S&P Global
Ratings

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Research Update:

Health Care Service Corp. Outlook Revised To Negative On Pending Medicare Acquisition; 'AA-' Ratings Affirmed

May 30, 2024

Overview

- On Nov. 15, 2023, we published our revised criteria for analyzing insurers' risk-based capital (see "Insurer Risk-Based Capital Adequacy--Methodology And Assumptions").
- The implementation of the revised capital model criteria has not affected our view of the capital adequacy of Health Care Service Corp. (HCSC).
- We revised our outlook on HCSC to negative from stable because of the expected risks associated with the acquisition of Cigna's Medicare business, and we affirmed our 'AA-' issuer credit and financial strength ratings on HCSC.
- The negative outlook reflects the anticipated execution and integration risks, weakened credit metrics, and earnings and capital strain that will come with the acquisition of Cigna's Medicare business, assuming it closes in early 2025.

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Rating Action

On May 30, 2024, S&P Global Ratings revised its outlook on Health Care Service Corp. (HCSC) to negative from stable. We affirmed our 'AA-' issuer credit and financial strength ratings on HCSC and 'A+' ratings on HCSC's senior unsecured debt.

Impact Of Revised Capital Model Criteria

- The implementation of our revised criteria for analyzing insurers' risk-based capital (RBC) did not have any impact on HCSC's capital adequacy at year-end 2023.
- Based on statutory financial statements at year-end 2023, HCSC's capital adequacy reflected modestly higher asset and liability risks, partially offset by greater risk diversification credit.
- Total adjusted capital showed a modest decline following the revised criteria.

Credit Highlights

Overview

Key strengths	Key risks
Brand strength and leading market position in five core markets.	Execution, integration and operating performance concerns stemming from Cigna Medicare acquisition.
Diversified health insurance portfolio combined with life insurance and ancillary product offerings.	Adjusted EBIT margin trending below 2%.
Pending acquisition that enhances MA market share and geographic presence.	Geographic concentration in five states (Illinois, New Mexico, Oklahoma, Texas, and Montana).

Outlook

The negative outlook indicates our expectation that HCSC's earnings and capital will deteriorate over the next 12-24 months, assuming the acquisition of Cigna's Medicare business closes. Specifically, we could lower our ratings if we expect HCSC to sustain profitability below 3%--as measured by adjusted EBIT return on revenue (ROR)--or if we no longer view capital and earnings as excellent. We expect HCSC's financial leverage, while increasing, to be manageable at 17%-20% in 2024-2025.

Downside scenario

We could lower our ratings in the next 12-24 months if we believe the company's run-rate adjusted EBIT ROR is likely to remain below similarly rated peers' or if HCSC's capital adequacy falls below the 99.99% redundancy level (extreme stress). We could also lower our ratings if HCSC increases and maintains financial leverage above 20%.

Upside scenario

We may affirm the ratings in the next 12-24 months if HCSC's adjusted EBIT ROR is in line with similarly rated peers', if its capital adequacy remains comfortably within the 99.99% level (extreme stress), and if financial leverage remains below 20%.

Rationale

The outlook revision reflects the integration and execution risks as well as the earnings and capital deterioration expected with HCSC's planned acquisition of The Cigna Group's Medicare Advantage (MA), Cigna Supplemental Benefits, Medicare Part D, and CareAllies businesses. The transaction is expected to close in the first quarter of 2025, with the sale currently on track and regulatory review of the deal by the Department of Justice complete.

Assuming the acquisition closes in early 2025, we expect HCSC's margins to be strained over the next few years. Cigna's government business has been underperforming financially, and we think it will be key for HCSC to make significant investments in this segment to deliver results in line with long-term expectations. Additionally, HCSC will contend with industrywide strains in MA, including lower MA rates, Star rating volatility, and ongoing utilization pressures.

We think this acquisition also presents material integration and execution risks. Historically, the company has mostly focused on organic growth and hasn't pursued acquisitions of this size, so we think the company could face some new challenges. Also, integration may take time as HCSC may contend with a corporate integrity agreement that could add integration difficulty. This will depend on how the Office of the Inspector General of the United States Department of Health and Human Services determines the corporate integrity agreement will apply to Cigna, the acquired business and/or HCSC following the closing of the acquisition. HCSC will have to determine what can be integrated into its existing operations without interfering with the corporate integrity agreement. Therefore, we think expenses could come under pressure in the near term.

We think the acquisition will help HCSC further its scale and geographic presence in government business while also making the company more competitive with both public and not-for-profit peers. Over the past few years, HCSC has been committed to government segment expansion, particularly in MA since it's the company's best opportunity for long-term growth. While HCSC's MA presence remains small relative to its commercial presence, it entered 344 new counties during 2022-2024--99 of those counties in 2024. Starting this year, HCSC covers about 82% of its service areas through its MA offerings.

As of year-end 2023, HCSC covered 17.8 million members (22 million members including Luminare, HCSC's third-party administrator (TPA) and Blue Card), an increase of 2% relative to the 17.5 million members at year-end 2022. HCSC has primarily operated in the commercial segment, which represented 90% of membership at year-end 2023. If the Cigna acquisition closes, HCSC's MA presence will double from approximately 5% to 10% of overall membership and its geographic presence and markets will expand to 33 states (in MA).

HCSC's material size and scale, well-known Blue Cross Blue Shield brand, market position in the health insurance market within its five core states, and significant market presence in national accounts support its competitive position. Despite being a regional health plan focusing on five states, HCSC is the fifth-largest health plan nationally in terms of membership and sixth-largest based on premiums (for year-end 2023). The company also provides life, dental, disability, and ancillary insurance products through its Dearborn Group subsidiary business. We view Dearborn as a strategically important subsidiary of the HCSC group. Additionally, Luminare Health Benefits enhances HCSC's ability to tailor its offerings to meet employer preference while expanding beyond its core five states.

In 2023, HCSC grew total revenue by 11% to $55.5 billion, supported by membership expansion within the commercial and individual segment as well as in Medicare Advantage. Medicaid saw enrollment declines due to the start of the Medicaid redetermination process in April 2023, though strong Medicaid growth in Illinois partially offset the losses.

Similar to the industry, Medicare Advantage utilization was elevated in 2023. Additionally, the commercial segment saw higher-than-expected utilization within the outpatient setting and elevated usage of GLP-1 drugs (glucagon-like peptide 1, for treating Type 2 diabetes). This resulted in HCSC's medical loss ratio (MLR) increasing to 87.9% from 87.1% in 2022. Given improved operating efficiencies, adjusted EBIT ROR in 2023 remained flat relative to the prior year at 3.3%.

In 2024, we expect an increase in revenue of 15%-20%, supported by strong membership growth across all segments, outside of Medicaid. The individual segment will continue to benefit from significant marketplace growth and better market positioning, particularly in Texas. Elevated utilization from 2023 is expected to continue through 2024 and result in the MLR further weakening to 88%-89%. Therefore, we expect margins to soften to 2%-3% for the year.

HCSC's capitalization has historically been a rating strength. According to our capital model at year-end 2023, HCSC's capital and earnings were excellent based on redundancy at the 99.99% level (extreme stress). The company's statutory surplus of $24.3 billion and RBC ratio of 1152% at year-end 2023 (based on the authorized control level) have been one of the strongest compared with peers.

In 2024, while we expect capital to continue to expand owing mostly to earnings growth, we anticipate the RBC ratio to decline to 1000%-1100%. We expect RBC will fall because of increased underwriting risk derived from the material growth in the individual segment. Additionally, targeted investments, particularly in advance of the closing of the Cigna acquisition could also lead to an RBC decline this year.

In 2025, assuming the Cigna acquisition closes, we think capital will decline as earnings are pressured and as government business is generally more capital intensive. We forecast the RBC ratio to decline below 900% since the subsidiaries that are being acquired operate with lower RBC. We expect that this could result in capital declining below the 99.99% stress level (extreme stress), which would strain our view of HCSC's financial risk.

As a mutual legal reserve company, HCSC has limited access to external capital sources. As of year-end 2023, it had $2 billion of debt outstanding--its senior unsecured notes issued in three tranches due 2025, 2030, and 2050. It maintains a $1 billion undrawn line of credit, supported by 11 high-profile banks, that matures in 2026. The company also is a member of the Federal Home Loan Bank of Chicago, with board-approved access to borrow up to $1.75 billion.

We expect HCSC to access the capital markets in anticipation of funding part of the $3.3 billion acquisition. The company also plans to invest $1 billion post-close for working capital and needed system upgrades to help manage the acquired business appropriately.

While still manageable, we forecast financial leverage (which includes the net present value of operating lease and unfunded pension deficit adjustments) will increase to 17%-20% in 2024-2025 from 9% in 2023.

We expect HCSC's liquidity to remain adequate, with a liquidity ratio exceeding 100%. The company's primary liquidity sources include its:

- Cash and cash investments and investment portfolio;
- Operating cash flow; and
- Debt facilities, which include its revolving credit and capital facilities totaling $2.75 billion to provide short-term funding.

As of Dec. 31, 2023, the company had $1.99 billion in borrowed money and no outstanding balance on its facilities.

Ratings Score Snapshot

	To	From
Financial strength rating	**AA-/Negative/--**	**AA-/Stable/--**
Anchor	aa-	aa-
Business risk	Strong	Strong
IICRA	Low	Low
Competitive position	Strong	Strong
Financial risk	Excellent	Excellent
Capital and earnings	Excellent	Excellent
Risk exposure	Moderately low	Moderately low
Funding structure	Neutral	Neutral
Modifiers		
Governance	Neutral	Neutral
Liquidity	Adequate	Adequate
Comparable ratings analysis	0	0
Support		
Group support	0	0
Government support	0	0

IICRA--Insurance Industry And Country Risk Assessment.

Related Criteria

- Criteria | Insurance | General: Insurer Risk-Based Capital Adequacy--Methodology And Assumptions, Nov. 15, 2023
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Insurance | General: Insurers Rating Methodology, July 1, 2019
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Dearborn Life Insurance Co. Outlook Revised To Negative On Parent HCSC's Pending Acquisition; 'A+' Ratings Affirmed, May 30, 2024

Ratings List

Ratings Affirmed		
Health Care Service Corp. d/b/a Blue Cross and Blue Shield of Illinois, New Mexico, Oklahoma, Texas and Montana		
Senior Unsecured	A+	

Ratings Affirmed; Outlook Action		
	To	**From**
Health Care Service Corp. d/b/a Blue Cross and Blue Shield of Illinois, New Mexico, Oklahoma, Texas and Montana		
Issuer Credit Rating		
Local Currency	AA-/Negative/--	AA-/Stable/--
Financial Strength Rating		
Local Currency	AA-/Negative/--	AA-/Stable/--

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.spglobal.com/ratings for further information. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings.