BEFORE THE COMMISSIONER OF SECURITIES AND INSURANCE
MONTANA STATE AUDITOR

IN THE MATTER OF THE CONVERSION OF BLUE CROSS AND BLUE SHIELD OF MONTANA, INC., AND ALLIANCE WITH HEALTH CARE SERVICE CORPORATION Applicants.	Case No.: INS-2012-238 **DIRECT EXPERT TESTIMONY OF TIMOTHY J. BLACKMER ON FAIR MARKET VALUATION ON BEHALF OF THE STATE OF MONTANA**

Q. PLEASE STATE YOUR NAME, CURRENT POSITION, AND BUSINESS ADDRESS.

A. My name is Timothy J. Blackmer. I contract with MDS Consulting, LLC and other professional firms, to provide business valuations and other financial services for their clients. MDS Consulting's business address is 24596 Hawthorne Boulevard, Torrance, CA 90505.

Q. PLEASE DESCRIBE YOUR EDUCATION, QUALIFICATIONS AND EXPERIENCE.

A. I am a Certified Public Accountant (CPA) licensed in California and Washington State and I hold several accreditations in business valuation, including Accredited Business Valuation (ABV) from the American Institute of CPAs, Certified Business Appraiser (CBA) from the Institute of Business Appraisers, and Accredited Senior Appraiser (ASA) from the American Society of Appraisers. I also have a Masters degree in Business Administration, with an emphasis in Finance, from the University of Nevada. I have instructed undergraduate courses in Accounting at Seattle City University, Seattle, WA and for The University of Phoenix, Los Angeles, CA. I have also given seminars and classroom instruction on numerous topics including 'Valuation and Physician Integration during Healthcare Reform', 'Business Valuation and the Healthcare Industry', and 'An Overview of Business Valuation.' I am also experienced in the general operations of various business ventures. I have completed valuations of asset portfolios for principals with annual gross revenues ranging from $100,000 to over $800 million. I have prepared hundreds of net tangible and intangible asset appraisals for clients within a variety of regulated industries, including healthcare and insurance. This is only a selection of my most relevant qualifications and experience.

Q. HAVE YOU PROVIDED A COPY OF YOUR RESUME?

A. Yes, a copy of my resume has been provided to counsel. Also please see pages 60 and 61 of the expert report for a general summary of my education, qualifications, and experience.

Q. ON WHOSE BEHALF ARE YOU APPEARING?

A. I have been asked by the State of Montana, Office of the Attorney General to provide my expert opinion regarding the fair market value of Blue Cross Blue Shield of Montana (BCBS) in conjunction with the Application for Approval of Alliance submitted by BCBS and Health Care Service, Corp. (HCSC). I have prepared a report summarizing my expert opinion of the fair market value of BCBS as of June 30, 2012.

Q. HAVE YOU TESTIFIED PREVIOUSLY IN ANY FORMAL PROCEDINGS IN MONTANA OR IN ANY OTHER STATE?

A. I have not previously testified in any formal proceeding in Montana. However, I have testified in New Jersey in 2011 with regard to a Calculation of Value report I prepared on behalf of an Ambulatory Surgery Center located in the State of New Jersey.

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. The purpose for this proceeding is to assist the Attorney General and the Commissioner of Securities and Insurance, Montana State Auditor, in determining whether the proposed transaction is in the public interest. Montana statute states that, "In determining whether a conversion transaction is in the public interest, the attorney general shall require that: . . . (c) the fair market value of the public assets of a nonprofit health entity will be distributed as provided in 50-4-720 [to an existing or new foundation or other nonprofit organization to be held in a trust . . .]." In my opinion, the fair market value of all net tangible and intangible assets of Blue Cross Blue Shield of Montana, Inc. as of June 30, 2012 is between <u>$182,477,551</u> and <u>$210,564,755</u>. After reconciling the low range and the high range and rounding the figures, I arrived at a rounded estimate of surplus value of <u>$193,800,000</u>. The values for particular tangible and intangible assets that comprise the rounded estimate of surplus value are summarized on page 4 with specific adjustments to these balances detailed on page <u>30</u> of the expert report.

<u>Q. PLEASE EXPLAIN WHY THE VALUE OF CONTRACTS, BRAND AND COMMUNITY GOODWILL INCREASED BY $510,000 IN YOUR REVISED REPORT AS COMPARED TO YOUR REPORT DATED JANUARY 25, 2013.</u>

<u>**A.** A Business Valuation does not normally require the explicit measurement of intangible asset values although a business valuation infers the existence and an aggregate value for the goodwill of the company, which usually includes the (yet-to-be-defined) intangible assets and their individual values. An explicit determination and measurement of intangible assets, their useful lives and their estimated value is prepared when allocating a purchase price for a company to the books-of-record of the investor (acquirer). At that time it is important to identify and value each intangible asset included in the acquisition which had previously been captured in the aggregate as "goodwill". In a business valuation the inferred goodwill is the difference between</u>

the conclusion of value (when expressed as a single amount) and the normalized surplus or equity balance of the company. In this instance the difference between the normalized surplus balance and the weighted opinion of value in the updated report changed approximately $2.5M while the surplus balance changed approximately $3.0M. The net effect was to increase the "residual" difference (aggregated goodwill) by approximately $500K. In my valuation measurement I included the measurement for a Trained and Assembled Workforce which uses payroll detail and employee benefit costs and other related assumptions to achieve a measurement. Hence, the value associated with the workforce (approximately $13.4M) remained the same in both valuation measurements. The additional $500K therefore, is allocated to the remaining 'residual' balance which captures the value for all intangible assets (yet to be specifically identified). Included among this residual balance is the value for contracts, brand names, leases, etc.

Q. PLEASE EXPLAIN WHY THERE IS A SLIGHT DECREASE IN THE VALUE OF RECEIVABLES IN YOUR REVISED REPORT.

A. A valuation measurement includes numerous estimates and approximations. It can be confusing to use "accounting precision" when reporting balances (for valuation purposes) because the interactions for valuation purposes require estimates and approximations within sliding ranges. Some appraisal reports (explanations) use balances rounded to the third or fourth digit as a means of demonstrating this type of distinction from accounting reports which usually reconcile balances with greater precision. In the initial valuation report and in the updated valuation report, the total accounts receivable as of the date-of-value was $ 58,425,742. This aggregated amount did not change from report to report as demonstrated through the normalized balance sheets presented with each written explanation. However, when grouping numbers together for different purposes, the A/R balance might appear as $58,425,000 or alternatively $58,430,000 depending upon the issue being explained through the use of the specific schedule. Another example of this methodology is the Conclusion of Value (expressed as a range) which represents 'Indications' of value as low as $182,477,551 and as high as $210,564,755. These are 'indications of value' that (on a stand-alone basis) offer important but incomplete information about the business being examined. Collectively, these indications of value help the analyst appreciate the 'going-concern' and ultimately offer an opinion-of-value with that range of value 'indications'. No single 'indication' defines the true value for any particular business but collectively, the indications allow the analyst to approximate, to estimate a good and reasonable measurement of value at a specific point in time. Hence, the range of value is best explained in rounded terms i.e., approximately $182,500,000 to approximately $210,600,000. This is true throughout the valuation process and as a consequence, an auditor's precision is generally not included in the valuation analyst's explanation of the results achieved. I frequently retain the precision demonstrated in the financial statements when normalizing as represented in the Exhibits to the reported explanation.

Q. PLEASE EXPLAIN THE INCREASE IN CURRENT LIABILITIES IN YOUR REVISED REPORT.

A. In this instance, current liabilities were increased to account for the future (September 2012) cash payment of $3,000,385 for a parcel of vacant land.

Q. PLEASE EXPLAIN THE SLIGHT INCREASE IN LIABILITIES REFLECTED IN YOUR REVISED REPORT IN THE 'PENSION AND RETIREE OBLIGATIONS' LINE ITEM.

A. As noted in the Exhibits to the both reports, the aggregated amounts for these accounts have not changed. However, in the written explanation of the valuation effort, these collective balances have been presented in rounded form to ease the focus on the subject matter being explained through a particular schedule. Hence, the 'accounting precision' of $53,743,282 demonstrated in the financial statements can be expressed as $53,745,000 or perhaps $53,740,000 depending upon the rounding convention used in a particular schedule for different purposes.

Q. ARE YOU FAMILIAR WITH THE PROPOSED TRANSACTION THAT IS THE SUBJECT OF THIS PROCEDING?

A. Generally, I understand that a third party investor is seeking to acquire selected net tangible and intangible assets of BCBS.

Q. DOES YOUR VALUATION TAKE INTO ACCOUNT THE PARTICULAR PURCHASER, HCSC, AND THE PARTICULAR DETAILS OF THE PROPOSED TRANSACTION?

A. No. Under IRS Revenue Ruling 59-60, the fair market value standard must be applied with a hypothetical buyer perspective, not a particular buyer. If you bias that by considering any one particular investor, you have changed the standard of value from fair market value to investment value, which is a different standard of measurement. Generally, the person performing the valuation should be mindful of not mixing the focus of fair market value versus investment value and should not allude to the fact that there is a particular investor that is being considered. Fair Market Value is achieved absent the influence of any proposed transaction.

Q. DID YOU REVIEW WRITTEN MATERIAL TO FORM YOUR OPINION ABOUT THE FAIR MARKET VALUE OF BCBS?

A. Yes. Written information was provided by the management of BCBS in response to a written request for data that I submitted to BCBS on December 13, 2012.

Q. WHAT WRITTEN INFORMATION DID YOU REQUEST?

A. I requested numerous items from BCBS. Generally, the requests included financial statements and tax returns, general ledger detail and other financial data, operating data, and information about the company. Following the initial review of the documents received, numerous questions were prepared and submitted to BCBS for response and additional source detail was requested.

Q. DID YOU RECEIVE THE INFORMATION FROM BCBS THAT YOU REQUESTED?

A. Most of it. BCBS produced a large volume of materials in response to my request. I did not receive detailed depreciation schedules or indications from management regarding their interpretation of the fair market value of depreciable equipment. Further, I did not receive any information regarding new debt or current adjustments in deferred taxes.

Q. DID YOU GATHER ANY OTHER INFORMATION IN FORMING YOUR OPINION?

A. Yes. I conducted a site visit of BCBS on January 15th and 16th, 2013. During the site visit, there were extensive discussions with BCBS management and key personnel about the history of the company and their expectations for the future.

Q. PLEASE LIST THE BCBS MANAGEMENT AND KEY PERSONNEL THAT YOU MET WITH DURING YOUR SITE VISIT WHO PROVIDED YOU INFORMATION USED TO FORM YOUR OPINION.

A. Michael Frank, President & CEO

Mark Burzynski, Chief Financial Officer

Mary Belcher, General Counsel

Sean Slanger, Associate General Counsel

Fred Olson, M.D., Chief Medical Officer

Frank Cote, Chief Sales Officer

Jim Spencer, FSA, MAAA, Senior Director Actuarial Services

Paul Pederson, Senior Director, Provider Network Administration and Contracting

Chris Manger, Controller

Deborah Thompson, Human Resources, (by phone on Monday January 21, 2013)

Bob Janicek, President & CEO of Health-e-Web, subsidiary of BCBS

Lynn Etchart, Director, Enterprise Financial Strategies

Terry Stubby, Manager, Facilities

Q. WHAT INFORMATION DID YOU RECEIVE FROM BCBS EMPLOYEES DURING YOUR SITE VISIT?

A. Generally, we addressed the following topics:

The primary growth issues involving the current subscriber base and future plans for the company to address those issues if the proposed transaction is not perfected;

Whether BCBS expects to achieve expansions in their provider network or negotiated subscriber benefits;

What changes in the use of subsidiaries BCBS anticipates within the next three to five years;

The impact of projected revenues and the resulting changes in capacity, including labor and physical growth as well as related capital investments, from 2013 to 2017;

The methods used to replace BCBS's current labor force, labor recruitment methods, the interview process for various positions, the proportion of their labor force that requires specialized training, and the time and investment necessary to bring a new hire to full productivity;

The proportion of the subscriber or provider base that individual senior managers influence and;

Absent the proposed transaction, the implementation dates of projects in progress and whether BCBS anticipates any additional revenues or cost reductions expected once the projects are put into service.

Management was also asked to comment on the changes in Montana resulting from the Affordable Care Act and what management perceived as positive action they could implement to either take advantage of these changes or mitigate some of the negative effects of ACA.

Q. WHAT ELSE DID YOU DO TO FORM YOUR OPINION?

A. I also toured the 3 buildings located in Helena listed on BCBS's books and obtained additional information regarding reported tangible capital investments from the Facilities Manager as well as assorted BCBS personnel in other conversations.

Q. DID YOU DO ANYTHING ELSE TO FORM YOUR OPINION?

A. I considered factors relating to the broader competitive environment of the healthcare business, including national and regional trends in healthcare and medical insurance, current local and national economic conditions, and specific characteristics of health and medical insurer businesses. Much of this additional information was provided through professional organizations offering comparative detail and surveys of private and public market competitors.

Q. DID ANYONE ASSIST YOU IN IDENTIFYING AND ANALYZING NATIONAL ECONOMIC TRENDS AND ISSUES AFFECTING THE HEALTHCARE INDUSTRY?

A. Yes. I had additional conversations with Phil Dalton, President and CEO of MDS Consulting, LLC, regarding national trends in the health care industry. Mr. Dalton is active in the healthcare industry at many levels and offers valuable insights on national trends, particularly with regard to the forthcoming changes in the health care industry due to the Affordable Care Act. Mr. Dalton was also present at the site visit. It is a customary and accepted practice for a business valuation consultant to consider information received from a qualified consultant, such as Mr. Dalton, particularly with respect to systematic risk and its bearing on discount rates.

Q. HAVE YOU PREPARED A SUMMARY OF THE SOURCES OF INFORMATION YOU RELIED UPON IN FORMING YOUR OPINION?

A. Yes. Please see pages 8 and 9 of the expert report for a summary listing of many of the sources of information I used in forming my opinion.

Q. WHAT IS FAIR MARKET VALUE?

A. U.S. Treasury Department Revenue Ruling 59-60 defines Fair Market Value as "the price at which property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts."

Q. WHAT PREMISE OF VALUE DID YOU USE TO ANALYZE THE FAIR MARKET VALUE OF BCBS?

A. A Going Concern Value premise, which is defined by the International Glossary of Business Valuation Terms as "the value of a business enterprise that is expected to continue to operate in to the future."

Q. WHY DID YOU USE A GOING CONCERN PREMISE?

A. I used a Going Concern Premise of Value, because I determined that the highest and best use for the assemblage of income producing assets of BCBS is as an ongoing business enterprise.

Q. DID YOU CONSIDER ANY OTHER PREMISE OF VALUE?

A. I also considered the Liquidation Premise of Value. Liquidation Value assumes value in exchange, on a piecemeal basis not as part of a mass assemblage of assets, rather as part of either an orderly or forced disposition of all assets on an individual basis.

Q. PLEASE GENERALLY EXPLAIN THE PROCESS YOU USE TO DETERMINE THE FAIR MARKET VALUE OF A BUSINESS LIKE BCBS.

A. As discussed within the Scope of Work and Value Assessment section of my report, see page 7, a Fair Market Valuation should be performed in conjunction with the Standards Rules provided in the Uniform Standards of Professional Appraisal Practice (USPAP) and follow the direction and valuation framework provided in U.S. Treasury Revenue Ruling 59-60. Both documents provide the foundation for professional standards appropriate in any valuation engagement.

In achieving a complete and unbiased measurement, the analyst should understand the elements of the specific engagement including: who is requesting the measurement; the legal description of the business that is the subject of the measurement; the ownership interest being valued; the standard and premise of value being applied; the form of report being requested; the timing for the report and the fee associated with the engagement.

Then, the analyst begins to gather information regarding the history of the business, the industry in which it operates, unique risks and/or benefits associated with the industry, the immediate marketplace, and the products and/or services offered by the subject.

Included in this effort is the collection of historical financial statements, tax returns, trial balances and general ledger detail; as well as supporting schedules and work papers that help the analyst better understand the financial reports and better compare the operations of the subject with private and public market competitors.

As indicated on page 7 of my report, the effort to obtain appropriate detail includes the use of economic surveys, as well as industry samples as a means of better appreciating the strengths and weaknesses of the subject business at a specific point in time.

These examinations allow the analyst an opportunity make certain adjustments to financial reports that help define a normal operating pattern for the subjects business. This effort, called normalization, is generally accomplished through the application of five types of adjustments:

1. Generally Accepted Accounting Principles (GAAP) items, which takes significant items from the financial data that are not in keeping with GAAP reporting and adjusts them to GAAP for standardized measurements across the financial data;

2. Non-economic items which consider income tax based adjustments that may distort economic profit, for instance, accelerated depreciation methods;

3. Non-recurring items are revenues and expenses that are not a part of the normal business cycle and distort consistent profit performance, such as catastrophes;

4. Non-arm's length items, which focus on transactions listed on the books that reflect the influence of a related party, like an owner of the company. This category can include an owner's expenses for travel and entertainment or non-market rent paid to the owners, and;

5. Non-operational items, which reflect subjective choices not required to generate normal operating income that the current management of the business has made, but that an acquirer may not make, such as donations or luxury autos.

The normalized financial statements are a better representation of the subject business for use in direct comparison with industry standards and financial ratios of competitors within the private and public marketplace.

Following normalization, the analyst can better select the valuation methods within each of the three Approaches to Value that use the most reliable data identified through the examinations.

Valuation theory allows for the use of three approaches to value: The Income Approach, The Cost (Asset-based) Approach and The Market Approach to Value.

The **Income Approach** relates the value of the business to its ability to generate a return-on-investment measured as its economic income stream. Since the value of a business depends on the future benefits it will generate, then the basis of the income approach is to project the future economic benefit associated with the business and to measure the present value of that benefit at a discount rate that is appropriate for the expected risks associated with obtaining that prospective economic income stream. The income approach is based upon the economic principle of anticipation, or expectation. The investor anticipates the expected economic income to be earned from the business. This expectation of prospective economic income is then converted to a present value, which is an indication of value of the subject business. Key in the application of this method is the development of a discount rate that is appropriate for the specific definition of economic (as opposed to accounting) income.

The **Cost Approach** is built around valuing the existing assets of a business, with accounting estimates of value or book value often as a starting point. A fundamental business valuation principle is: the current value of the business assets minus the current value of liabilities equals the current value of the business owners' equity. When using this approach, the analyst will apply the appropriate standard of value as current value, for example, "mark-to-market," for all of the assets and liabilities of the valuation subject.

The **Market Approach** estimates the value of a business by looking at the pricing of comparable businesses relative to a selection of common variables like economic earnings, cash flows, book value, gross sales, etc. Regardless of the method selected within this approach, finding a business with the exact characteristics as the valuation subject is an impossibility. Rather, the standard sought is one of reasonable and justifiable similarity. The preliminary distinction as a comparable business should include more than just a similar line of business or similar industry. Recent court cases have mandated that the search for similarities should include: capital structure; management depth; personnel experience and duties; nature of competition; maturity and market share of the business.

What an analyst achieves at the end of the application of these valuation approaches is a measurement of value usually associated with the equity or total invested capital of the business. That value frequently includes the value of tangible and intangible assets and goodwill. It is important to note that the goodwill of a business usually includes the value of the assembled and trained workforce of that subject business. Although an Assembled and Trained Workforce is frequently included in discussions regarding intangible assets, accounting regulations do not consider an Assembled & Trained Workforce separable from the business. Accordingly, it cannot be assigned a finite life and is generally considered to be a part of residual goodwill.

An Assembled & Trained Workforce underwrites the Return on Tangible Assets and the Return on Intangible Assets. Hence, its value should be included in each measurement even though it is not generally included among the assets listed on a balance sheet.

An Assembled & Trained Workforce is best valued through a cost savings approach. The concept is that the business does not have to expend additional time, effort and money to recruit, select and train employees with comparable skills and expertise.

Q. DID YOU FOLLOW THE UNIFORM STANDARDS OF PROFESSIONAL APPRAISAL PRACTICE WHEN PREPARING THE MEASUREMENT?

A. Yes.

Q. DISCUSS THE IMPACT OF NORMALIZATION ON THE FINANCIAL REPORTS.

A. As shown on page 30 of my report numerous normalizing entries were prepared to adjust account balances in BCBS financial statements.

Investments in subsidiaries are tangent investments, in other words, they are not a part of the core operation of BCBS. Therefore, normalizing entries applied in historical periods, removed the impact of subsidiary operations except for the operations of Health-e-Web, Inc.

Health-e-Web, Inc. (HeW) began operations in 1986 in support of their parent organization Blue Cross and Blue Shield of Montana, Inc. but HeW has blossomed into a national competitor, with expanded service offerings to include a full suite of Revenue Cycle Management solutions and Clearinghouse connections with over 2,000 Health Insurance Carriers across the country.

As a wholly owned subsidiary of BCBS, the operating activities of HeW have been retained in the financial reports of BCBS to be included in the measurement of the surplus value of BCBS. Additionally, the fair market value of HeW was independently measured using standard valuation procedures and the resulting measurement of $4,290,000 was the basis for the normalizing adjustment to the HeW investment account on the financial statements of BCBS. <u>A copy of the HeW valuation report was filed with the revised BCBS valuation report, both dated February 26, 2013.</u>

Normalization in the current year also included adjustments to market value for various BCBS investments as directed by external statements of account, property appraisals and other financial reports.

Projected operating expenses were also adjusted because total operating expenses provided by management in their projections for 2012, 2013, 2014 and 2015 represented a much stronger proportion of revenues than the percent of revenue represented by total operating expenses in historical financial reports 2011 and 2012 trailing twelve months (ttm).

The adjustment made to operating expenses was also based on discussions with management about their intention to keep operating expenses low as a way to achieve economic strength and their further explanation of their historical success in cutting operating expenses for those purposes.

These adjustments to the financial statements of BCBS help to define an expected pattern of operations for BCBS within the marketplace.

<u>Q. PLEASE EXPLAIN WHY YOU DID NOT MAKE A NORMALIZING ADJUSTMENT TO THE DEFERRED TAX BENEFITS OF BCBS.</u>

A. Briefly, a deferred tax liability is recognized for 'temporary differences' that will result in taxable amounts in future years. A deferred tax asset is recognized for 'temporary differences' that will result in deductible amounts in future years and for carry forwards. A 'temporary difference' is created between the reported amount (per the financial statements) and the tax basis of a liability for estimated expenses if, for tax purposes, those estimated expenses are not deductible until a future year. Settlement of that liability will result in tax deductions in future years, and a deferred tax asset is recognized in the current year for the reduction in taxes payable in future years.

A valuation allowance is recognized if, based on the weight of available evidence, it is more likely than not that some portion or all of the deferred tax asset will not be realized.

All available evidence, both positive and negative, is considered to determine whether, based on the weight of that evidence, a valuation allowance is needed for some portion or all of a deferred tax asset.

Judgment must be used in considering the relative impact of negative and positive evidence. The weight given to the potential effect of negative and positive evidence should be commensurate with the extent to which it can be objectively verified.

The annual audit reports provide significant detail (see Note 10 – Income Taxes pp. 30-31 in the BCBS Audit Report for December 31, 2011) regarding the current and historical calculations of deferred taxes and the reversal (over time) of these 'temporary differences'.

The audit reports also discuss the timing differences related to the use of varying tax rates when applied to changing claims expenses, benefit expenses and net operating losses experienced in different years and reported differently for financial statement and income tax purposes. Further, there are changes in prior year tax liabilities and additional changes required due to the reporting distinctions between GAAP and Statutory financial statements.

My review of the audit reports reveals the consistent reporting of 'net' deferred tax assets reported under audit. Specifically, in 2010 'net' deferred tax assets amounted to $4,170,000 and in 2011 'net' deferred tax assets equaled $9,495,000.

When preparing the estimate of value, I spoke with both the Tax Partner for Eide Bailly (auditors for BCBS) and the Tax Manager currently performing the deferred tax calculations for 2012. Their indication was that deferred taxes for 2012 (which were not yet completed) would suggest a further increase in the 'net' deferred tax asset balance.

Given the complexity of the deferred tax measurement to include access to historical income tax filings and prior year working papers as well as the 'reversing nature' of the resulting balance over time, it was my decision to assume that the level of estimated future tax benefit available to BCBS as reported under audit effective December 31, 2011 and adjusted internally for current income tax receivable was the best indication of future tax benefits available to BCBS as a going-concern.

Q. PLEASE EXPLAIN WHY YOU DID NOT MAKE A NORMALIZING ADJUSTMENT TO LINE ITEMS CONCERNING THE VALUE OF SOFTWARE CURRENTLY IN USE BY BCBS.

A. I did not obtain an independent appraisal of the system software currently in use by BCBS. All indications are that it is currently performing as required and able to support current operations. My best information is that current regulatory requirements include an upgrade from the ICD-9 system to the ICD-10 system for the entire United States Healthcare Industry effective October 2014. Current indications are that many health care providers are facing the difficulty associated with this massive upgrade and there are numerous expectations associated with the phase-in of the system across the country. One of the more practical expectations includes a two-to-three year phase-in of the new system where all industry competitors will run parallel tracks (dual systems) until the transition of all participants is complete.

Despite the fact that some potential investors may already have transitioned to ICD-10 or may enjoy more advance tangent software programs, it is more realistic to assume that many other potential-investors in the market place have yet to perfect the ICD-10 transition and may also be operating with less-than-optimum software capabilities. Hence, the current systems that have been relied upon historically by BCBS, will likely be continued to be relied upon into the foreseeable future as computerized communications among all industry participants are brought-up to a similar level. Absent near-immediate plans to replace or discard existing software, their value-in-use to BCBS continues.

Q. IF THE SOFTWARE CURRENTLY IN USE BY BCBS IS OBSOLETE AND WILL BE REPLACED SOON, WOULD THAT CHANGE YOUR OPINION ABOUT THE NECESSITY OF A NORMALIZING ADJUSTMENT TO THE SOFTWARE?

A. See earlier comments regarding the industry-wide upgrade to ICD-10. If the exchange of operating software was eminent and the cost for purchase and installation was contracted for then those adjustments might be appropriate. My understanding is that the current software is fully operational (within its limited capacity) and accomplishes what needs to be accomplished in order to generate a business profit. That capability has value. The current book value is reflective of the economic basis for the system that has been depreciated on a straight-line basis over its useful life. I gave no additional value to the software through the value measurement but I also did not reduce value below its current book value for an obsolescence that is being forced on the system by a mandated regulatory upgrade for the industry at large; because the older system will be required to continue doing its job currently through the date of upgrade October 2014 and thereafter for a period of time (currently estimated as two years) when the industry-at-large will be transitioning to the newer (more internationally approved) software capabilities.

Q. PLEASE EXPLAIN YOUR UNDERSTANDING OF THE PROJECTS IN PROGRESS BASED ON YOUR CONVERSATIONS WITH BCBS MANAGEMENT.

A. In response to MDS Question 1M10, BCBS indicated that "Projects-in-Progress" represented "accumulated purchases and development costs related to projects are placed in the Project-in-Progress account until the asset is ready for deployment or placed in[to] service. These costs would include any cost to place the asset in[to] service." The listing of Projects-in-Progress included nine (9) entries representing Quote-to-Card; ITS Host Real Time system; New Commission system; Data Warehouse; Network re-design and other smaller expenditures. BCBS commented that "Costs accumulated into this account relate to mandated initiatives of the Blue Cross Blue Shield Association or other initiatives *that were largely started prior to the planned alliance with HCSC. Because of the planned alliance and ultimate conversion to HCSC platforms, many of these costs will have very limited value (if any) beyond August 2014 when all business is scheduled to complete conversion to HCSC platforms*" (emphasis supplied).

Q. PLEASE EXPLAIN WHY YOU DID NOT MAKE A NORMALIZING ADJUSTMENT TO THE VALUE OF THE PROJECTS IN PROGRESS?

A. Under a Fair Market Value Standard of Value when assuming a Going-Concern Premise of Value the "planned alliance" with HCSC cannot be a decision trigger when adjusting the operations of BCBS for the fair market at large. The concept of a fair market value is a value appropriate to any hypothetical investor in the marketplace. When adjustments are made in anticipation of a specific transaction with a specific investor, then the Standard of Value has changed from Fair Market Value to Investment Value. The Investment Value focus is perfectly acceptable as a basis for measuring value but it is biased to a particular investor or investment group and it ignores other potential investors in the market place. Hence, an Investment Value is distinguishable from Fair Market Value which must work at maintaining a measurement that is most reflective of the continuing (going-concern) operations of BCBS without the synergies, potentials or advantages provided by any one specific investor.

Q. WHAT IS THE SOURCE OF THE GUIDELINES COMPANIES SELECTED?

A. Morningstar's Industry Premia Company List Report effective 2Q12, SIC 6324 provided numerous publicly traded companies transacting in the health insurance industry that also have at least 36 months of return data available. These companies generally represent more established industry competitors and most definitive of market trends.

Q WHAT IS THE SOURCE OF PRIVATE COMPANY FINANCIAL RATIOS USED FOR COMPARISON WITH BCBS?

A. The Risk Management Association (RMA) Annual Statement Studies, which collect comparative data that comes directly from financial statements of the small and medium-size businesses competing in the same industry as the subject business.

Q. WHY DID YOU SELECT THESE COMPARISON COMPANIES?

A. Because they are most representative of industry activity within the public marketplace and support lines of business similar to the general operations of BCBS.

Q. PLEASE SUMMARIZE WHETHER BCBS IS DOING BETTER OR WORSE THAN OTHER COMPANIES WITH REGARD TO KEY FINANCIAL INDICATORS.

A. BCBS outperforms comparison companies in some areas. It has shown continued growth in revenues and BCBS carries no interest bearing debt, which underlies its strong Coverage and Leverage Ratios comparisons with other private market competitors. BCBS has also maintained an increasing trend in total asset investment and positive surplus growth. However, its payment of claims is growing faster than its revenue suggesting a more vulnerable subscriber base. Also, the indicators show problem areas in the company's liquidity and profitability. Please see pages 31 through 35 of the expert report, along with Exhibits 5 through 10 attached to the report for more detail on public and private market ratio comparisons and a discussion of BCBS's financial indications as compared to other like companies.

Q. WHAT APPROACHES TO VALUE DID YOU USE TO ANALYZE THE FAIR MARKET VALUE OF BCBS?

A. The Income Approach, the Cost Approach, and the Market Approach. Descriptions of each approach are found at page 40 of the expert report.

Q. WHY DID YOU CHOOSE THESE APPROACHES TO VALUE?

A. I chose these approaches to value because they comprise the generally accepted basis from which all indications of value are developed and refined through selected valuation methods. These approaches are appropriate to apply to BCBS and the industry of health and medical insurance.

Q. PLEASE SUMMARIZE YOUR APPLICATION OF THE INCOME APPROACH TO VALUE TO BCBS.

A. Utilizing a Discounted Future Cash Flows Analysis I estimated the present value of future earnings of BCBS (defined as the discounted cash flows to invested capital) and capitalized the Terminal Year cash flows to invested capital as representative of normal operations extending into perpetuity.

Management provided a summary of projected financial balances for the annual periods 2012, 2013, 2014 and 2015. The revenue growth demonstrated in these management-projections was accepted as appropriate even though it surpassed expected industry growth rates forecast in external publications representing the same time period.

Projected operating expenses were adjusted for administrative expense reimbursements which also corrected the common sizing of total operating expenses to more closely approximate the percent of revenue achieved through historical periods.

For valuation purposes, the projections were extended for two additional years through 2017. The extended projections were achieved through the application of a rolling average based on management's projections between 2013 and 2015. The resulting cash flows were adjusted for reinvestment in working capital as well as required investments in capital asset strength.

Then, the residual cash flows to invested capital were discounted to a present value using a rate achieved through the application of a Weighted Average Cost of Capital, reflective of a public industry-based average capital structure.

Q. WHAT WAS THE NATURE OF THE ASSUMPTIONS MADE BY MANAGEMENT, REFLECTED IN THEIR PROJECTED FUTURE FINANCIAL PICTURE?

A. Management projected revenue growth between 2013 and 2015 that surpassed industry averages; during this same time frame, operating expenses were projected to exceed the historical percentage relationship between operating expenses and revenues. This inordinate growth in expense appears to exceed the cost-control focus BCBS management has developed since the 2009 recession and do not appear consistent with historical figures.

Q. WHY DID YOU ONLY PROVIDE A FIVE YEAR PROJECTION?

A. I only projected the expected economic benefits for five years because projections beyond five years are too tentative, relying heavily on speculation about the performance of the specific company or the industry as a whole. Beyond a five year time frame there is a reduced focus with regard to the regulatory environment, taxation, economic influences, and a host of other unknowns, which during the short-term of 1 to 5 years are more easily estimated. Projections beyond five years are simply too speculative to be reliable.

Q. WHAT OTHER ASSUMPTIONS WERE MADE IN ANALYZING THE VALUE OF BCBS USING THE INCOME APPROACH TO VALUE?

A. There are other assumptions regarding operating expenses, working capital requirements, capital expenditures, and the sustainable growth rate. Please see page 42 of the expert report for a discussion of the assumptions used in the Income Approach to value.

Q. WHAT ELSE DID YOU DO TO DETERMINE THE VALUE OF BCBS UNDER THE INCOME APPROACH TO VALUE?

A. I applied a discounted cash flow analysis as a method to determine the value of BCBS based on projected future cash flows. Discounted cash flow is an intuitive value measurement because it is a direct reflection of the future cash flow expected to be generated from purchasing the company. The discounted cash flow method requires three determinations:

1. A determination of the expected annual cash flows available to the company based on projected earnings. Such determination necessarily includes assumptions made by management

in their projections as well as assumptions made by the appraiser in normalizing the initial figures;

2. A determination of the future value of the cash flows at the end of the projection time frame, which is called the terminal value. There are various methods that can be used to estimate the Terminal Value depending upon the analyst's expectations for the future. The way the Terminal Value is computed in this report is a common assumption that after the discrete projection period of 1 to 5 years, the economic income will grow at some constant compounded rate into perpetuity. This version of the Terminal Value estimate continues the projection of prospective economic benefit with a simplifying assumption of a constant growth rate past the discrete projection period.

3. A determination of a discount rate for the present value of the projected annual cash flows and the Terminal Value. The Cost of Equity Capital and Cost of Debt Capital were based on data and factors relevant to the economy, the industry, the public market, and unique to BCBS as of the date of value. These costs were weighted in terms of the public market capital structure to arrive at the Weighted Average Cost of Capital.

The Cost of Equity (18.38%) was achieved through the Build Up Method of the Capital Asset Pricing Model (CAPM) as discussed on pages 42 and 43 of my report. This method was modified to include a Beta indication from the public market as inferred through the schedule on page 34.

Published betas for publicly traded stocks reflect the actual capital structure of the respective company. As such, they are referred to as levered betas, betas reflecting the actual financial leverage in the company's capital structure. In this circumstance, I identified 11 comparative companies that are currently being traded in public markets. Due to the fact that the individual financial leverage of guideline companies is considerably different I adjusted their betas in estimating the required rate of return on equity within the context of the CAPM. This adjustment requires the original betas to be unlevered, thereby releasing the impact of individual capital structures, and then re-levered with the median capital structure for the public market in the aggregate. The re-levered beta can now be utilized to adjust the Equity Risk Premium within the context of the CAPM.

Using the estimates of the Cost of Equity achieved through the CAPM and the median capital structure of the public marketplace and weighting them based on that assumed capital structure, the Weighted Average Cost of Capital (WACC) is achieved.

The WACC is a simple combination of the Cost of Equity times the percentage of common equity in the (public median) capital structure; plus the Cost of Debt (tax-affected) defined through the public market times the percentage of debt in the capital structure (market value). The resulting WACC used in the report was 14.86%.

After making these determinations these rates were applied to the cash flows achieved through the Discounted Cash Flow analysis to arrive at the indication of market value under the Income Approach. The figures showing the exact calculation for the estimate of fair market value under the Income Approach is shown on page 43 of the expert report.

Q. WHAT ARE THE TANGENT INVESTMENTS THAT YOU ADDED BACK IN AFTER APPLYING THE DISCOUNTED CASH FLOW ANALYSIS?

A. The tangent investments are assets that are not core to the direct day-to-day operations of BCBS. The amount that I added back in represents the Fair Market Value of all tangent assets, primarily investments in real property and investments in subsidiary companies, the value of which totals $88,167,024. These tangent assets and supporting calculations are delineated on page 17 of my report.

Q. WHY DID YOU CHARACTERIZE THESE ASSETS AS NON-CORE?

A. I included the Great Falls building, the Donovan Building, and recently acquired vacant land in my list of tangent assets because those assets do not generate revenue for BCBS as part of normal operations. My characterizations of these items as tangent assets is because the Great Falls building has been vacant for at least one year, the Donovan Building is leased to the Montana Department of Revenue, and the vacant land has no improvement on it that adds to the core generation of revenue for BCBS.

Q. WHY DOES THE SCHEDULE ON PAGE 43 INDICATE A SUBSTANTIAL DIP IN THE EXPECTED CASH FLOW TO INVESTED CAPITAL IN 2014?

A. All healthcare providers are required to begin their transition to ICD-10 system software by October 2014. BCBS management suggested that they would be able to complete the effort within an eight year time frame. For projection purposes, it was assumed that the implementation would follow a straight-line process at approximately $5 million per year. In addition to the advent of ICD-10, there is also the expectation that current FF&E would become obsolete and/or require updating or replacement on a continuing basis. For projection purposes, FF&E replacement costs are estimated at $3 million per year on a straight-line basis. These annual uses of cash flow are larger than the $2 million carve-out estimated for the first projection period. This $2 million expenditure agrees with current expectations for anticipated upgrades and/or replacement of existing FF&E.

It is also important to comment that these projection-based estimates do not include any reclassification of the expected ICD-10 carve-out as an offset to period utilization. In an effort to provide some relief to the industry, current regulations will allow a portion of the ICD-10 cost to be applied in the determination of the new Medical Loss Ratio requirements. Specifically, up to 0.3% of BCBS premium revenue can be included as healthcare benefits for BCBS subscribers in the determination of period Medical Loss Ratio.

Q. WHAT WAS YOUR DETERMINATION OF THE FAIR MARKET VALUE OF BCBS UNDER THE INCOME APPROACH?

A. $210,564,755

Q. MOVING ON TO THE COST APPROACH TO VALUE, PLEASE DESCRIBE YOUR ANALYSIS OF BCBS UNDER THIS APPROACH.

A. The Cost, or Asset-Based, Approach seeks to value the total assets of a company. To accomplish this, I used the capitalization of excess earnings method of identifying and valuing all tangible and intangible assets, as well as the replacement cost method to determine the value of the workforce of the business. These methods provide a collective measurement of value for BCBS.

Using the capitalization of excess earnings method, I considered all net tangible and intangible assets of BCBS to achieve an indication of value. The estimated normalized cash flow from company operations provides a return on all assets. By developing a rate of return on net tangible assets to be expected from the marketplace and applying that rate to net tangible assets of the business, the analyst can estimate the proportion of cash flows that reflect the investment in tangible assets. The remaining cash flow infers the existence of intangible assets.

By capitalizing the remaining cash flow, I estimated the collective value of all previously undefined intangible assets. The analyst can now add the known net tangible asset balance to the inferred intangible asset balance to achieve an indication of total net asset value.

However, this process ignores the impact of an Assembled & Trained Workforce which is not specifically defined as either a tangible asset or an intangible asset, which can be carved-out of operations and sold or leased separately from the business.

The Assembled & Trained Workforce is needed to underwrite the returns achieved from both sets of asset investments and accordingly, is not captured in the value of either set of assets, but is rather an independent measurement of value that must be computed and included in the total summation in order for the value of the business to be complete.

The value of the Assembled and Trained Workforce was achieved through a cost savings method. I included estimates of the cost to recruit replacements, including the necessity to hire temporary help. This category also includes advertising, media, and special fees associated with the process of recruitment. BCBS estimates that these costs would approximate a variable percentage of the employee's base salary. I also estimated the cost to train new employees, including the time needed for an employee to gain proficiency in their job to reach full productivity. I also estimated the costs associated with interviewing, deciding, and hiring a new employee, which vary with the position being offered.

To achieve a detailed understanding of these costs, I separately identified and valued each of five categories of employees, including executives, management, professionals, administration, and sales. Please see pages 44 and 45 of the expert report for further detail on the application of the cost savings indications of value.

Please see pages 46 and 47 for an explanation and table depicting the calculations applied within the Capitalization of Excess Earnings.

Q. WHY DID YOU USE THE CAPITALIZATION OF EXCESS EARNINGS METHOD WITHIN THE COST (ASSET-BASED) APPROACH TO VALUE?

A. There are two general methods in the Cost (Asset-Based) Approach to business valuation:

- The individual revaluation of all assets and liabilities of the business. This is frequently referred to as the net asset value method; and
- The collective revaluation of all assets and liabilities of the business. This analysis is usually conducted through the application of the Capitalized Excess Earnings method.

The US Treasury Department did not promulgate this valuation method in 1920 to estimate the value of the total business enterprise. Rather, this valuation method was created to measure the total value of intangible assets.

Through Revenue Ruling 68-609 the Internal Revenue Service has determined that it is logical from an economic perspective that the intangible value identified by the capitalized excess earnings valuation method can be added to the net tangible asset value of a business to estimate the total business enterprise value. But the ruling contains many ambiguities, undefined variables, and unanswered questions which make it unpopular because of the additional work the analyst must perform to achieve a collective revaluation.

The key in applying this method is to remember that the nature of identified intangible assets is that they can be separated from the business (uniquely separate from tangible assets) and can be sold or leased separately.

That quality is not true of the Assembled & Trained Workforce. This asset cannot be separated from either the tangible or the intangible assets when they are included in the total assemblage of assets as within a going-concern premise.

Accordingly, the Assembled & Trained Workforce underwrites the return on investment achieved by both the tangible assets and the intangible assets of the business even though it is not directly associated with the value of any other asset which can be separated from the business and sold or leased separately.

Nonetheless, the Assembled & Trained Workforce has a unique value and must be included in the measurement of the enterprise value of the business. Hence, the value for the Assembled & Trained Workforce is best measured as the cost savings to the businesses for not having to expend the time and resources necessary to create said workforce.

When performing the collective revaluation of all assets and liabilities of the business, the indication of value should include the net tangible assets, as normalized for market value, plus the total intangible assets inferred through the return of excess earnings, and the value for the Assembled and Trained Workforce needed to direct and activate this assemblage of assets.

I selected the Capitalization of Excess Earnings to specifically introduce the Assembled & Trained Workforce of BCBS which is comprised of 510 individuals responsible for the continuing operations of this dynamic assemblage of tangible and intangible assets.

Q. WHAT WAS YOUR DETERMINATION OF THE FAIR MARKET VALUE OF BCBS UNDER THE COST APPROACH?

A. $182,447,551

Q. UNDER THE MARKET APPROACH TO VALUE, PLEASE DESCRIBE YOUR ANALYSIS OF BCBS UNDER THIS APPROACH.

A. This approach uses sales transactions of comparable companies in the market to identify financial relationships between the sales price and the underlying financial performance of the purchased company, which can then be applied to the value of BCBS. The market approach emphasizes the economic principle of substitution, where a buyer will pay no more for something than for a substitute that provides equivalent economic utility.

The approach uses the price of stocks of selected guideline companies in comparison to BCBS's fundamental data to reach an estimate of value. Further description of the methodology to compare guideline companies to BCBS is found on page 48 of the expert report.

The eleven public guideline comparative companies are the same as those previously discussed. Exhibits 5 through 10 attached to the expert report provide a selection of data regarding the computed Market Value of Invested Capital for each public firm in comparison to various benefit streams available for comparison to BCBS. The public guideline companies selected are: American Independence Corp.; Aetna, Inc.; Cigna Corporation; Coventry Health Care, Inc.; WellPoint, Inc.; United Health Group Incorporated; Aflac Incorporated; CNO Financial Group, Inc.; Unum Group; Humana Inc., and; Health Net, Inc. A description of each of these guideline comparative companies is found at pages 48 through 53 of the expert report.

Following examinations of the benefits stream detail in Exhibits 5 through 10, I determined that the shifts in value suggested through the use of these benefits streams were too variable to offer a sense of reliability. Hence, the comparative metric selected for use is the Market Value of Invested Capital to the Book Value or Surplus of BCBS. The nature of the business and the need to reserve large collections of resources suggest that the most complete measurement of value would be the net measurement of all assets (tangible and intangible) as expected in the Book Value balance.

The schedule that depicts these Book Value metrics is presented on page 54 of the report. The application of these Book Value metrics is demonstrated directly beneath the schedule on page 54.

The core book value of BCBS was determined by taking the normalized book value and subtracting the tangent investments worth roughly $88 million, which were previously identified. This residual book value was then multiplied by the median market metric for MVIC/BVIC to achieve an indication of a book value for the core operations of the business of $100,161,723. Then by adding back the tangent investments removed earlier, the full indication of value for BCBS can be estimated.

Q. WHAT WAS YOUR DETERMINATION OF THE FAIR MARKET VALUE OF BCBS UNDER THE MARKET APPROACH?

A. $188,328,747

V. CONCLUSIONS

Q. GIVEN THE THREE VALUATION APPROACHES YOU USED AND THE THREE DIFFERENT VALUES DETERMINED UNDER EACH APPROACH, HAVE YOU FORMED AN OPINION WITH RESPECT TO THE FAIR MARKET VALUE OF BCBS?

A. Yes.

Q. PLEASE SUMMARIZE YOUR CONCLUSIONS REGARDING THE FAIR MARKET VALUE OF BCBS.

A. It is my opinion that the value of a 100% controlling-ownership interest in all tangible and intangible assets of BCBS, assuming a fair market value standard, as of June 30, 2012 was $193,790,157.

Q. PLEASE DISCUSS HOW YOU APPLIED THE THREE DIFFERNT VALUES OF BCBS DETERMINED BY THE THREE VALUATION APPROACHES TO REACH THIS CONCLUSION.

A. Using all of the information that I gathered and applying the process of valuation I have described, the fair market valuation of $193,800,000 is the result of a reconciliation process that assigns a weight to the three different approaches analyzed based on the reliability of each approach. In this case, I assigned an equal weight of 33% to the reliability of each approach. Please see page 55 of the expert report for a table showing the figures and weight assigned to each valuation approach and the resulting conclusion of fair market value.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

VERIFICATION

STATE OF CALIFORNIA)
) ss.
Los Angeles COUNTY)

I, Timothy Blackmer, being first duly sworn, upon my oath, state that I have read, know and understand the contents of the foregoing testimony and that the statements contained therein are true and correct to the best of my knowledge, information, and belief.

TIMOTHY J. BLACKMER

SUBSCRIBED AND SWORN to before me this 5th day of March, 2013.

NOTARY PUBLIC for the State of California
Printed Name: ______________________
(SEAL) Residing at ________________, California.

My Commission expires: ______________

STATE OF CALIFORNIA
COUNTY OF LOS ANGELES
Subscribed and sworn to (or affirmed) before me
this 05th day of March, 2013
by Timothy J. Blackmer
proved to me on the basis of satisfactory
evidence to be the person(s) who appeared before me.

JOHN K. CHO
COMM. #1929298
Notary Public - California
LOS ANGELES COUNTY
My Comm. Exp. Mar. 24, 2015

CERTIFICATE OF SERVICE

I hereby certify that a true and accurate copy of the foregoing was served on the 6th day of March, 2013, by US mail, first-class postage paid, to the following:

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