The Medicare Bubble Has Burst

Government health-insurance program had been a gold mine for private insurers until recently

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ILLUSTRATION: DOMINIC BUGATTO

For years, the privately run Medicare Advantage business generated outsize profit growth for health-insurance giants.

With hundreds of billions of taxpayer dollars flowing to insurers in a fast-growing market buoyed by aging baby boomers, there was little not to like as far as Wall Street was concerned. Companies like UnitedHealth Group UNH 0.22%increase; green up pointing triangle and Humana HUM 0.08%increase; green up pointing triangle bet big on the program, and investors generally rewarded them for it. Medicare Advantage, in which the government pays insurers a set amount to manage the care of seniors, recently surpassed traditional Medicare's share of beneficiaries. It was 30% a decade ago.

But the gold rush is over for investors, at least for now. After years of reports, lawsuits and whistleblower accounts accusing big insurers of gaming the system and overcharging the

government, the Biden administration has made a series of policy changes that have negatively affected what the plans get paid. Meanwhile, a post-Covid surge in seniors' medical costs caught insurers by surprise.

The stark drop in profitability is rattling corporate boards and investors. One of the biggest losers is CVS Health CVS -0.56%decrease; red down pointing triangle, whose Aetna unit bet big on Medicare right before costs soared. To gain market share, CVS-Aetna offered generous plans this year, surprising some executives at rival insurers. While the move paid off in terms of membership count—CVS added more than 700,000 Medicare Advantage members this year—the company underestimated what it would cost to insure them. In its first-quarter earnings report earlier this month, CVS said the segment helped drive medical costs $900 million higher than the company had expected. Its shares had their largest one-day drop in almost 15 years in response and are down 26% for the year, giving it a market capitalization of just over $70 billion. That is roughly what it paid for Aetna back in 2018.

CVS isn't the only one in trouble: Medicare-focused insurers, some of which had vastly outperformed the stock market in the past several years, are underperforming this year. Humana shares are down more than 20% this year and even industry leader UnitedHealth, which was more conservative in how it priced its plans, was down as much as 16% for the year in April before recouping much of the losses.

That by no means signals insurers are about to flee Medicare Advantage (though Cigna CI -0.76%decrease; red down pointing triangle did agree to sell its business earlier this year). Annual spending on the program, which is now hardwired into America's healthcare system, is projected to approach $1 trillion by the start of the next decade. And while declining profit expectations have negatively affected share performances, there are still plenty of profits to be made.

Take hard-hit Humana, which is mostly focused on Medicare Advantage. The firm is expected to earn significantly less in 2024, but analysts polled by FactSet still see it making just over $16 per share this year. By 2026, analysts expect earnings to rise back to $26 per share—some $3 billion in net income.

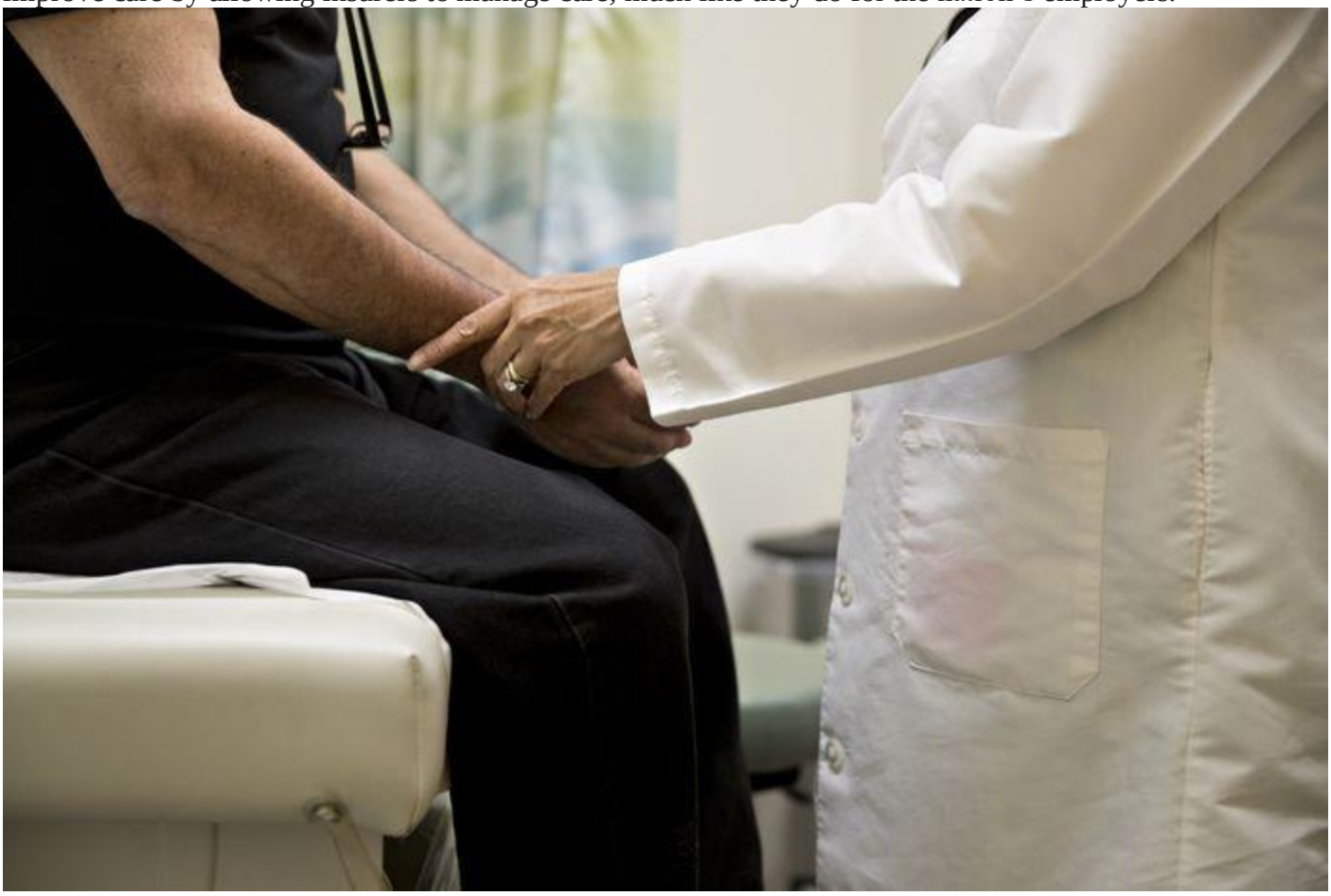
The high cost of covering seniors is likely a temporary problem for insurers, who get to submit their bids to the Centers for Medicare and Medicaid Services every year. While they are limited in the changes they can make, CVS and others said they are planning to exit some counties and cut back on things such as vision benefits to boost margins.

"The goal for next year is margin over membership," CVS Chief Financial Officer Thomas Cowhey said at a recent conference. "Could we lose up to 10% of our existing Medicare members next year? That's entirely possible." By all indications, other large players such as Humana will also be shifting from growth to profits. That could create an opportunity for leader UnitedHealth, which has relatively better profit margins, to grab more market share, argues Scott Fidel, an analyst at Stephens.

The tougher challenge is on the regulatory side. The Biden administration's changes, from releasing stingier payment rates to changes in how programs can code patient risk, signal an era of tighter purse strings. With such a big part of their business at stake, the industry's effort to sway public and policymakers' opinions is expected to go into overdrive.

"I can assure you that the companies will be investing pretty heavily through campaign donations and lobbying to try to figure out what they can do from a public policy point of view," said Wendell Potter, a former top communications employee at Cigna Group who is now a critic of the industry.

For decades, policymakers have sought to bring private insurers along as a way to manage soaring Medicare costs. In 2003, Congress passed the Medicare Modernization Act, which created Medicare Advantage as we know it. The idea, in a nutshell, is to bring down costs and improve care by allowing insurers to manage care, much like they do for the nation's employers.



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But critics point to studies showing that Medicare Advantage plans cost the government and taxpayers billions of dollars more than traditional Medicare.

"For well over a decade, Medicare Advantage plans have been making extremely high profits. What's going on now are long overdue policy changes to bring their pricing and coding practices back into line," said Dr. Don Berwick, former head of the Centers for Medicare and Medicaid Services.

In the near term, the best hope for a quick shift to insurers' fortunes could be a Donald Trump win in the coming presidential elections, Fidel said. Republican administrations, which tend to favor privatization of government services, have been more favorable toward Medicare Advantage.

In either case, it isn't going away—the business remains highly profitable. But the bonanza investors and health conglomerates got accustomed to in recent years has diminished for the foreseeable future.