CHESAPEAKE HEALTH PLANS

ASSESSING HMO PERFORMANCE

2

CHESAPEAKE HEALTH PLANS is one of Virginia's largest managed care organizations (MCOs). In fact, it is the largest of the state's not-for-profit MCOs. It offers prepaid health coverage to more than 400,000 members in 15 counties, including the following major cities: Richmond, Norfolk, Virginia Beach, Arlington, Alexandria, and Roanoke.

Chesapeake's various products include commercial health maintenance organizations (HMOs), preferred provider organizations (PPOs), and point of service (POS) plans as well as Medicare HMOs (Medicare Advantage Plans), which are all designed to meet the needs of a wide segment of Virginia's population of approximately 8 million. The breakdown of plan types is as follows:

Plan Type	*Percent of Revenue*
Commercial HMO	46
Medicare HMO	39
PPO	10
POS	5
	100

Chesapeake was the first HMO in Virginia to seek and receive accreditation from the National Committee for Quality Assurance (NCQA), and each of its component plans has the highest accreditation level: excellent. NCQA judges HMOs on how well they comply

with more than 60 standards and performance measures that fall into broad categories such as access and service, provider qualifications, and staying healthy. Some of the evaluation focuses on systems and processes, but accreditation results also depend on clinical performance as measured by HEDIS (Health Plan Employer Data and Information Set) and patient satisfaction as measured by CAHPS (Consumer Assessment of Healthcare Providers and Systems). (For more information on the NCQA, visit its website at www.ncqa.org.)

A summary of Chesapeake's 2008 and 2009 HMO plan financial data is presented in Exhibit 2.1, while Exhibit 2.2 contains a summary of operating and enrollment data. To help in analyzing Chesapeake's performance, its managers have classified the following four Virginia HMOs as "primary competitors."

HMO	*Number of Counties Served*	*2009 Total Enrollment*	*2009 Total Assets (000s)*
WellLife	23	516,858	$408,707
Signet Healthcare	15	360,252	178,662
Proxima	15	247,109	144,982
Sparta	28	205,296	103,504

These plans have the geographic coverage and financial resources to be prominent players in the Virginia managed care industry. Furthermore, the primary competitors are operating in the same service areas and have a similar product mix as Chesapeake and hence are potential threats to its future success. In addition to comparisons to national data, all internal analyses that use benchmarking compare Chesapeake's performance to the state average as well as to the primary competitor list. **Note, however, that not all relevant performance measures have a complete set of comparative data available.**

Exhibit 2.3 contains selected financial and operating ratios for Chesapeake's primary competitors as well as the means and medians for all Virginia HMOs. Exhibit 2.4 contains selected national data. Note that all comparative data are for HMO plans only. Data relevant to competitors' other plans, such as PPO and POS plans, are not available. Exhibit 2.5 contains selected ratio definitions. (For a better understanding of the types of comparative data available for managed

care plans, see the Health Leaders-InterStudy website at www.hmo-data.com.)

Assume that you have just started an administrative residency at Chesapeake Health Plans. On your first day at the organization, Charles Redman, the chief executive officer, stated that the best way to get to know the financial and operating condition of any business is to do a brief financial statement and operating indicator analysis; thus, he assigned you the task. Although you agree that this is a great way to learn more about Chesapeake and its competitors, you wonder whether he has any hidden motives. Perhaps the company is having financial problems and he thinks that you can spot them, or perhaps he just wants to test your analytical skills.

In any event, he has already scheduled a financial and operating performance analysis presentation for the next executive committee meeting as a way for you to demonstrate your skills to Chesapeake's senior managers. In preparing for the meeting, you called Jennifer Wall, the previous administrative resident, to get some hints on how to prepare for your presentation to the executive committee. Jennifer just left Chesapeake for a great job with Humana. Her advice was to do a standard financial statement analysis, including statement of cash flows analysis, Du Pont analysis, and ratio and operating indicator analyses.

As you began the analysis, it became apparent that the ratios used and their interpretations differ across industries; that is, the ratios that are critical to identifying the financial condition of a hospital are not necessarily the same as the ratios that are critical to a managed care plan. In addition, many of the ratios that are relevant to both hospitals and managed care plans have values that differ substantially. To help the executive committee in interpreting your presentation, you plan to point out key differences between your analysis for a health plan and that for a hospital as they occur. Last, you know that identifying key areas of concern and recommending courses of action are more important than merely going over the numbers.

EXHIBIT 2.1
Chesapeake Health Plans: HMO Plan Financial Data (millions of dollars)

	2008	*2009*
Statements of Operations		
Premium revenue	$313.7	$357.6
Interest income	2.4	3.5
Total revenues	$316.1	$361.1
Operating expenses:		
Medical costs	$263.0	$291.8
Selling and administrative	36.8	43.6
Depreciation	4.7	5.0
Total operating expenses	$304.5	$340.4
Net income	$ 11.6	$ 20.7
Balance Sheets		
Cash	$ 37.2	$ 27.2
Marketable securities	42.7	60.9
Premiums receivable	3.7	7.4
Total current assets	$ 83.6	$ 95.5
Net fixed assets	30.0	31.7
Total assets	$113.6	$ 127.2
Medical costs payable	$ 44.8	$ 48.7
Accounts payable/accruals	15.4	17.3
Total current liabilities	$ 60.2	$ 66.0
Long-term debt	17.1	4.2
Net assets (equity)	36.3	57.0
Total liabilities and net assets	$113.6	$127.2
Other Data		
Medical loss ratio	83.8%	81.6%
Administrative cost ratio	13.2%	13.6%
Total commercial premium revenue	$170.9	$205.6
Total Medicare revenue	$142.8	$152.0
Total physician services expense	$125.6	$127.1
Total inpatient expense	$ 80.8	$ 90.1
Total other medical expense	$ 56.6	$ 74.6

EXHIBIT 2.2
Chesapeake Health Plans: HMO Plan Operating and Enrollment Data

	2008	*2009*
Commercial premium revenue PMPM	$127.82	$127.90
Medicare revenue PMPM	$449.37	$437.23
Commercial patient days per 1,000 enrollees	302.9	266.4
Medicare patient days per 1,000 enrollees	1,622.4	1,418.1
Commercial member–months	1,337,036	1,607,036
Commercial physician encounters	594,381	622,749
Commercial inpatient days	43,661	39,763
Medicare member–months	317,778	347,643
Medicare physician encounters	149,622	185,283

PMPM: per member per month

EXHIBIT 2.3
Selected State HMO Industry Financial and Operating Data (millions of dollars)

	2008	*2009*
Total Margin		
WellLife	4.8%	5.8%
Signet Healthcare	3.0	3.2
Proxima	9.1	(0.7)
Sparta	10.5	9.1
State average	3.8	(3.9)
State median	4.8	4.7
Percent Administrative Expense		
WellLife	12.1%	11.5%
Signet Healthcare	12.2	13.4
Proxima	13.6	16.4
Sparta	23.9	26.8
State average	15.5	17.4
State median	14.8	15.7
Percent Inpatient Expense		
WellLife	32.2%	30.3%
Signet Healthcare	22.8	22.4
Proxima	21.2	23.0
Sparta	18.2	18.8
State average	25.2	23.3
State median	23.6	24.3

EXHIBIT 2.3 (continued) Selected State HMO Industry Financial and Operating Data (millions of dollars)

	2008	*2009*
Percent Physician Expense		
WellLife	54.1%	56.9%
Signet Healthcare	31.3	30.3
Proxima	22.7	24.9
Sparta	12.8	18.6
State average	28.8	31.3
State median	31.1	31.6
Percent Other Medical Expense		
WellLife	0.1%	0.1%
Signet Healthcare	8.9	7.8
Proxima	27.5	30.2
Sparta	45.7	35.0
State average	14.6	12.5
State median	10.2	8.9
Commercial Premium Revenue PMPM		
WellLife	$108.68	$110.19
Signet Healthcare	39.86	27.50
Proxima	120.68	124.27
Sparta	88.41	95.06
State average	101.17	102.53
State median	108.32	108.95
Medicare Revenue PMPM		
WellLife	$406.57	$421.57
Signet Healthcare	N/A	N/A
Proxima	N/A	N/A
Sparta	N/A	N/A
State average	365.12	376.04
State median	426.18	430.57
Commercial Inpatient Days per 1,000 Enrollees		
WellLife	245.4	246.0
Signet Healthcare	258.4	248.8
Proxima	251.8	259.2
Sparta	198.2	248.9
State average	278.0	237.0
State median	279.1	248.8

EXHIBIT 2.3 (continued) Selected State HMO Industry Financial and Operating Data (millions of dollars)

	2008	*2009*
Medicare Inpatient Days per 1,000 Enrollees		
WellLife	1,388.4	1,323.8
Signet Healthcare	1,165.2	1,188.7
Proxima	1,518.8	1,382.2
Sparta	1,623.8	1,566.9
State average	1,432.1	1,375.5
State median	1,380.5	1,350.6
Commercial Physician Encounters per Member		
WellLife	2.2	3.6
Signet Healthcare	1.5	1.4
Proxima	2.7	2.6
Sparta	3.5	3.6
State average	3.8	3.8
State median	3.9	3.7
Medicare Physician Encounters per Member		
WellLife	9.8	9.6
Signet Healthcare	6.6	6.9
Proxima	10.1	10.0
Sparta	11.2	11.3
State average	9.1	9.1
State median	8.6	8.9

Note: The Virginia data for the HMO industry contained in this table are for illustrative purposes only. These data should not be used to conduct actual financial analyses.

EXHIBIT 2.4
Selected 2009 National HMO Industry Financial and Operating Data

Average copay per office visit	$ 8
Average copay per hospitalization	$36
Average copay per pharmacy prescription	$ 7
Medical loss ratio	
Upper quartile	89.0%
Median	84.9
Lower quartile	80.0
Administrative cost ratio	
Upper quartile	14.4%
Median	12.0
Lower quartile	9.0
Operating margin	
Upper quartile	5.0%
Median	2.5
Lower quartile	1.1
Total margin	
Upper quartile	5.5%
Median	2.9
Lower quartile	1.5
Return on assets (ROA)	
Upper quartile	16.5%
Median	11.3
Lower quartile	4.8
Return on equity (ROE)	
Upper quartile	50.2%
Median	31.4
Lower quartile	18.2
Current ratio	
Upper quartile	1.29
Median	0.95
Lower quartile	0.49
Days cash on hand	
Upper quartile	32.7
Median	10.3
Lower quartile	0.8

EXHIBIT 2.4 (continued) Selected 2009 National HMO Industry Financial and Operating Data

Current asset turnover	
Upper quartile	14.1
Median	6.4
Lower quartile	3.7
Total asset turnover	
Upper quartile	4.1
Median	3.1
Lower quartile	2.2
Days premiums receivable	
Upper quartile	14.0
Median	8.9
Lower quartile	7.0
Debt ratio	
Upper quartile	81.3%
Median	68.4
Lower quartile	59.7

Note: The national data for the HMO industry contained in this table are for illustrative purposes only. These data should not be used to conduct actual financial analyses.

EXHIBIT 2.5
Selected Ratio Definitions

Medical Loss Ratio	$\frac{\text{Medical expenses}}{\text{Premium revenue}}$
Administrative Cost Ratio	$\frac{\text{Selling and administrative expenses + Depreciation}}{\text{Premium revenue}}$
Operating Margin	$\frac{\text{Net income – Interest income}}{\text{Premium revenue}}$
Percent Administrative Expense	$\frac{\text{Selling and administrative expense}}{\text{Total operating expenses}}$
Percent Inpatient Expense	$\frac{\text{Inpatient expense}}{\text{Total operating expenses}}$
Percent Physician Expense	$\frac{\text{Physician services expense}}{\text{Total operating expenses}}$
Percent Other Medical Expense	$\frac{\text{Other medical expense}}{\text{Total operating expenses}}$