

Health Care Service Corp. (d/b/a Blue Cross & Blue Shield of Illinois, New Mexico, Oklahoma, and Texas)

Major Rating Factors

Strengths:

- Excellent balance sheet strength.
- Very strong competitive position.
- Strong profitability.

Weaknesses:

- Geographic underwriting concentrations.
- Financial profile is moderately less diverse relative to peers.

Rationale

The insurer financial strength rating on Health Care Service Corp. (HCSC), which does business as Blue Cross & Blue Shield of Illinois, Texas, Oklahoma, and New Mexico, reflects its very strong competitive position, excellent balance sheet profile, and strong profitability. Offsetting factors include a moderately less well-diversified earnings profile relative to its peer group and a more limited geographic underwriting profile.

HCSC's excellent balance sheet profile is well supported by a highly liquid investment portfolio, high tangible net worth, and very modest debt leverage. HCSC's capital adequacy ratio (CAR), based on Standard & Poor's Ratings Services' model, was 373% at the end of 2006, which is moderately higher than the 347% CAR at year-end 2005. In 2006, surplus grew by \$1.0 billion, or 23%, to \$5.3 billion, mainly because of improved statutory net income results.

Current Ratings >>

Financial Strength Rating

Local Currency

AA-/Stable/—

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Publication Date

April 25, 2007

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The company maintains strong franchises in its core markets through the leverage of the Blue brand, establishing a meaningful presence across key market segments. HCSC has established itself as the leading provider of health insurance coverage in each of its primary markets by means of its well-developed distribution channels, long-standing provider relationships, and competitive servicing capabilities. As of Dec. 31, 2006, HCSC provided health insurance and related services to more than 11.2 million members, reflecting a five-year cumulative annual growth rate of more than 10% (excluding Blue Card Host members).

HCSC's earnings adequacy ratio (EAR), as measured by Standard & Poor's model, was 565% for the five-year period ended Dec. 31, 2006, strong overall relative to the rating. Consolidated operating performance has steadily improved in the past five years because of a disciplined pricing strategy, effective medical cost management, and sustained improvement in the Texas health maintenance organization (HMO) marketplace. Pretax income for 2006 increased modestly, to \$1.4 billion, reflecting a 9.4% ROR.

Most of HCSC's insurance contracts are aligned with customers that reside in two generally competitive state markets: Illinois and Texas. HCSC's at-risk or insured members constitute 37% of total membership (including federal employees), and generate 87% of revenue. Its large base of customers overall enhances provider contracting and boosts operational efficiencies. Because of the at-risk concentrations, HCSC's insured customer base is somewhat less diversified geographically compared with its peers. Such a concentration of insured members potentially exposes the company in a significant way to adverse developments on the legislative, regulatory, and economic fronts. In addition, most of the company's cash flow is from a limited number of markets. Its unregulated fee-based cash flow resources are modest relative to total revenue, and are essentially driven by its network rental business, which is tied to its national profile.

Outlook

The outlook reflects no expectation for a rating change in the next 12-18 months. The company has executed its growth strategy and returns objectives, bolstering its competitive position, strengthening its balance sheet, and producing strong operating performance.

Standard & Poor's expects HCSC's enrollment on a same-store basis to grow by about 5% and be near 11.6 million members for 2007. Consolidated pretax income is expected to be about \$1.2 billion (about 8% ROR), which is very strong and generally consistent with the expected five-year average pretax ROR in the range of 8%-10%. If HCSC meets our expectations for profitability, interest coverage is expected to exceed 40x, and debt leverage will be less than 10% on an adjusted-net-worth basis. Surplus growth in the range of 15%-20% is expected, and capital adequacy is expected to be in the range of 390%-410%, which is very strong relative to the rating.

Competitive Position: Strong Franchise Through BCBS Brand

HCSC's business profile has improved significantly in connection with the sustained development of its national account business, which has been a significant contributor to member growth in the past several years. The company has developed a strong franchise in its core markets through the leveraging of the Blue brand and by means of its well-developed distribution channels, long-standing provider relationships, and competitive servicing capabilities.

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Table 1

Health Care Service Corp./Selected Statistics					
	—Year ended Dec. 31—				
(Mil. \$)	2006	2005*	2004†	2003†	2002†
Enrollment (000s) - from statutory statement	11,225.0	10,561.5	9,526.2	8,765.3	7,976.0
Premiums earned	12,971.6	11,713.9	6,991.3	6,249.8	5,509.8
Net underwriting gain/loss	1,144.5	1,168.1	990.3	785.0	370.0
Net income/loss	1,115.4	1,145.6	994.7	624.6	245.9
Pretax return on revenue (excluding realized capital gains/losses) (%)	10.6	11.3	12.5	10.5	6.0
Pretax return on revenue (including realized capital gains/losses) (%)	10.6	11.3	12.5	10.4	5.6
Total assets	9,162.7	7,770.4	5,886.8	4,939.4	4,161.0
Total adjusted capital	5,262.8	4,268.3	2,900.4	2,156.9	1,468.2

*2005 numbers reflect consolidation with Blue cross Blue Shield of Oklahoma; †2002-2004 premium excludes HMO product line revenue.

Table 2

Health Care Service Corp./Business Statistics					
	—Year ended Dec. 31—				
(Mil. \$)	2006	2005*	2004†	2003†	2002†
Enrollment (000s)	11,225.0	10,561.5	9,526.2	8,765.3	7,976.0
Year-over-year change (%)	6.3	10.9	8.7	9.9	5.6
Premiums earned	12,971.6	11,713.9	6,991.3	6,249.8	5,509.8
Year-over-year change (%)	10.7	67.6	11.9	13.4	20.5

*2005 numbers reflect consolidation with Blue cross Blue Shield of Oklahoma; †2002-2004 premium excludes HMO product line revenue.

HCSC is the leading provider of insurance coverage and maintains strong market positions. Based on an estimate of the insured commercial market, the company's market share positions are Illinois, 46%; Texas, 26%; Oklahoma, 23%; and New Mexico, 29%. HCSC has achieved member growth in part through ceding arrangements with other licensed Blue Cross Blue Shield plans. In most instances, these plans could opt to service the accounts directly, which could result in slower short-term growth for the company.

Historical

HCSC is a non-investor-owned mutual legal reserve company that conducts business as Blue Cross Blue Shield of Illinois, Blue Cross Blue Shield of Texas, Blue Cross Blue Shield of Oklahoma, and Blue Cross Blue Shield of New Mexico. At year-end 2006, the company provided health insurance products and services to 11.2 million members (63% self-insured and 37% at-risk) in the private and public sectors.

The company is primarily a managed care organization, with more than 90% of its membership enrolled in managed care plans. A substantial portion of HCSC's health insurance business is transacted through the HCSC legal entity, which is also the parent to several downstream companies. HCSC markets its products and services primarily in Illinois, Texas, Oklahoma, New Mexico, and nationally through affiliations with other BCBS plans as approved by the Blue Cross Blue Shield Association (BCBSA). HCSC provides group and individual indemnity health insurance and managed

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care products, such as HMOs, participating provider/preferred options (PPOs), point-of-service (POS) plans, and consumer-driven health plans (CDHP), as well as Medicare supplemental coverage, dental, vision, and prescription drug products. HCSC also now provides Medicare Part D prescription and Medicare Advantage products in limited markets.

HCSC has built strong relationships with several national consulting organizations, general agents, producers, and brokers to distribute its products. HCSC works closely with consulting firms to sell to larger groups and national accounts, which usually are the accounts with the highest customization of products. In the individual and small-group segments, general agents, producers, and independent brokers are primarily used in each local market. Online quoting and enrollment capabilities have helped to improve growth in the highly competitive small-group market segment.

Prospective

Standard & Poor's expects HCSC to focus mainly on existing core-market opportunities in 2007 and in the next 12-18 months not to be involved with significant M&A deals that might result in material operational risk for the company. Instead, Standard & Poor's expects the company's efforts to be directed at sustaining its already strong market positions in Illinois, Texas, Oklahoma, and New Mexico while pursuing organic national account growth opportunities. For 2007, we expect HCSC's enrollment on a same-store basis to grow by 4%–6%, to 11.5 million–11.7 million members.

HCSC has eased away from its consolidator stance, but acknowledges that merger opportunities with smaller nonprofit Blue plans will always be considered. Standard & Poor's believes a merger could result in at least some temporary disruption to ongoing operations, depending on the magnitude of the deal. In the near term, Standard & Poor's believes that HCSC will rely more on targeted investments and additional Blue collaboration to drive competitive advantage.

Management And Corporate Strategy: Balanced Growth Through Increased Membership And Industry Consolidation

HCSC is executing its intermediate strategy of maintaining a balanced growth in membership and earnings by leveraging its brand positioning and enhancing product design. Strong operating performance has provided the means to support expansion as the industry continues to consolidate.

Operational management

The company's operational objective is to build on its financially sound, efficient, and competitively priced product assortment, leveraging its infrastructure capacity and consolidating its negotiating power with providers and distribution channels. Advanced IT and superior operations are included in this goal. HCSC's recent history has included several acquisitions. The primary objective of this strategy is to enhance the scale and cost efficiency needed to compete effectively with large national health care companies while remaining true to its mission as a non-investor-owned Blue Cross Blue Shield carrier.

Financial management

Given the need to remain price competitive, particularly in its national and large account segments, HCSC has adopted a policy of expense control that emphasizes improved efficiencies, enhanced technology, and economies of scale. HCSC's leadership is committed to conservative financial

management. The company adheres to fundamentally sound business practices, including its reserving and underwriting, while maintaining prudent risk-adjusted capitalization.

The company maintains a somewhat conservative level of debt, with a target maximum of 20% of total capital on an adjusted-net-worth basis. Adjustments to better approximate GAAP valuation include provisions for various assets, including certain receivables, deferrals, goodwill, and other intangibles. Standard & Poor's uses this valuation to compute and assess financial leverage and other balance-sheet-quality measures. On this basis, as of Dec. 31, 2006, debt leverage was less than 10% and intangibles as a percentage of adjusted net worth was less than 5%, which Standard & Poor's views as very conservative.

The issuance of debt has historically improved the company's ability to fund strategic acquisitions and strengthen its working capital. The target capital structure would be exceeded only to finance a major acquisition, with the intention of returning it to 20% in the intermediate term.

Enterprise Risk Management: Conservative Risk Profile And Uncomplicated Product Portfolio

HCSC's enterprise risk management is adequate and reflects the conservative risk profile of the company. The company's product portfolio of health care products is not particularly complex. Its major risk is underwriting risk. The underwriting and pricing discipline is evident by the strong financial performance and the capital strength that HCSC has achieved in the past five years. Its current systems of monitoring claims and pricing trends are considered to be adequate. Management is expected to dedicate the resources needed to manage its risks.

Accounting

HCSC's financial reporting is reasonably conservative and transparent. Standard & Poor's believes the company employs revenue-recognition methods that are in the mainstream for its industry. HCSC does no off-balance sheet financing, nor has it established any special-purpose entities for any reason. Contingent liabilities are established at the best estimate if the exact amount is unknown, and in the middle of the range of reasonably possible outcomes if a best estimate is not given. The company tends to use operating earnings to set up reserves for various contingencies and has established medical reserves for its core health plan at or above claim development for each of the past five years.

Operating Performance: Indemnity And PPO Products Improve Performance

The company's EAR, as measured by Standard & Poor's model, was 565% for the five-year period ended Dec. 31, 2006, which is very strong for the rating. Consolidated operating performance has improved during the most recent four-year period because of generally strong returns from the company's indemnity and PPO products and improved profitability in the Texas HMO marketplace. Standard & Poor's further believes that HCSC's earnings profile has been enhanced by the material amount of fee-based revenue and income generated from its major/national account business lines.

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Table 3

Health Care Service Corp./Operating Statistics					
	—Year ended Dec. 31—				
<i>(Mil. \$)</i>	<i>2006</i>	<i>2005*</i>	<i>2004†</i>	<i>2003†</i>	<i>2002†</i>
Total revenue	13,228.5	11,883.9	9,813.4	8,194.6	7,312.3
Net underwriting gain or loss	1,144.5	1,168.1	990.3	785.0	370.0
Pretax income (excluding realized capital gains or losses)	1,401.4	1,338.1	1,228.5	857.8	440.9
Pretax income (including realized capital gains or losses)	1,398.4	1,338.4	1,230.6	855.5	406.0
Net income or loss	1,115.4	1,145.6	994.7	624.6	245.9
Pretax return on revenue (excluding realized capital gains or losses) (%)	10.6	11.3	12.5	10.5	6.0
Pretax return on revenue (including realized capital gains or losses) (%)	10.6	11.3	12.5	10.4	5.6
Earnings adequacy ratio (%)	566.0	529.0	493.5	328.0	260.0
Medical loss ratio (%)	81.3	81.5	78.4	78.5	79.3
Expense ratio (%)	9.7	8.5	3.6	6.6	10.3

*2005 numbers reflect consolidation with Blue cross Blue Shield of Oklahoma; †2002-2004 premium excludes HMO product line revenue.

Historical

Premium revenue (excluding equivalents) increased 11% (\$1.3 billion) to \$13.1 billion as of Dec. 31, 2006, compared with \$11.8 billion in 2005. The increase was driven by a combination of member growth and rate increases. Pretax income and pretax ROR (as a percentage of premium revenue and self-funded account fees) for 2006 were \$1.4 billion and 9.5%, respectively, compared with \$1.3 billion and 9.9% in 2005.

Prospective

For 2007, we expect pretax income to be about \$1.2 billion (about 8% ROR), which is considered very strong, and the five-year average pretax ROR is expected to be about 9%. Accordingly, the EAR for the five-year period ended Dec. 31, 2007, is expected to again exceed 500%, which is considered strong for the rating. Standard & Poor's expects profitability to be sustained by HCSC's core books of business in Illinois and Texas. If the company meets Standard & Poor's expectations for earnings, interest coverage would likely remain very strong for the rating.

Investments And Liquidity: Focus On Capital Preservation And Dependable Cash Flow

The company's investment portfolio is carefully managed, with an investment philosophy that focuses on preservation of capital and dependable cash flow. HCSC's investment portfolio contains mostly high-credit-quality fixed-income investments that provide strong liquidity. More than 95% of its fixed-income portfolio is in NAIC Class 1 securities, with 65% maturing within one year. The plan has had strong cash flow from operations in the past several years.

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Table 4

Health Care Service Corp./Investment Statistics					
	—Year ended Dec. 31—				
(Mil. \$)	2006	2005*	2004	2003	2002
Net investment income	258.5	159.3	51.7	25.3	30.9
Net realized capital gain	(3.1)	0.3	2.1	(2.3)	(34.9)
Net investment gain	255.4	159.5	53.8	23.0	(4.0)
Net investment yield (excluding realized capital gains and losses) %	4.7	3.7	1.6	0.9	1.3
Net investment yield (including realized capital gains and losses) %	4.7	3.7	1.6	0.8	(0.2)
Total invested assets (excluding real estate)	5,876.5	5,093.9	3,612.9	3,030.4	2,462.2
Portfolio composition					
Cash and short-term investments (%)	42.2	39.0	52.8	46.0	35.9
Bonds (%)	36.2	41.4	25.9	24.7	28.4
Preferred stock (%)	0.0	0.0	0.0	0.7	0.9
Total common stock (%)	17.1	15.1	14.7	21.6	26.1
Unaffiliated common stock (%)	6.8	5.6	4.4	3.4	3.6
Real estate (%)	4.2	4.3	5.7	7.1	8.3
Other (%)	0.3	0.2	0.8	0.0	0.4

*2005 numbers reflect consolidation with Blue cross Blue Shield of Oklahoma.

Table 5

Health Care Service Corp./Liquidity Statistics					
	—Year ended Dec. 31—				
(Mil. \$)	2006	2005*	2004¶	2003¶	2002¶
Cash flow from operations	743.2	1,245.5	569.6	583.1	337.0
Cash and short-term investments	2,589.0	2,074.8	2,025.3	1,498.8	964.1
Total invested assets (excluding real estate/affiliated investments/other)	5,232.9	4,579.2	3,185.9	2,414.8	1,823.8
Unpaid claims liability	1,287.6	1,158.8	636.8	686.2	689.4
Quick liquidity ratio (%)	201.1	179.0	318.0	218.4	139.8
Cash flow from operation to unpaid claims (%)	57.7	107.5	89.4	85.0	48.9
Liquidity ratio (%)	245.0	253.1	200.3	193.1	172.2
Claims turnover (days)	44.6	44.3	42.4	51.0	57.6

*2005 numbers reflect consolidation with Blue cross Blue Shield of Oklahoma; ¶2002-2004 premium excludes HMO product line revenue.

Liquidity is very strong for the rating, measured by a liquidity ratio of 250%-300% at year-end 2006, based on Standard & Poor's model estimate. The company maintains an untapped five-year, \$300 million line of revolving credit with a consortium of banks, which will expire in November 2009.

Capitalization: Improved Statutory Net Income Grows Surplus

HCSC's CAR, based on Standard & Poor's model, was 373% for the year ended Dec. 31, 2006, which is very strong and stable, given the absolute size of the surplus base and its limited sensitivity to material changes in business growth and capital shocks.

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Table 6

Health Care Service Corp./Capitalization Statistics					
	—Year ended Dec. 31—				
<i>(Mil. \$)</i>	<i>2006</i>	<i>2005*</i>	<i>2004¶</i>	<i>2003¶</i>	<i>2002¶</i>
Total assets	9,162.7	7,770.4	6,359.5	4,939.4	4,161.0
Total liabilities	3,899.9	3,502.1	3,258.4	2,798.5	2,700.2
Total adjusted capital	5,262.8	4,268.3	3,101.1	2,156.9	1,468.2
Total debt to capital (%)	7.4	8.6	11.4	15.6	21.4
Capital adequacy ratio (%)	372.5	346.6	277.6	203.7	144.9
Total equity assets to capital (%)	24.8	24.2	25.8	44.3	64.4

*2005 numbers reflect consolidation with Blue cross Blue Shield of Oklahoma; ¶2002-2004 premium excludes HMO product line revenue.

Historical

Capital adequacy improved in 2005 to 347%, which was materially better than expectations and significantly improved from 296% in 2004. HCSC has reported significant growth in its statutory earnings in the past few years, which has led to the significant strengthening of its capitalization level.

Prospective

Standard & Poor's expects HCSC's consolidated capital adequacy to remain strong for the rating category through year-end 2007, with strong profitability and a sustained focus on fee-based business growth. Standard & Poor's expects HCSC's CAR to be in the range of 390%-410% by year-end 2007.

Financial Flexibility: Capital And Earnings Provide Strong Flexibility Despite Not-For-Profit Status

HCSC's significantly enhanced capital position and improved earnings strength provide it with strong financial and operating flexibility, which have permitted investments in business growth through acquisitions, strategic alliances, and the development of its managed care networks. Nevertheless, HCSC's financial flexibility is limited somewhat by its non-investor-owned mutual legal reserve corporation status, which restricts access to the equity capital markets. Standard & Poor's does not expect the company to change its corporate structure over the near to intermediate term.

Its primary sources of funds consist of internally generated cash flow and its five-year, \$300 million credit facility, which expires in November 2009. Standard & Poor's expects that HCSC's capital needs will grow in the next several years, but also believes that internally generated funds will be more than sufficient to meet the company's needs. Nonetheless, HCSC's strong financial profile and modest financial leverage would allow for relatively easy access to the debt capital markets, if needed.

In 2001, the company issued \$400 million in 10-year senior unsecured notes by means of a 144A issuance. The majority of the proceeds were used to repay a commercial bank revolving credit facility. The debt obligation has the following repayment conditions and restrictions: The notes bear interest at a rate of 7.75% per annum, payable semiannually in arrears on June 15 and Dec. 15 of each year, and will mature on June 15, 2011. As of Dec. 31, 2006, debt leverage (as a percentage of adjusted net worth) was less than 10%, and debt to EBITDA was 0.3x, which Standard & Poor's views considers conservative for the rating. Standard & Poor's does not expect these metrics to change in the next 12-18 months in a way that would pressure the company's financial profile.

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Ratings Detail (As Of 25-Apr-2007)*	
Health Care Service Corp. (d/b/a Blue Cross & Blue Shield of Illinois, New Mexico, Oklahoma, and Texas)	
Financial Strength Rating	
<i>Local Currency</i>	AA-/Stable/—
Counterparty Credit Rating	
<i>Local Currency</i>	AA-/Stable/—
Senior Unsecured	
<i>Local Currency</i>	AA-
Holding Company	HCSC Group
Domicile	Illinois

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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