

Health Net, Inc.

TRICARE Update Conference Call

January 3, 2001

OPERATOR: Please stand by.

Good day everyone and welcome to this Health Net, Incorporated update conference call.

Today's call is being recorded.

At this time I would like to turn the call over to the Senior Vice President of Investor Relations, Mr. David Olson. Please go ahead, sir.

DAVID OLSON: Thank you very much.

Good afternoon everyone. Thank you for joining the call today.

As you know, we put out a release earlier today regarding circumstances about our government receivable, which we'll be talking about today. And the matters discussed in today's call will contain forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended, that involve risks and uncertainties. All statements other than statements of historical information provided herein may be deemed to be forward-looking statements. Without limiting the foregoing, the words "believes", "anticipates", "plans", "expects", and similar expressions are intended to identify forward-looking statements. Factors that could cause actual results to differ materially from those reflected in the forward-looking statements include, but are not limited to, the risks discussed in the "Risks Factors" and "Cautionary Statement" sections included within the company's most recent annual report on Form 10-K filed with the SEC and the risks discussed in the company's other filings with the SEC. Listeners are cautioned not

to place undue reliance on these forward-looking statements that reflect management's analysis, judgment, belief, or expectation only as of the date hereof. The company undertakes no obligation to publicly revise these forward-looking statements to reflect events or circumstances that arise after the date hereof.

And now that that's out of the way, we're going to turn the call over to our CEO, Jay Gellert.

JAY GELLERT: Thank you, David, and good afternoon.

I'd like to thank all of you for joining our call on such short notice. We know it's been a pretty eventful day, but we think the news we have is truly a breakthrough as it relates to our TRICARE business. What I'd like to do is just make a few brief comments and then we'll open it up to questions and answers. Steve Erwin, our CFO, is also joining me on the call.

Before I go any further though I'd like to congratulate Jim Woys and the entire team of our government operations, along with Gary Velasquez and Jeff Bairstow for this outstanding effort, which has lead to the completion of this important settlement. They worked long hours before, during the holidays, deserve a tremendous amount of credit. We also would like to thank the people at DoD who also worked with us diligently to get this done.

Let me start by saying that we have an agreement to settle \$389 million in outstanding receivables in the three TRICARE contracts. Those were formerly called CHAMPUS. We expect to receive these funds on or about January the fifth, 2000 (sic), that's the end of this week. While some of the funds are pledged to third parties, to the government, and relate to some of the receivable buildup in Q4, the payment will produce substantial improvements in our balance sheet and cash flow. We estimate that our total debt at the end of first quarter 2001 will be below \$650 million. That compares with

approximately \$945 million at the end of the third quarter of 2000, and more than \$1.4 billion in Q3 of '98. We have focused on debt reduction as we've indicated on these calls in the past, and we believe that this settlement is a key part of this strategy and that these results place us in a very strong position going into 2001. It will give us enhanced flexibility as we look to term out a portion of the remaining debt and will put us in a strong position in a potentially difficult credit market going forward later this year.

We also believe our operating cash flow in 2001 will benefit and will be substantially higher than previous guidance when you take into consideration these payments. We'll have more specifics on all of this when we announce our fourth quarter and year-end results on February 21st, but we think that this significant reduction in debt reflects the strengths of our strategy to this point in time, which we will continue going forward. The government receivable at March 31st will likely be below \$100 million. That compares with \$358 million at the end of the third quarter.

One very important thing the settlement underscores is the credibility of the process we've employed in managing this line of business and the items that make up the receivable on the balance sheet. A number of people have expressed concerns about that item on the balance sheet. I believe this affirms how methodically Jim and his team have worked on these items over the years, how tightly Steve Erwin has managed it, and this settlement affirms that their efforts were on the mark.

In recent quarters there has been justifiable concern over the growth in the receivable, but this settlement should allay that concern once and for all. We've said all along that a normal operating receivable at quarter end would be in the hundreds of -- \$125 million range and I think that's a conservative expectation going forward.

The press release also references some earnings guidance that I want to touch on. We're suggesting a range for EPS in 2001 of between \$1.55 and \$1.58, which is slightly

ahead of prior guidance. While the settlement is very positive, this settlement allows us to take advantage of these funds to help build our business for the future while keeping with our goal of 15 to 20 percent per annum EPS growth. One of the concerns that has been raised before with regard to our company is our ability to grow top line. We believe we have some very attractive growth opportunities in California and in the Northeast. We believe that we have an opportunity to grow in terms of PPO product offering that will diversify our mix. We believe we can strengthen our medical management capability, as well as build our brand as we go forward in the coming year. We think there's tremendous opportunities for us in the latter part of 2001 and 2002 and believe that this provides us with the resources to move from a turnaround state to a growth state in the context of our company. We believe these steps are essential in meeting expectations for 2001, but are also fundamental to prepare for strong profitable growth in 2002 and beyond. This has been an issue consistently raised by many of you, many of our holders and we believe we're now in a position to respond effectively to it.

This is certainly the right way to start off the New Year. We couldn't more pleased with this development. We probably could have been a little bit more pleased if it wouldn't have come on the same day as the Fed reduced the discount rate, but in terms of our company this really opens the door to a future and is very consistent with the strategy we've articulated over the course of the last two years.

So with that, let me open up to questions from any of you.

OPERATOR: Thank you.

Our question and answer session will be conducted electronically. If you would like to ask a question, please press the star key, followed by the digit one on your telephone. We'll take your questions in the order that you signal us and take as many questions as time permits.

Once again, if you would like to ask a question, please press star one. And we'll pause for just a moment to assemble our roster.

Our first question comes from Joshua Raskin with Lehman Brothers.

JOSHUA RASKIN: Hi. Congratulations, guys, on the announcement.

JAY GELLERT: Thanks.

JOSHUA RASKIN: First question is the, I guess, the appropriations that had come through that made this announcement possible. I was wondering, does that change the way that the sort of cash cycle is going to continue with the TRICARE program, or is this sort of a one-time benefit and you expect sort of a normalized, I think you say \$120 to \$125 million balance for the receivable going forward?

JAY GELLERT: Well, this money resolves issues in TRICARE periods one through five. As we said on our conference call in Q3, the extension is structured to make for a more timely payment process and make it so that the consistent receivable in that amount will continue so we won't need another appropriation in order to sustain it at that level. And as we said before, that level is consistent with the payable, so it reflects basically a breakeven balance sheet status in terms of the TRICARE contract.

JOSHUA RASKIN: Okay, that's helpful.

And then a second question, maybe for Steve, I think you mentioned he was there.

He'd given some targets for debt at the end of the year and I was wondering if he had an updated number? Are we talking somewhere in the \$600 million to maybe \$500 million range by the end of the '01?

STEVE ERWIN: I really, obviously the debt levels will be quite a bit lower than in prior guidance and what I'd really like to do is to bundle all that up in our fourth quarter call on February 21st. But these proceeds certainly will go to reduce debt and will be bringing that number down substantially during the course of the year.

JOSHUA RASKIN: Okay, I understand, thanks.

OPERATOR: Our next question now comes from Rob Hallisey with Sirios Capital.

ROB HALLISEY: Great, thanks.

Just a follow-up on Josh's question, so the extension is structured so that the payment process going forward is all set versus having to have it done in this agreement?

JAY GELLERT: That's right. The extensions are constructed so it won't balloon again and you won't have to have an appropriation in order to -- and a settlement in order to fix it as we did in this case.

ROB HALLISEY: Okay and then just one other question on Region 11. It says the extension continues through February of '01 and there's an option. Would we expect to hear about that before February or would that maybe go out a couple months beyond that?

JAY GELLERT: Well, at this point we're in negotiations on it and I would anticipate we'd be able to report on that in our call in February.

ROB HALLISEY: Okay, great. Thank you very much.

OPERATOR: Our next question comes from Charles Boorady with Goldman Sachs.

CHARLES BOORADY: Hi, good afternoon and congratulations on this.

A couple of questions, first, how does the \$389 million compare with what was booked in receivables? Is it an exact match or did you book a little higher or a little lower number?

JAY GELLERT: It's consistent with our booking.

CHARLES BOORADY: Okay, and in terms of what to expect now for the full year 2000, operating cash flow or for the combined 2000 and 2001, are we still at the

point that we're at for the combined two years and can you give us an estimate for the full year 2000 cash flow?

STEVE ERWIN: Well, again, this is Steve. I'd kind of like to hold the 2000, we're in the closing process, but this payment, of course, is a 2001 payment, Charles. So, what you will see for the two linked years, you make an excellent point, 2000 and 2001 will look really appreciably better by virtue of this payment. But certainly the earlier guidance that we gave on cash and debt levels and so forth are altered a little bit as a result of the payment just based on the timing. But when you couch it in terms of the first quarter of '01 and so forth, that's really where you're going to see it in the financials.

CHARLES BOORADY: Got you.

Just a final question and Jay this is probably for you in terms of this settlement. What's your opinion on new TRICARE business going forward and benefits for life for other new benefits in TRICARE? Are you more optimistic about the potential for this business or still skeptical on any new business?

JAY GELLERT: I think we were -- we've been very heartened by the process which DoD went through to reach this settlement. We've been heartened from a number of standpoints. One, as I mentioned, it verified that our assessments of the receivable is valid. So that gives us confidence that we do have a good solid working relationship with DoD and that as long as we can get away from the vagaries of the appropriation process that we can have a viable business relationship. And so I think that the second thing that's important to us is that we do in the future focus on developing contractual relationships that don't get us encumbered in the appropriations process because that's where this gets all bottlenecked up. But set in place processes where there's basically funding from continuing resolution. And I think that's the direction we've gone and I think as long as we do that we're increasingly confident with the quality of our working

relationship. I think our people have built credibility with the Department of Defense and the Department of Defense, I think, has reflected by doing this, the importance of maintaining a good partnership with us going forward. So, this gives us confidence in our relationship with the Department of Defense and gives us the lesson and the need to structure the contractual relationship so that they can't get hung up in extraneous matters in Congress.

CHARLES BOORADY: When will you know or tell us whether you would participate in any new benefits for retirees?

JAY GELLERT: Well, I think that that discussion is going on and we should have some better insight in that by our call in February.

CHARLES BOORADY: Okay, terrific, thanks.

OPERATOR: And once again, as a reminder, if you would like to ask a question, please press the star key followed by the digit one. And Roberta Goodman with Merrill Lynch has our next question.

ROBERTA GOODMAN: Thanks.

I'm switching gears just a little bit. You were talking about using some of the excess funds to build for the future and you mentioned the growth opportunities in California and the Northeast and strengthening medical management and building up the brand. Could you talk a little bit more about what would be involved in each of those and what kinds of concrete things we should be watching for you to do?

JAY GELLERT: Yes. I think first of all, in terms of the growth opportunities, one of the key issues with regard to the PPO is for us to build relationships with brokers that gives them confidence we're going to stay in the market. One of the mistakes people have made before when they've entered the small group market is rather than investing in underwriters and broker relationships they tried to low-ball the price, which we will not

do. And so we believe that both advertising, broker relationships, and constructing in some key areas some partnerships with some providers is critical if we're going to be successful in that marketplace in a broader way and that's what our focus is.

Secondly, in terms of medical management, as we move away from dual risk and as we move to fee-for-service in the PPO process, this will allow us to kind of build ourselves ahead a little bit in bringing people online for medical management so we don't -- we further diminish any risk that anything untoward could happen in that regard. It basically allows us a kind of three months front-end before the business actually comes online, which we found to be increasingly critical. As well as allows us to continue to focus on reducing our inventory so we always have timely claims information so we can price appropriately.

The final area has to do with advertising and just getting our name out there with our new name, Health Net, Inc., in both the Northeast and in California. And honestly I think that in all three of those areas we've not had the ability to invest since we've been involved in a turnaround. But because of certain provider issues in California, because of some issues with some of our competitors, we think there's some unique growth opportunities for us now to make it worthwhile to kind of take on these initiatives. But again, to do it only when we have the medical management in place in advance so we don't end up having a six-month meltdown as we start the product. And secondly, to do it in a fashion where we make initial investments rather than cut the price in order to get into it because those, in our view, are things you never can recover from as you enter these product markets.

ROBERTA GOODMAN: Great. Thank you very much.

OPERATOR: And we'll now move on to Ed Kroll with SG Cowen Investments.

ED KROLL: Good afternoon and congratulations.

What might be the timing of going to the ratings agencies to seek an upgrade?

STEVE ERWIN: Well, I think that's going to be certainly a natural outgrowth. They're aware of the release. They received a copy of it simultaneous with the release to the market and so certainly it's up to the agency to evaluate this extremely positive news. But the parallel process is underway just by virtue of the announcement itself.

ED KROLL: So, would you say it sounds like a Q1 process, a Q1 event to me. Is that a fair statement?

STEVE ERWIN: I would not be comfortable speaking on behalf of the agency just because they have their own internal process and procedure to follow. But this is certainly is very resoundingly strong news and we would hope that they'd agree to greet it accordingly and their process will follow suit and I hope it would be well within the timeline that you suggested.

ED KROLL: Okay, thanks.

And then since we've got you here, I wonder if there's any update or further information you could give us on the Florida plan and your previously announced intention to sell it?

JAY GELLERT: As we indicated on our Q3 call, we're hopeful that we would have a definitive agreement with regard to the disposition of the Florida plan before our February Q4 call and nothing has occurred since then to change our perspective on that.

ED KROLL: Thanks very much.

OPERATOR: Gary Frazier with Deutsche Bank has our next question.

GARY FRAZIER: Hi guys, congratulations.

I was just curious if you would be so nice to give us a sense in terms of the higher guidance for 2001, the degree to which like what percentage of that is driven directly from the settlement and the balance sheet benefits versus the -- perhaps increased

business prospects that you're already observing as we sit here today versus the increased business that you're expected to generate from increased investments in 2001? So, I guess there's kind of three buckets where I'd like to get a little bit of an insight in terms of the variance between the old consensus and where we're going for 2001.

JAY GELLERT: At present all of the increase in the guidance is the result of this settlement. As I indicated on an earlier call, we don't want to end up doing new business that isn't profitable, but we do want to front load the medical management and some of the broker investments in terms of - in some of the things we're doing - in terms of branding in 2001 for 2002. So, there's some one-time expenses we see in terms of building our capacity to deal with it that we've included for 2001, but so that the additional business prospects would -- we've not increased the guidance based on that. It's all based on this settlement and, in fact, that to some degree we've provided ourselves an investment cushion in that regard in 2001 because of the opportunities we see out there.

GARY FRAZIER: So, it'd be pretty fair to characterize this as kind of conservative guidance at this point?

JAY GELLERT: I think it's conservative guidance if we were only operating for 2001. I think it's solid guidance if we are building for growth in 2002 and I think one of the mistakes -- we studied a lot of our company's past and other companies and you get to a point like this and it seems to us that's when you have to invest for growth, rather -- operationally, that is, not in terms of new capital or run the risk of kind of hitting the wall and having to do a deal to grow. And we've really selected the former strategy and we think that this is the tool to give us it. So, we think our guidance is sound and solid, but also provides us the opportunity to build ourself towards growth rather than just a status quo company.

GARY FRAZIER: Got you. Okay, thanks.

OPERATOR: And we'll now move on and take a question from Christine Arnold with Morgan Stanley.

CHRISTINE ARNOLD: Good afternoon.

You talked about the move away from dual risk to fee-for-service in the PPO process. Can you update us on how that's going external to the PPO process? Are you still seeing movement consistent with your expectations or has that changed?

JAY GELLERT: At present, the movement that we've seen is consistent with the expectations that we articulated in Q3.

CHRISTINE ARNOLD: Great. Thank you.

JAY GELLERT: Yeah.

OPERATOR: And once again, as a reminder, if you would like to ask a question, please press the star key followed by the digit one.

Our next question is a follow-up coming from Rob Hallisey.

ROB HALLISEY: Oh thanks. It's already been answered.

OPERATOR: And we'll now move on to Charles Birdie (sic).

CHARLES BOORADY: I changed my name to get a follow-up in.

JAY GELLERT: We don't normally allow follow-ups so that was a very sneaky move.

CHARLES BOORADY: Thank you.

This is a question for Steve probably. How many basis points lower and I'm positive that you said this that you think your interest rate can go if you refinance the debt?

STEVE ERWIN: Well, actually, you know, it's an interplay between lower levels generally and a shifting of the outstanding amounts from the revolver to a little longer

term, 10'r. And so actually the rate on the longer term debt would be higher than our revolver debt. And the market right now today is kind of moving around a bit but I'd say we could be 100 bps higher on a longer term piece.

CHARLES BOORADY: Okay, so actually go up but it would be termed.

STEVE ERWIN: That's right. It'd be and I'm thinking in 10 year bullet terms , so that's my mind set when I responded to your question and it's just subject to market conditions at the time. The longer end of the market has been very warm, it's been bending downward and of course this news certainly will help our standing in terms of how we're evaluated as an issuer.

CHARLES BOORADY: And the guidance you gave us, does that assume the potential for 100 bp increase in the rate?

STEVE ERWIN: Yeah, at least that. It's always subject to market conditions when we decide it would be appropriate to move forward with it.

CHARLES BOORADY: Okay.

And then in terms of the mix of profits expected in '01. I was a little surprised as we discussed before in a mix of government versus commercial earnings that was in the third quarter queue. And I'm just wondering going forward what to expect in terms of percent of earnings coming from government versus commercial in '01?

STEVE ERWIN: You'll see a shifting back more to the commercial side because the numbers that you saw in the third quarter just happen to reflect a little softer performance out of two of our health plans that are turning around smartly. One of which is on the block, as Jay has already commented on. So, you'll see a more traditional relationship going forward.

CHARLES BOORADY: Okay. Back to the same relative mix or slightly higher in government?

STEVE ERWIN: I would think so.

CHARLES BOORADY: Okay, thanks for the follow-up.

OPERATOR: And there is one name remaining in our queue. Once again, if you would like to ask a question, please press the star key followed by the digit one.

PAUL GOULEKAS with Conning Research has our next question.

PAUL GOULEKAS: Good afternoon.

I just wanted to follow-up on the timeline of your capital management strategy. In the last conference call you laid out a strategy whereby as you pay down debt we get to the point where you can get an investment grade debt rating and then hopefully reposition your portfolio. And at that point you would consider share repurchase, or at least an authorization for that, and that looks like that was about a year out. That seems to have been accelerated and if, in fact, you are successful in getting that debt rating upgrade by mid-year, might we anticipate you'll move onto that next step in the second half of this year?

STEVE ERWIN: First of all, in terms of the timing it would be my hope that the rating agency would move us to investment grade prior to an offering. Then we'd get the year-end work behind us and the announcement out and so forth and evaluate market conditions at that time. And in terms of any buyback, I think what I'd like to do really is defer my comment until we've gotten that behind us. Maybe in February we'll have a little more to say. But it conceivably could be, but right now I'd just like to hold any further comment on it.

PAUL GOULEKAS: Well, thank you very much.

JAY GELLERT: Yeah, Paul, the rating agencies don't look all that favorably about people rushing to buy back. I think we should try and get through the rating agency process and then we can assess where we are.

STEVE ERWIN: Yeah I committed to them really that I-- we really wouldn't do any buy back and certainly this settlement is very positive from many of our metric standpoint, but I'd just like to evaluate us going forward and just see how it all works out. But in terms of the literal timeline, that may be accelerated a slight bit, subject to evaluation, but the concept is the same irrespective of this and that is to get the rating upgrade on or about the time we'd like to do it, a longer term market offering, then use the proceeds to pay down the debt and further strengthen our balance sheet.

PAUL GOULEKAS: Okay, thank you.

OPERATOR: And at this point, Mr. Olson, there are no further questions in our queue. I'd like to turn the conference back over to you for any additional or closing remarks.

DAVID OLSON: Well, thank you very much.

Thank you everyone for joining the call and I'll be available the rest of the week for questions and thanks again and Happy New Year.

OPERATOR: That does conclude today's conference. Thank you for your participation. Thank you for choosing Premiere Conferencing.

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