Stock Pick of the Week: Aetna (AET)

We tend to like insurance businesses for value investors (and it seems we're not alone). If you can get them for cheap, a well-run insurance company is one of the very best investments you can make. Inflows from underwriting are only paid out much later as claims, giving insurance companies a large float to reinvest almost indefinitely. Being in the health insurance industry is even better, as it is less prone to catastrophic claims payouts from natural disasters than the property and casualty business. Throw in the new insurance mandate in the United States, and you've got a recipe for upside. This week's stock pick of the week is Aetna Inc. (AET).

After Our Successful Cigna Call, We Like Aetna

At the beginning of 2015, we let our subscribers know about Cigna (CI), one of our favorite stocks for 2015. This call has proven to be a good one, as CI is up 19% so far this year. We see many of the same characteristics in Aetna that we saw in Cigna: consistent profit growth, a healthy return on invested capital (ROIC), and a cheap valuation.

Aetna operates in three segments: Health Care, Group Insurance, and Large Case Pensions. The Health Care segment contains all of Aetna's Health Care-related products, while Group Insurance is provided to employers seeking life, disability, and long-term care insurance. The Large Case Pensions segment is no longer being actively marketed, but continues to service and accept payments from legacy customers.

The Profitability Continues its Steady Uptrend

Aetna generated an after-tax operating profit (NOPAT) of almost $2.6 billion in 2014, its highest ever. 2014's 13% NOPAT growth was just the next step in a long trend of Aetna's 12% compounded annual profit growth since the company's spin-off in 2000. While margins were down by 0.3% in 2014, revenue growth of 23% drove profits higher.

This increase in profits raised the company's ROIC from 6% in 2013 to 7% in 2014, despite over $400 million in acquisitions in 2014 and $5.7 billion in 2013. While Aetna's ROIC is less than stellar, this jump in ROIC is a good sign that the aforementioned acquisitions were smart for Aetna's business and were made for the right price. All too often, we see businesses paying too much for bolt-on acquisitions, so it's good to see Aetna as an exception to that trend. Based on these positive first year results, we expect thee acquisitions to be accretive going forward.

These Adjustments Reveal Aetna's Operating Profitability and Valuation

While investors looking at GAAP net income saw an almost 7% increase in profits in 2014, stripping away some non-operating expenses reveals that 2014's after-tax operating profit actually increased 13% over 2013. Non-recurring and non-operating expenses that we stripped away include $181 million loss on the extinguishment of long-term debt and $329 million in interest expense. These items do not reflect the recurring profitability of Aetna's core business.

Removing these items reveals a NOPAT of $2.6 billion, which is 27% higher than Aetna's net income of just over $2 billion.

On the other hand, we also add back $1.1 billion in amortized goodwill, $3.3 billion in accumulated asset write downs, and $1.1 billion in other comprehensive income to Aetna's reported net assets to reach its invested capital for 2014. We hold the company accountable for all of the assets that have disappeared from its balance sheet to obtain a clear view of all of the capital that has gone into the business over its lifetime.

Should You Worry About the ACA?

Many health care analysts are concerned about the financial effect of the Affordable Care Act on health insurers, especially those with large exposure to Medicare and Medicaid such as Aetna. While some parts of the law have yet to take effect, most of the provisions of the ACA went into effect in 2014, which was by almost all measures a great year for AET.

Aetna's business was only minimally affected by the opening of federal and state health care exchanges last year. The company only added 600,000 public exchange members in 2014, relative to the company's total medical membership of almost 24 million.

This being said, investors should keep an eye on health care prices and premium prices. Both of these prices continue to rise as the number of insured Americans rises and the health of the insured population decreases on average.

Why You Should Consider Picking Up AET at Current Prices

Perhaps as a result of its understated profitability, Aetna is undervalued at its current price of $102/share. This price gives AET a price to economic book value (PEBV) ratio of under 1.2, which implies that the market expects Aetna's profits to increase by less than 20% over the rest of the company's lifetime. This seems pessimistic when considering Aetna's 13% NOPAT grown in the past year alone.

If Aetna can maintain current margins of 5% and grow NOPAT by just 8% compounded annually for the next 10 years, the company is worth $204/share — a 102% upside from current levels. It will be difficult for Aetna to fail to beat expectations as low as these when considering the company's historical profit growth rate of 12% compounded annually since 2000.

At current levels Aetna has excellent upside potential and little downside. The company's healthy free cash flow should give it a cushion to deal with upcoming regulatory hurdles, and we look forward to seeing how the company's recent acquisitions will benefit the company going forward.

Disclosure: David Trainer André Rouillard receive no compensation to write about any specific stock, style, or theme.

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