Courtney Smith & Co

Company Commentary: Coventry Health Care Inc.

5 September 2004

Courtney Smith, Chairman • courtney@courtneysmithco.com

Courtney Smith & Co., Inc is an independent research and management firm based in New York. The Company produces research on global macro investments and on specific companies and investments. The Company manages money for high-net individuals and institutions.

The Outlook for Coventry Health Care

The underlying fundamentals are bullish for Coventry Health Care, Inc. (CVH, www.cvty.com). The company has done an excellent job of adding to profits and cash flow through internal growth and acquisitions. Management has done a superlative job.

In out opinion, the only potential problems are a possible compression of margins due to a less favorable pricing environment and a disappointment on the part of investors as growth slows from the 50% rate of the last five years.

In spite of incredible growth, the stock remains cheap to fairly valued using our preferred metrics.

In addition, the technicals look solid.

The bottom line is that we are bullish this company and its stock.

Covance Description

Coventry Health Care (CVH) has been a major success story for years. The company provides managed health programs primarily in the mid-Atlantic region. It has grown through organic growth as well as acquisitions.

Fundamentals

The underlying fundamentals are bullish for CVH. Clearly the company has executed perfectly over the past. Earnings have grown at a rate of over 47% per year over the last five years. The company has consistently surprised analysts on the upside in spite in ever increasing analyst estimates. Return on equity is an eye-popping 33%. This company has more than proven that they know what they are doing.

So the question is are they fairly priced for the future?

Analysts expect earnings to be $3.64 this year and $4.13 next year. We look for $3.69 this year and $4.25 next year. We are on the high end of these estimates because we believe that management will continue to baffle Wall Street with their ability to execute both internal profit generation as well as acquisitions.

However, even we expect a slowdown from the insanely strong growth going forward. The company was fortunate to be swept along by good market conditions. They had a nice tailwind.

However, we believe that there will be lower premium price increases this year. CVH themselves have said that the price increases of the last 5 years may not be sustainable.

However, we believe that the track record of management so far suggests that they will find ways of cutting expenses to at least help offset the slower growth in premiums. For example, spending on information technology could have a strong impact on the bottom line.

Free cash flow is running about $413 million which gives an 11 multiple or, to put in another way, a 9.11% free cash flow yield. That is a very high yield and compares very favorably with interest rates. This also suggests that there is still value in this highly performing stock.

We also like the fact that just under 20% of the stock is still held by insiders. Insiders are slight sellers but well within the normal range. Unfortunately, institutions own a very large percent yet added 7.3 million shares in the last three months. However, their percentage is now so large that we don not consider them as potential buyers going forward.

Total cash per share is about $6.17 which management has shown they know how to invest.

CVH trades for a slight premium to its industry peers but we tend to think that they deserve it. Analysts expect CVH to grow 15% over the next five years versus 15.4% for the industry. This gives CVH a PEG ration of .93, still very good, versus a very strong .76 for the industry.

Valuation metrics, such as P/E show that CVH is in the middle of its historical range for the last several years. Its current P/E is 13.8 on 2004 earnings and 12.3 on next year's projected earnings. Equivalent P/S analysis suggests that the stock is on the high side of historicals. However, this is common when a company is growing earnings more rapidly than sales due to operating efficiencies.

Price to cash flow puts CVH in a very cheap position, particularly against its peers. Of course, we consider cash flow, particularly free cash flow, as just about the most important indicator when examining companies.

Their return on equity is 32.9%, almost double the industry average of 16.5%. We also rank ROE high on our fundamental criteria.

Margins are improving significantly. For example, EBIT margins have increased from 2.9% five years ago to 8.8% in the last year. We look for this to continue.

The company will not likely declare a dividend any time soon but they have a history of share buybacks that may tempt management. They bought back $240 million worth of stock in 2002. They are generating a huge amount of cash and will use it either to fund new acquisitions or buy back shares. Most likely, either of these would be good for shareholders.

Technicals

The stock is clearly in a bull market and has been for a long time. The gap down in early August was filled and surmounted quickly which is bullish.

Recent price action has been sluggish on low volume which is likely merely a reflection of summer doldrums.

We will be technically bullish unless the stock breaks the lows near $45.

The Bottom Line/Strategy/Tactics

Coventry is a solid company with excellent fundamentals and good technicals. The major concern going forward will be the effect of a slowdown in earnings growth from insanely great to mere excellent.

For the long run, we suggest holding if you are already long and to buy near current levels if you are not. We believe that there is sufficient value at current levels to not recommend hesitating to buy.

Even long term traders should place protective stop losses if the price breaks down through $45.

Traders should look for some type of minor entry signal to get long. A stop at $45 should be placed at the very minimum. Traders should monitor our www.investorsnet.blogspot.com site for updates to the trading tactics.

We are currently long for our money management clients.


CVH Daily
9/03/04
55
50
45
40
35
30
Volume
©BigCharts.com
6
4
2
0
Millions
Oct
Nov
Dec
04
Feb
Mar
Apr
May
Jun
Jul
Aug

Disclaimer & Disclosure

This Industry Overview does not contain a complete analysis of every material fact regarding the companies profiled herein and inclusion of a company in this newsletter does not imply a "buy" or "sell" recommendation. As in life, the opinions expressed here are subject to change without notice, and the writers and Courtney Smith & Co., Inc. make no warranty or representations as to their accuracy, usefulness, or value. Data and statements of facts were obtained from or based upon publicly available reports from the companies profiled herein and were not based upon any independent verification or analysis. Information was also obtained from publicly available sources that we believe to be reliable, but the individual writers and Courtney Smith & Co., Inc. reserves the right to be wrong. Past results are not necessarily an indication of future performance. Readers should not trade in a stock just because of what is read here. Courtney Smith & Co., Inc. and the writers will not be liable for any loss that may be sustained based upon the material published here. Courtney Smith & Co., Inc. may own and from time to time may sell shares in the companies profiled herein. In fact, some money management clients of Courtney Smith & Co., Inc. were long Coventry Health Care stock on the day this issue is dated.

This Industry Overview is provided for information purpose only. Under no circumstances is it to be used or considered as an offer, solicitation, or recommendation to buy, sell, or solicit the purchase or sale of any securities of any companies profiled herein.

In connection with this Industry Overview, Courtney Smith & Co., Inc. does not make any guarantees that it is accurate, complete, timely, or contains the correct sequencing of the information, and shall not have any liability or entertain any claims, losses or damages arising from any inaccuracy, error, delay or omission, or from the use or reliance upon any of the information pertaining to the companies profiled in this newsletter. Courtney Smith & Co., Inc. and/or its officers and employees may from time to time acquire, hold or sell a position in the securities mentioned herein.

Courtney Smith & Co., Inc. is not a Broker/Dealer.

Courtney Smith & Co

Courtney Smith & Co., Inc.

The Chrysler Building

132 East 43rd St.

Suite 4500

New York, NY 10003

Phone: (212) 905-6024

Fax: (212) 656-1774

www.courtneysmithco.com