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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.cvtv.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 our 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 of 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 do 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 ratio 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.



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