTM shareholders will own ~67% of the combined company, while CI shareholders own the remaining ~33%. The transaction is expected to close in the second half of 2016.

ANTM will fund the cash portion (~$28B) of the acquisition through a combination of existing cash and debt financing, which will raise the company's pro forma debt-to-capital ratio to 49%. However, management believes that the combined company would maintain an investment-grade rating and expects to de-lever to the low 40% range within two years post-close. Additionally, management noted that it would stop its repurchase authorization this year and maintain flexibility with repurchases going forward in order to de-lever its balance sheet, but expects to maintain its dividend payout ratio of 25% to 30%. Meanwhile, ANTM will issue roughly 133M shares to cover the balance of the consideration.

ANTM noted that if the transaction does not close--for any reason including regulatory--there will be a 3.8% breakup/reverse breakup fee. The breakup fee does not seem to be excessive as it is in line with the breakup fee for the Aetna-Humana transaction (3.75%).

Upon the close of the transaction, Joseph Swedish will remain as chairman and CEO, while David Cordani will be president and COO. Additionally, David Cordani and four directors from CI will join the Anthem board of directors, expanding the total number of directors to 14 members from nine.

Financial Implications

Anthem plans to finance the deal with $28B in cash (funded by debt and cash on hand) and $21B in stock to Cigna shareholders. The pro forma debt to cap would stand at 49%, but the company expects to lower that to the low 40% range two years out. Management expects to suspend its share buyback program this year in an effort to prepare for the transaction and minimize its reliance on debt.

Accretion in Year 1 (2017) is expected to be 10% to EPS, which will more than double in Year 2 (2018). Due to more than $3.00 accretion in 2018, the company estimates EPS of $17.00+, compared to its prior target of $14.00. The accretion will be driven by synergies that are expected to approach $2B within two years. Furthermore, these estimates include implementation costs of $600M spread out over two years and no benefit from the PBM optionality. The synergies are weighted toward SG&A (70-75%), including administrative structure, operating efficiencies, network efficiencies, leveraging CI specialty capabilities and dual capabilities.

We have developed our own pro forma model and believe that the deal would be more than $4.00 accretive, based on $2B in synergies, $300M in annual implementation costs and a 4% interest rate. Furthermore, that could increase by ~$0.50/year once the implementation costs wind down. Our projections assume no divestitures and are using our '16 projections for both Cigna and Anthem since we don't have a 2017 or 2018 model (both unadjusted for pre-announcements).

Anthem - Cigna Pro Forma

	ANTM - 2016	CI- 2016	Synerg/Adj	Pro Forma
Premiums	79,532.1	23,775.0		103,307.1
Administrative fees	5,268.5	4,668.0		9,936.5
Other revenue	44.4	10,206.0		10,250.4
Total Operating Revenue	**84,845.0**	**38,649.0**		**123,494.0**
Medical expenses	65,960.2	19,333.0		85,293.2
MLR	*82.9%*	*81.3%*		*82.6%*
Total SG&A (including Depreciation)	13,730.8	9,448.0	(1,700.0)	21,478.8
Total SG&A ratio	*16.2%*	*24.4%*		*17.4%*
EBITDA (depreciation removed)	**6,033.2**	**9,868.0**	**1,700.0**	**17,601.2**
	7.1%	*25.5%*		*14.3%*
Depreciation/Amortization and Other Expenses	879.2	7,129.0		8,008.2
	1.0%	*18.4%*		*6.5%*
Operating Income	**5,154.0**	**2,739.0**	**1,700.0**	**9,593.0**
	5.9%	*7.1%*		*7.8%*
Net investment income	678.8	1,323.0		2,001.8
	0.8%	*3.4%*		*1.6%*
Interest Expense	622.0	310.0	832.9	1,764.9
	0.7%	*0.8%*		*1.4%*
Income Before Taxes	**5,210.8**	**3,752.0**	**867.1**	**9,829.9**
	5.9%	9.7%		8.0%
Income taxes	2,219.9	1,340.0	**300.6**	3,860.5
Tax Rate	*44.1%*	*35.7%*	*34.7%*	*39.3%*
Minority Interest	0.0	0.0		0.0
Net Income	**2,810.9**	**2,412.0**	**566.6**	**5,969.4**
Net Income Margin	***3%***	***6%***		***5%***
Net realized gains	**0.0**			
Tax net realized gains	**0.0**			
Extraordinary items	**0.0**			
Tax on extraordinary items	**0.0**			
Net Income as Reported	**2,810.9**	**2,412.0**		**5,969.4**
Diluted EPS	**$10.64**			**$15.00**
Diluted shares (Millions)	**264.2**		**133.6**	**397.8**

Accretion	%
$4.37	**41.0%**

Source: Oppenheimer & Co. and company reports

Longer Term Valuation

Anthem

Given the potential accretion, we took a closer look at ANTM's potential long-term valuation if it can achieve its expectations. Earnings are expected to ramp to $17.00+/shr by 2018, which is based on its original $14.00/share target and $3.00+ in accretion. The historical average forward multiple for ANTM is 12.7x (if we exclude the 2008-2010 period when valuations reflected doubt over the future for managed care). Applying that to 2018 earnings and then discounting 8% per year (our estimated cost of equity for ANTM) would yield a valuation today of $180. If we used the 10-year average for the diversified names of 13.6x (UNH, ANTM, AET, CI, HNT), we would get to a valuation today of $193. Assuming the deal can get done and the company can achieve its targets, we believe there is still significant upside in the stock today.

Cigna

Additionally, we still believe CI is attractively positioned with a favorable risk/reward profile. We looked at the two scenarios and believe the market is only pricing in a ~27% chance that the deal goes through.

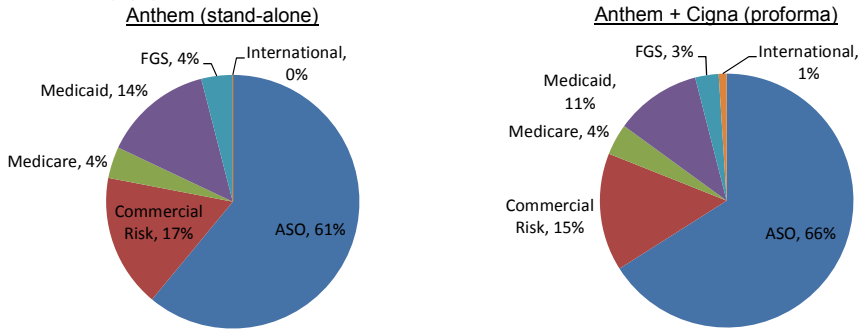
Our analysis suggests:

- **Scenario I. The deal closes ($181):** Assuming the deal can get done, CI stock should be worth ~ $181 (at current ANTM stock price of $151), which gives ~24% upside that could be realized in a 12-17 month period. For simplicity's sake, we are not discounting the cash component for the time value of money.
- **Scenario 2. The deal fails to close ($132):** We believe the downside is limited even if the transaction fails to close. If the transaction does not close for reasons other than CI finding a new buyer, CI will receive a 3.8% breakup fee which equates to approximately $4.60/share after-tax. If we subtract this $4.60 from CI's current price of $145.00 to analyze the core operations of the company, we believe the stock is trading at ~15x the FY16 Street consensus EPS estimate of ~$9.40. This is a premium to CI's historical average forward multiple of 12.0x and the industry long-term average of 13.5x, but in line with the current industry average multiple of 15x. These multiples, with the addition of the break-up fee, suggest CI's stand-alone stock should be trading at an average of $132 ($117, $132, $146) in case the transaction fails to close.

If we assume that the two scenarios are the only outcomes, we believe that the stock implies a ~27% chance of the deal going through based on CI's latest stock price of $145, which sits roughly 1/4 of the way above the bottom end of the range between Scenario 2 ($132) and Scenario 1 ($181). If we use the most conservative of valuations ($117), the current CI stock price implies a 44% chance of a deal going through. However, we are removing our former Outperform rating (moving to Not Rated) and $142 PT for Cigna, as it will no longer trade on fundamentals.

Combined Entity Highlights

Medical Membership (%)



Source: ANTM Presentation

The combined entity would rank first among managed care companies with respect to total medical membership (~53M) and second with respect to 2015E revenues (~$115B). Some highlights of the combined entity following the transaction include:

- **Total Membership**—Transaction adds over 14.7M medical members, putting the total pro forma membership at 53.2M;
- **Commercial Business**—Transaction adds 2.5M Commercial Risk members and 11.7M ASO members, putting the total pro forma Commercial membership at 44.2M.
- **MA Business**—Transaction adds 492,000 MA members, putting the total pro forma MA membership at 1.9M. The combined company will have approximately 6.3% of MA market share.
- **Medicaid business**—Transaction adds 66,000 Medicaid members, putting the total pro forma Medicaid membership at 5.7M.
- **Revenues**—Pro forma 2015E premium & service revenue of $115B.

Strategic Rationale

Besides the obvious financial benefits, ANTM's management cited numerous factors supporting the combination with Cigna, including:

- **Increased membership and diversification:** For managed care organizations, scale is as important as ever due to minimum medical loss ratios (MLRs), growth in higher MLR products and the fixed costs of Obamacare. The transaction will add over 14.7M medical members and help Anthem to gain relative scale in two underpenetrated businesses: Medicare and Large Group. The deal would allow Anthem to double its Medicare business and nearly double its large group business.
- **Stronger Commercial Business:** ANTM would leverage CI's IT Platforms, including wellness programs and client reporting capabilities, to improve its Large Group business offerings. At the local level, CI's stop loss, ASO, and clinical programs would expand ANTM's product offerings. Additionally, CI's strong specialty business would enhance its ability to serve commercial and government customers.
- **Enhanced MA Presence:** The combined company would rank No. 3 in Medicare with respect to membership, with approximately 6.3% of MA market share. The transaction adds Florida and Texas, which combined with California, New York and Ohio, would give ANTM a meaningful presence in the most significant MA growth markets.

- **Improved Geographical Presence:** Cigna's strong geographic reach and national account presence would allow Anthem to enhance its presence nationally and internationally. The combined company would have opportunities to generate additional revenues from expanding international product offerings across its larger customer base.
- **PBM Synergies**: The transaction would provide ANTM with more PBM options given CI's significant membership base, allowing the company to meaningfully improve its pharmacy costs. However, the company conservatively excluded any potential PBM synergies from its current accretion analysis. CI previously noted that it has enough control over the contract with Catamaran, and it will continue to examine its options. Meanwhile, the current contract between ANTM and Express Scripts expires in 2019. ANTM will not make any significant decisions around integration of the PBM until after the close of the transaction.

Regulatory Concerns

No Major BCBS Complications: Management expects the restrictions imposed by the rules of the BCBS to not obstruct the transaction. While ANTM did not yet have meaningful conversations with other Blues plans, it believes there will be a collaborative effort with other plans to develop a working model and strengthen relationships. However, we note that ANTM will not be able to use the Blue Cross and Blue Shield brand in states where it does not have the license and will be forced to sell plans under a different brand. Meanwhile, ANTM will have two years, in addition to the one-year regulatory review, to become compliant with the Blue rules, which the company thinks would give it enough time to make the necessary adjustments.

Regulatory Concern: ANTM management is very optimistic that the deal will get approved without major regulatory hurdles, as it sees only minimal overlap in its businesses. Meanwhile, we also don't view the overlap of markets to be too significant, so any regulatory risk to the deal would likely be from a national perspective.

CI, ANTM Large Group State Exposure

States	Large Group						
	State Total	Cigna	Mkt Shr	ANTM	Mkt Shr	CI + ANTM	Mkt Shr
Alabama	2,561,515	60,382	2%	245	0%	60,627	2%
Alaska	306,552	18,246	6%	4	0%	18,250	6%
Arizona	2,785,337	383,882	14%	372	0%	384,254	14%
Arkansas	996,670	38,199	4%	31	0%	38,230	4%
California	69,284,009	2,371,005	3%	9,330,666	13%	11,701,671	17%
Colorado	4,275,334	491,125	11%	541,026	13%	1,032,151	24%
Connecticut	3,229,904	399,318	12%	615,491	19%	1,014,809	31%
Delaware	931,382	35,016	4%	19	0%	35,035	4%
DC	1,789,305	63,081	4%	17	0%	63,099	4%
Florida	12,424,652	892,166	7%	504	0%	892,671	7%
Georgia	5,396,596	452,033	8%	1,193,943	22%	1,645,976	31%
Hawaii	2,239,836	9,965	0%	6	0%	9,971	0%
Idaho	884,552	28,087	3%	5	0%	28,092	3%
Illinois	11,293,292	358,609	3%	10,691	0%	369,300	3%
Indiana	2,162,079	156,796	7%	758,668	35%	915,463	42%
Iowa	2,082,234	42,463	2%	645	0%	43,108	2%
Kansas	1,899,019	70,651	4%	67	0%	70,718	4%
Kentucky	2,436,427	82,483	3%	876,773	36%	959,256	39%
Louisiana	2,495,417	131,038	5%	47	0%	131,085	5%
Maine	1,184,300	90,824	8%	607,184	51%	698,007	59%
Maryland	4,605,850	371,554	8%	480	0%	372,034	8%
Massachusetts	8,344,453	216,166	3%	73,602	1%	289,768	3%
Michigan	9,087,016	189,532	2%	16,314	0%	205,846	2%
Minnesota	3,743,066	142,744	4%	393	0%	143,137	4%
Mississippi	1,545,823	57,546	4%	-	0%	57,546	4%
Missouri	3,840,384	153,916	4%	730,406	19%	884,322	23%
Montana	287,998	51,515	18%	1	0%	51,515	18%
Nebraska	1,351,077	26,302	2%	96	0%	26,399	2%
Nevada	1,739,017	73,508	4%	203,586	12%	277,094	16%
New Hampshire	1,083,756	102,275	9%	334,582	31%	436,857	40%
New Jersey	9,046,509	644,406	7%	1,803	0%	646,209	7%
New Mexico	756,926	37,348	5%	381	0%	37,729	5%
New York	20,016,121	1,182,349	6%	1,510,470	8%	2,692,818	13%
North Carolina	4,436,078	312,622	7%	1,318	0%	313,940	7%
North Dakota	690,850	9,019	1%	1	0%	9,020	1%
Ohio	6,119,410	255,795	4%	1,421,951	23%	1,677,746	27%
Oklahoma	2,538,613	68,765	3%	12	0%	68,777	3%
Oregon	3,613,901	96,570	3%	23	0%	96,593	3%
Pennsylvania	11,511,969	370,157	3%	373	0%	370,530	3%
Rhode Island	864,752	27,842	3%	92	0%	27,934	3%
South Carolina	2,034,386	119,197	6%	57	0%	119,254	6%
South Dakota	470,836	7,565	2%	8	0%	7,573	2%
Tennessee	3,207,732	245,763	8%	566	0%	246,330	8%
Texas	11,772,827	1,065,171	9%	7,870	0%	1,073,041	9%
Utah	1,815,639	66,915	4%	46	0%	66,961	4%
Vermont	454,230	53,784	12%	133	0%	53,918	12%
Virginia	6,051,029	466,115	8%	1,627,124	27%	2,093,240	35%
Washington	5,695,620	218,774	4%	57	0%	218,831	4%
West Virginia	856,852	34,184	4%	82	0%	34,265	4%
Wisconsin	5,726,821	68,925	1%	381,142	7%	450,068	8%
Wyoming	141,244	33,087	23%	1	0%	33,088	23%
Total	264,109,194	12,944,781	5%	20,249,374	8%	33,194,155	13%

Source: SNL (2014 data) and Oppenheimer & Co. Inc.

Pending Lawsuit Against The Blues: CI rejected ANTM's first public bid citing multiple reasons, including the ongoing litigation alleging that Blue Cross and Blue Shield health insurers are avoiding competing against one another, driving up premiums and pushing down payments to providers. CI expressed concern that the lawsuit could "have enormous consequences for the BCBSA and could redefine the market for all of its member companies." However, ANTM management was optimistic regarding the outcome of the case and showed confidence that any impact will be effectively managed.

2Q Financial Results Update

During the call, ANTM previewed strong 2Q15 results, expecting adjusted EPS of $3.10, compared to our estimate of $2.75 and Street consensus of $2.68. Management noted the strong results were driven by strong membership growth and margin performance, while key quality metrics, including MLR, remained strong.

Meanwhile, Cigna pre-announced 2Q15 adjusted EPS of $2.50+ (GAAP: $2.21+) vs. our estimate and Street consensus of $2.24. Adj. results exclude a $65M after-tax charge ($0.25/shr) for debt redemption. Additionally, management raised FY15 EPS guidance to $8.30-$8.60 from $8.15-$8.50, while maintaining a revenue growth rate of 8-10%.

Conclusion

Overall, we view this deal favorably as the acquisition price appears reasonable considering the significant potential accretion benefits and improved capabilities gained in the Medicare and Large Group businesses. Now most questions will be pointed toward whether or not regulators will be comfortable with the move from five to three large diversified players.

Price Target Calculation

ANTM: Our $166 price target is based on a combination of two methodologies: 1) Our DCF valuation is $164, based on a beta of 0.99, a terminal growth rate of 1.0% and a WACC of 6.8% on an estimated $7,318 of EBITDA in 2019, and 2) our P/E target is $167, representing 15x our FY2016 cash EPS estimate of $11.10, in line with the current forward average for the diversified names.

Key Risks to Price Target

ANTM:

Healthcare Reform and Other Federal/State Regulations: There are a number of provisions in healthcare reform that have affected Anthem's business, including: guaranteed coverage; annual rate review process; minimum MLRs; Medicare Advantage cuts; and the industry fee. These changes, along with the potential for other federal/state regulation changes in this highly-regulated business, add risk to Anthem's revenues, earnings and cash flow.

Changes in Cost Trend: While Anthem's premiums/revenues are highly predictable, earnings and cash flow are highly dependent on cost trend, including utilization and acuity of medical costs for its members. To the extent that the company does not successfully project medical costs, or if there is a spike in costs, the company's profits and cash flow could be significantly impacted.

Rate Reviews Impact ANTM's CA Individual Business: Anthem's California individual business was subject to a rate review by the California Department of Insurance, which ultimately led to a lower premium increase than requested in the company's original filing. The risk of future rate reviews adds risk to the company's commercial business.

Potential for Adverse Selection in Individual Segment: With limited information available about how the individual exchanges will be structured, it is still difficult to evaluate the risk of adverse selection. However, the broad components of reform—including a weak individual mandate and mandatory coverage—would seem to indicate that coverage could be sought as needed. This would lead to higher premiums, which would make it cost-ineffective for healthy/profitable people to seek coverage on the exchanges. The individual business accounts for about 5% of ANTM's membership.

Companies with Updates:

OUTPERFORM
Anthem(ANTM,$150.86)

NOT RATED
CIGNA Corp.(CI,$145.72)

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Neutral - anticipates that the shares will trade at or near their current price and generally in line with the leading market averages due to a perceived absence of strong dynamics that would cause volatility either to the upside or downside, and/or will perform less well than higher rated companies within its peer group. Our readers should be aware that when a rating change occurs to Neutral from Buy, aggressive trading accounts might decide to liquidate their positions to employ the funds elsewhere.

Sell - anticipates that the shares will depreciate 10% or more in price within the next 12 months, due to fundamental weakness perceived in the company or for valuation reasons, or are expected to perform significantly worse than equities within the peer group.

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			IB Serv/Past 12 Mos.	
Rating	**Count**	**Percent**	**Count**	**Percent**
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PERFORM [P]	249	42.42	89	35.74
UNDERPERFORM [U]	6	1.02	2	33.33

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