



March 2019

Health Insurance:

*Using Intangibles to Make
Better Buy-Side M&A Decisions*

JAHANI & ASSOCIATES

AFTER MOST M&A DEALS CLOSE, the new business does not create the value that executives predicted.¹ Jahani and Associates (J&A) has determined this is because of two reasons:

- 1. Overstated and overambitious goals made by executives during the M&A process**
- 2. Intangible asset reporting that is below acceptable standards for both the buyer and seller**

J&A solves the problem created by inadequate intangible asset reporting through a unique strategy based on empirical evidence. J&A's experience suggests that solving this problem also reduces the ability of eager executives to overstate benefits, synergies, and business combinations during the M&A process. Passionate executives are good for capital markets, but passion should be moderated with measurable value.

The following describes J&A's strategy along with supporting empirical research for health insurance M&A buy-side decisions. This evidence is based on the M&A activity completed by the United States' largest health insurance companies between 2010 and 2017: Aetna, Anthem, Centene, Cigna, Humana, Magellan, Molina, UnitedHealthcare, and WellCare. This analysis is specific to healthcare markets; similar analysis can be done for any industry.

J&A solves the problem created by inadequate intangible asset reporting through a unique strategy based on empirical evidence.

J&A's research has proved that intangible assets make up over 90 percent of M&A value. Within this 90 percent, customer related intangible assets are most prominent for health insurance companies. Customer related intangibles account for approximately 65 percent of the M&A deal value.

This research also relates specific intangible assets to financial performance. Medicaid buyers such as Molina and Centene achieved the greatest revenue growth between 2010 and 2017. J&A believes Medicaid acquisitions caused revenue growth for these companies based on regulatory dynamics. The final part of this paper delivers the strategy J&A uses for its health insurance and healthcare clients to help them make better buy-side M&A decisions.

International health insurance M&A spend was

\$70-\$120 BILLION

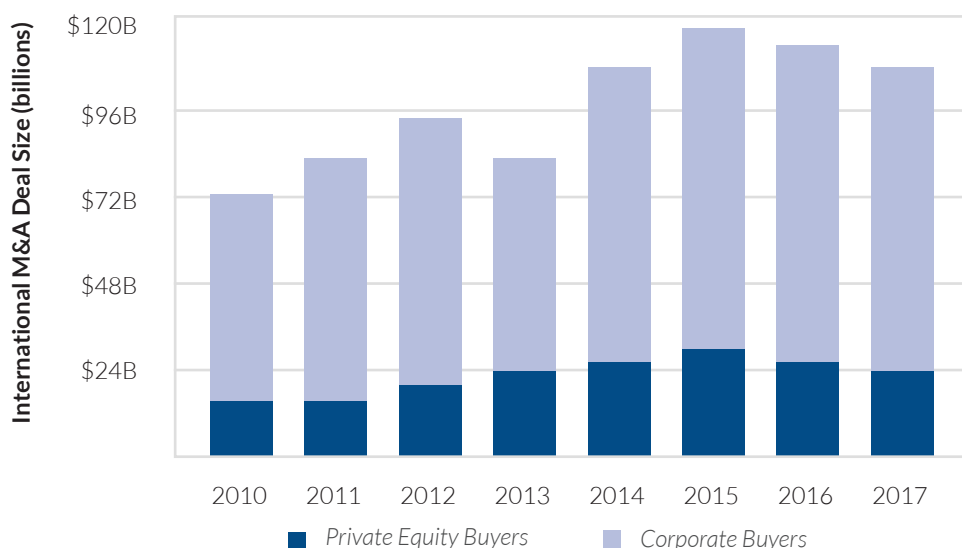
per year between 2010 and 2017.

Identifying the Intangible Assets That Matter

The international health insurance M&A market is very large, representing between \$70 and \$120 billion per year between 2010 and 2017.

Figure 1 shows the international health insurance M&A deal size from 2010 to 2017. This data does not include initial public offerings. The majority of deals were completed by corporate M&A buyers. These buyers comprised over 80 percent of the money spent and over 70 percent of the transactions completed.

FIGURE 1



Source: Pitchbook data, 2019

The most common way to describe M&A value is through financial statement metrics such as earnings before interest, tax, depreciation, and amortization (EBITDA) or revenue. But financial statements have become decreasingly relevant since the dot-com boom in 1995 because they do not contain information about intangible assets. This is a challenge for buy-side M&A decision-making. Without standard reporting, it is very difficult to collect data on members related to Medicare, Medicaid, duals, commercial, and other populations. These challenges are especially prevalent in the private markets. Private company reporting is ad hoc, disorganized, and unstandardized.

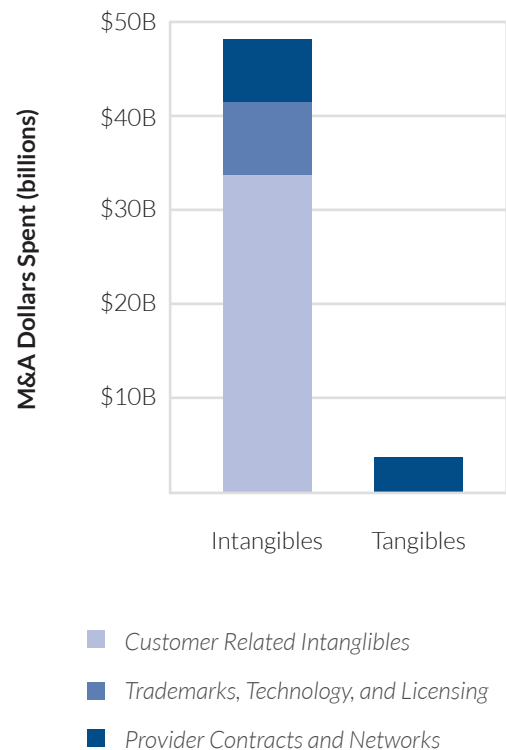
Because of this information gap, health insurance companies must have a better strategy to acquire the right intangibles and integrate those intangibles into the buyer's existing business. They need to collect information about intangibles throughout scouting, solicitation, diligence, closing, and integration. Collecting and analyzing this information must be part of the buy-side M&A process, which is usually led by a banker.

Health Insurance Companies Spend Fourteen Times More Money on Intangible Assets Than Tangible Ones

To define the intangibles that create the most M&A value for the buyer, J&A collected the purchase price allocations for all acquisitions completed by Aetna, Anthem, Centene, Cigna, Humana, Magellan, Molina, UnitedHealthcare, and WellCare from 2010 to 2017. These purchase price allocations show that health insurance giants spent fourteen times more money on intangible assets than tangible ones. Customer related intangibles accounted for 65 percent of M&A deal value.

Customer related intangibles include both contractual and non-contractual assets. Contractual health insurance customer relationships are active members across all lines of business. Non-contractual relationships include past customers or customers who have terminated coverage for a variety of

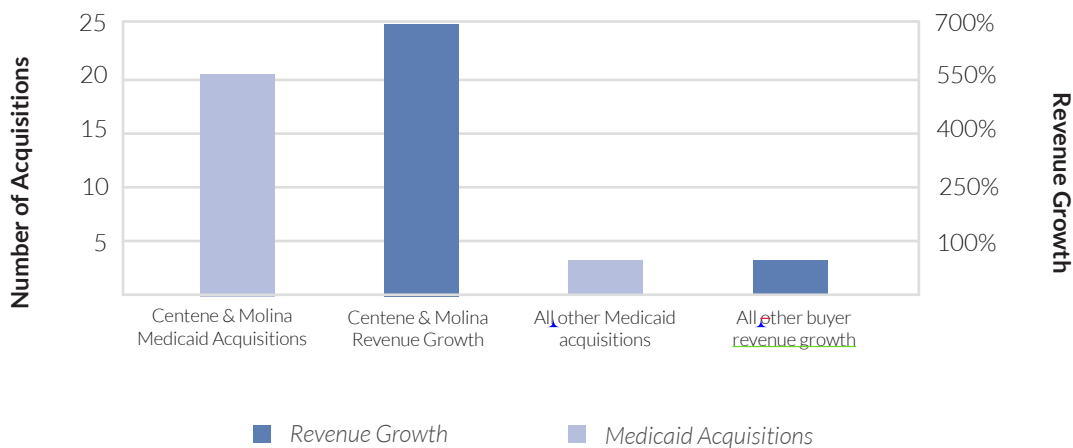
FIGURE 2



reasons. Examples of customer intangible assets according to the Financial Accounting Standards Board (FASB) are customer lists, order backlog, current members, and past members.

Not all intangibles are created equal: the top revenue growth performers purchased specific customer intangibles. UnitedHealthcare purchased the most customer intangibles among its competitors but did not achieve the greatest proportionate revenue growth when compared to Molina and Centene.² In fact, top performers purchased mostly Medicaid customers. Simply buying the most customer related intangibles did not guarantee the greatest revenue growth.

FIGURE 3

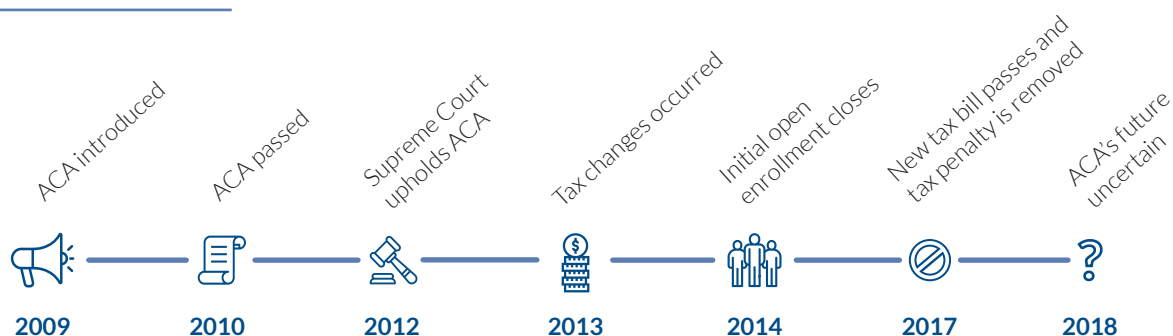


J&A chose revenue growth as the major indicator of M&A performance because of the health insurance business model. Literature review supports the performance of Molina's and Centene's stock prices above their competitors.²

Top performers purchased more Medicaid customers than any other kind of membership. This decision was driven by the Affordable Care Act (ACA).

Simply buying the most customer related intangibles did not guarantee the greatest revenue growth.

FIGURE 4



The ACA increased federal poverty limits for Medicaid, SNAP, CHIP, and TANF populations.³ This increased the volume of those eligible for Medicaid and, therefore, the size of the market. Combined with insurance exchanges and an individual mandate to acquire health insurance, this also increased Medicaid funding for the States.⁴

The combination of an individual mandate, increased Medicaid spending, and an increase in the Medicaid population allowed health insurance companies like Molina and Centene to outperform competitors in revenue growth. Molina's and Centene's premium revenues grew 373 percent and 934 percent respectively from 2010 to 2017, whereas all other health insurance companies' premium revenues increased an average of 109 percent during the same time period. Molina and Centene made twenty acquisitions specific to Medicaid; all other health plans combined made only four.

A NOTE ABOUT INTEGRATION: Creating Long-Term Value from Purchased Intangibles

Not all health insurance members are equal since not all health insurance lines of business are equally valuable at the same time to buyers. The most effective way to perform integration analysis during the M&A diligence process is to confirm the company's definitions of customer value overlap between buyer and seller. When possible, data related to Net Promoter Score (NPS) can also be used to identify customer sentiment in a selected target. None of these indicators are contained in the financial statements, and they are generally outside the investment banker's due diligence process. However, buyers, bankers, and advisors must utilize these tools to identify and acquire the intangibles that are needed. The importance of integration is supported by J&A's health insurance M&A analysis showing 87 percent of the top performers purchased companies in regions where the buyer had existing operations. Growing in existing markets was more attractive than expanding to new markets.

J&A's Recommended Strategy for Health Insurance Buy-Side M&A

Phase 1: Identify

A buy-side that is integration focused

Determine how customer intangible performance is measured
Understand market and regulatory dynamics
Create integration plans based on acquired intangibles
Set evidence standards for M&A decision-making

Phase 2: Develop

Buy-side execution driven by intangible assets

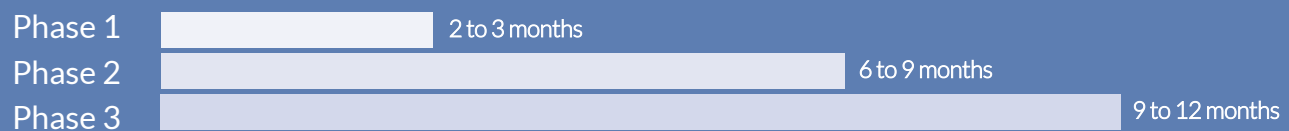
Create an acquisition target and due diligence process to confirm intangible synergy is present
Solicit acquisition targets
Conduct intangible and tangible asset due diligence
Negotiate purchase prices through transparent value identification
Close deal

Phase 3: Monetize

Acquisition integration resulting in accelerated accretion

Utilize pre-built integration artifacts confirmed through the buy-side process to inform stakeholders
Integrate targets based on corporate strategy

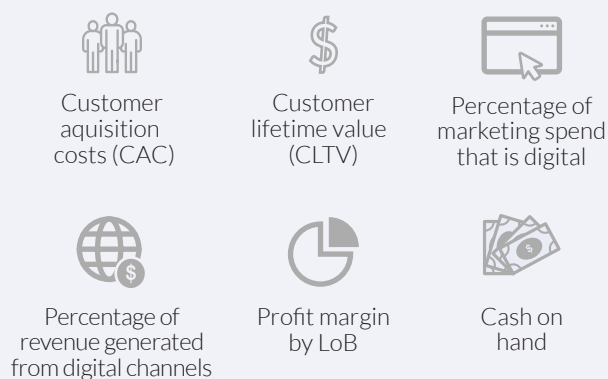
Phase Duration



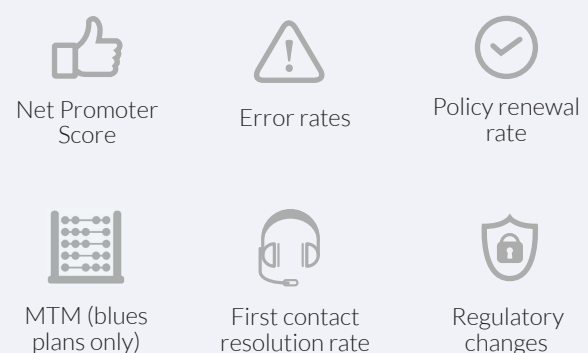
Examples for Health Insurance M&A

When customer contracts are the most important asset

Finance-Focused KPIs



Customer-Focused KPIs



PHASE 1: Identify How Customer Intangible Performance Is Measured

Since J&A's research revealed that health insurance M&A dollars are mostly spent on customer related intangibles, health insurance buyers must take care to make sure their buy-side process recognizes this by measuring the intangible assets that matter before, during, and after a deal is closed. The first step in identifying the intangibles that will drive value is to understand internal corporate strategy. In the case of Molina, the buyer used an existing competitive advantage of serving Medicaid populations to expand its market share. Other top performing examples include Cigna's acquisition of Great American Supplemental Benefits to increase cross-selling and up-selling opportunities to Cigna's already large population of members. All top revenue performers purchased homogeneous customer intangibles and customer lists.

These findings show companies must determine which lines of business are most profitable, which ones are best positioned for growth, and how that growth and success is internally measured. Successful M&A starts with applying internal growth measurement standards to the target's intangibles during the buy-side process.

PHASE 2: Develop an Acquisition Target and Due Diligence Process to Confirm Intangible Synergy Is Present

Tools like Net Promoter Score (NPS) or customer service ratings are often bullet points for marketing that are managed by a few business leaders who invest in improving the scores. But these metrics show important information about how customers perceive the value of their health insurance provider. Not utilizing these metrics during the buy-side process will lead to poor intangible reporting and, therefore, increased risk of a failed acquisition.^{5,6}

J&A has provided examples of how to use CLTV, CAC, NPS, and regulatory strategy analysis to make better buy-side decisions. These examples are not limitative, and many others should be considered to minimize the risk of derailing the M&A process.

PHASE 3: Monetize Intangible Assets Through Better Integration to Create Lasting Returns

Through all of this, buyers can integrate their targets more seamlessly post-acquisition by measuring the most important assets before a deal is signed.

Intangible assets matter most, and customer related intangibles matter most to health insurance buyers. Health insurance buyers must run an M&A buy-side process that integrates this intangible reality into the entire process.

In the age of the intangible economy, typical reporting is inadequate. Buyers must take careful and deliberate steps to develop a better understanding of intangibles in order to drive M&A performance.

For an acquisition to be successful, purchased intangibles must create tangible value. The only way for buyers to accomplish this transformation is to remain disciplined and diligent during the integration process. This integration process is completely dependent on what is measured and acquired. Knowing what to measure and how to measure are two key factors to creating a winning strategy. Ignoring these facts exacerbates the two challenges stated earlier: overstated or overambitious executive goals and the lack of intangible asset reporting or understanding that leads to failed acquisitions.

Removing the disconnect between traditional M&A buy-side practices and intangible reporting can dispel negative consequences from overstated executive goals during the M&A process. In the age of the intangible economy, typical reporting is inadequate. Buyers must take careful and deliberate steps to develop a better understanding of intangibles in order to drive M&A performance.

Mergers and acquisitions fail to create desired value when post-merger integrations do not perform. By focusing on intangible assets, buyers can collect and analyze key integration activity and information before a deal is closed. By collecting intangible asset information up front, buyers will conduct a more precise M&A process and maximize shareholder returns. Buyers should determine their M&A goals, then utilize J&A's strategy during scouting, solicitation, diligence, closing, and integration. ■

Examples of J&A's Approach for Health Insurance M&A



Customer Lifetime Value (CLTV)

Why It Matters

Health insurance companies should utilize lifetime value principles to determine the best membership populations to buy and integrate. More importantly, the definition of customer lifetime value must align between the buyer and the target. This alignment must be determined before the acquisition is closed. Fundamental differences in defining success and value cause significant barriers to accretion and effective integration.^{6,7}

CLTV is a balance of the revenue generated and costs needed to service a customer. Therefore, both cost savings and revenue growth factors are relevant to CLTV calculations. Insurance companies spend significant sums of money on customer service. CLTV can show buyers the efficacy of dollars spent and identify areas for potential cost synergies.

Driving Questions Used for Buy-Side Decision-Making

1. What method is being used to calculate CLTV?
2. How much time is required to achieve positive return on investment (ROI)?
3. What revenue sources are inputs for CLTV?

What Buyers Should Remember

There are many models and methodologies used to measure customer lifetime value. Buyers should remember that the way CLTV is measured is more important than the exact number calculated. Overlaps in measurement methodology, inputs, and outputs will create more synergy post-acquisition.



Customer Acquisition Costs (CAC)

Why It Matters

Customer acquisitions costs may be the most important intangible key performance indicator (KPI) for health insurers. Since health plan revenue is a function of membership and membership is predictable within a calendar year, cost containment is the best way insurers can improve profit margins. Cost reporting and measurement is also essential for current regulations regarding medical loss ratio and risk adjustment standards.

CAC is calculated by dividing total sales and marketing expenses by the number of customers acquired, usually on an annual basis. Much value can be extracted from this by determining the CAC by line of business.

Driving Questions Used for Buy-Side Decision-Making

1. What method is being used to calculate CAC?
2. What sales and marketing costs create the greatest ROI?
3. Will costs be synergistic?

What Buyers Should Remember

As an example, comparing digital marketing customer acquisition and traditional marketing customer acquisition can give buyers insights into cost synergies. Based on this information, buyers can then decide on this information if the target has a proven customer acquisition strategy that is in line with the mandate.



Net Promoter Score (NPS)

Why It Matters

Raw NPS data is usually available upon request. Reviewing NPS shows the buyer what kind of customers were surveyed, where they were surveyed, and how they were surveyed. Comparing the target's information to the buyer's provides tremendous insight into how customer relationships are maintained and managed.

Due to the increased retailing of the health insurance industry, customer service has become an increasingly expensive cost center. Because investments in customer service are represented as costs on financial statements, diligence is required to make sure investments generate results and that those results overlap with the same success factors of the buyer's internal systems. The costs to generate meaningful intangible assets should be treated differently than costs with less impact.

Driving Questions Used for Buy-Side Decision-Making

1. How is NPS data collected?
2. How do profiles of promoters and detractors between the buyer and the target overlap?
3. Are there customer service insights contained in NPS data?

What Buyers Should Remember

Customer service metrics can be tricky to compare if they are not calculated the same way. Buyers need to make sure they are speaking the same language as the target in terms of the definitions of KPIs such as NPS, this goes beyond the number itself.



Regulatory Strategy

Why It Matters

The United States health insurance market is a common political topic and a pillar in party platforms. Due to this, political changes influence the health insurance market through regulation. The Medicaid growth in the United States is an example of this. Additional examples are the ACA, the creation of Medicare in 1965, and President Trump's recent proposals to change Medicaid, CHIP, and the ability for health insurers to sell across state lines.

Therefore, no health insurance buy-side strategy is complete without regulatory analysis. Health insurers should monitor political dynamics with careful consideration of which healthcare policies will survive multiple election cycles. Court decisions, such as *National Federation of Independent Business v. Sebelius* in 2012, and litigation are the best indicators for which policies will endure. *National Federation of Independent Business v. Sebelius* solidified many of the regulations passed in the ACA.^{8,9}

Driving Questions Used for Buy-Side Decision-Making

1. What political changes will happen in upcoming election cycles?
2. What healthcare changes have been upheld by courts and what changes are political hyperbole?
3. How will technology and regulation influence each other?

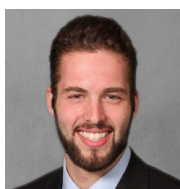
What Buyers Should Remember

Healthcare regulation changes constantly. Campaign promises are not always implemented into law. Buyers must find strategies for growth that are difficult to politically influence. This minimizes risk and can lead to lasting returns no matter the political climate.

A Word of Caution Regarding Customer Service Performance Indicators

J&A recommends buyers use KPIs such as Net Promoter Score and other customer service quality metrics to evaluate acquisition targets. As stated earlier, analysis should focus on methodology and not on the actual numerical values. There is no conclusive evidence that the scores of customer service KPIs directly correlate to stock performance. These intangible metrics do provide valuable insight into customer related intangibles. J&A does not suggest that similar KPI numbers create revenue, cost, or operational synergy but that similar KPI measuring methodologies do.

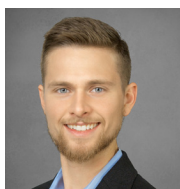
WHO WE ARE



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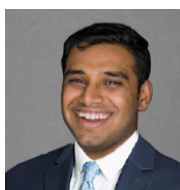
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ABOUT THE RESEARCH

In 2018, Jahani and Associates reviewed 62 acquisitions among health insurance giants and recorded their purchase price allocations. Information was only collected from publicly available data sources. Intangible-asset pro formas were taken from Securities and Exchange Commission (SEC) reports only. J&A also surveyed over 34 business leaders from health insurance companies to understand how executives used intangible asset reporting to make business decisions.

ABOUT JAHANI & ASSOCIATES

Jahani and Associates (J&A) is an independent investment bank located in New York, New York. The firm specializes in healthcare and technology and provides specialized M&A and capital markets advisory services. The combination of J&A's unmatched skills in technology, engineering, and business operations allows the firm to create sustainable value for its clients. J&A works at the intersection of cutting-edge financial theory and business practicality. Creativity is highly valued within the firm which allows J&A to continually improve the way businesses thrive.

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