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WellCare Health Plans, Inc. (WCG)

Q1 2016 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to the WellCare First Quarter 2016 Earnings Conference Call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please note, this event is being recorded.

I would now like to turn the conference over to Angie McCabe. Please go ahead.

Angeline C. McCabe

Vice President-Investor Relations

Thank you, Kate, and thank you all for joining us this morning for a discussion of WellCare's first quarter 2016 results. Today we will be making forward-looking statements, including but not limited to, our 2016 financial guidance and outlook. Various risks and uncertainties such as those described in our filings with the SEC, including our Annual Report on Form 10-K for the year ended December 31, 2015 may materially impact those statements. While these risks and uncertainties may cause our future results to differ from today's statements, we are not undertaking any obligation to update or revise any forward-looking statement.

Certain financial information that we will discuss today includes adjustments to expenses related to previously disclosed government investigations and related litigation, transitory costs associated with our decision to change pharmacy benefit managers effective January 1, 2016, Sterling divestiture-related costs and Iowa-related costs that we believe are not indicative of long-term business operations.

Our forward-looking non-GAAP measures beginning in 2016 also exclude the amortization expense associated with prior acquisitions and we have conformed our 2015 results for this. We will identify results that have been adjusted. In addition, please refer to our news release published this morning for supplemental schedules that reconcile results determined under GAAP to our adjusted results. The news release is available on our website at, wellcare.com.

Our discussion today will be led by Ken Burdick, WellCare's Chief Executive Officer; and Drew Asher, the company's Chief Financial Officer. I will now turn the discussion over to Ken.

Kenneth A. Burdick

Chief Executive Officer & Director

Thank you, Angie. Good morning, everyone and thank you for joining us for our first quarter earnings call this morning. We are very pleased to report a strong first quarter and an increase in our full year 2016 guidance. More than a year ago, we laid out a plan to improve our near-term operational and financial performance while positioning WellCare for long-term growth. With investments in people, processes and tools since 2014, we entered 2016 with a strong foundation, a clear multi-year strategy and momentum from 2015.

Our first quarter performance demonstrates the progress we continue to make toward our target of 2%-plus adjusted net income margin on our existing business while layering on new business opportunities. This morning, I will review some of the highlights from the first quarter that demonstrate this progress, and then Drew will review the financial results from the quarter in more detail and provide comments on our 2016 outlook.

Let's begin with several highlights from the quarter. All three of our lines of business, Medicaid, Medicare and Medicare PDP produced year-over-year operational and financial improvements. This morning we reported adjusted EPS of $1.06, which was ahead of our expectations. Adjusted net income margin of 1.4% increased 70 basis points compared with the first quarter of 2015.

We are also pleased that we were selected and have entered into an agreement to participate in Nebraska's Medicaid Managed Care program effective January 1, 2017. Also during the quarter, we announced the acquisition of certain assets of Advicare, a Medicaid Managed Care organization in South Carolina. And as I discussed on our fourth quarter earnings call, we successfully transitioned our PBM to CVS Health on January 1. As we announced this morning, we raised our full year 2016 adjusted earnings per diluted share guidance to a range of $4.55 to $4.70 from our previous guidance range of $4.35 to $4.60.

I will now discuss each line of business. Our Medicaid business performed well this quarter, achieving modest growth and MBR improvement. The Medicaid business is benefiting from our improved cost structure produced by stronger clinical performance and our new PBM agreement. With regards to our Georgia Medicaid business, in September of last year, we received a Notice of Intent to Award a contract from the Georgia Department of Community Health to continue serving Medicaid beneficiaries in the state. It now appears that the new contract will not be effective until 2017. In the meantime, our focus remains on partnering with the Department of Community Health to serve Medicaid beneficiaries throughout Georgia.

Turning now to Nebraska's new Medicaid Managed Care program, Heritage Health. WellCare is one of three managed care plans selected to serve Nebraska's new state-wide, integrated Medicaid health program that will combine Nebraska's existing physical health, behavior health and pharmacy programs into a single, comprehensive and coordinated delivery system for approximately 230,000 beneficiaries. The new contract has a five-year term and is expected to begin on January 1, 2017. We are very pleased with our progress in Nebraska and the engagement of all the stakeholders in preparation for this integrated Medicaid program.

Lastly, CMS recently issued the final version of the Medicaid mega rule. It is generally consistent with the original proposal and we will work with our state partners to implement its various requirements over the established timeframes.

Turning now to our Medicare Health Plan segment, as we've communicated previously, our goal is to position this business for margin expansion and profitable growth. The performance of our Medicare business in the first quarter reflects our focus on stabilizing and improving the business through a more disciplined bid process and improved execution.

As expected, membership declined during the quarter. We expect to grow throughout the remainder of this year. We continue to make good progress as evidenced by our first quarter results, but we still have plenty of work to do to achieve our longer-term goals.

As we look forward, we are pleased with the changes to the HCC risk model and star ratings published in CMS' 2017 file notice. This has been a multi-year effort that began with engaging CMS and others to recognize the socioeconomic determinants on health status and has now led to the significant action in the final notice. We will continue to work with our regulatory partners to ensure that these changes fully account for the recognized disparities.

Turning now to our Medicare PDP segment. We are very pleased with its performance in the quarter which largely reflects an improved cost structure; a particular note is the successful transition of our PBM to CVS. This complex implementation was a significant operational success. As you know, our industry has experienced multiple PBM conversions that did not go smoothly. This successful transition is a clear example of the focus on change management execution at WellCare. The successful PBM conversion represents the strong traction that we have gained from our investments in people, processes and tools over the past couple of years. We've taken a disciplined, methodical approach to investing in and strengthening our infrastructure to position us for margin expansion and long-term growth.

I have previously mentioned our commitment to strengthening our management team. Last month, we announced that Darren Ghanayem joined the company as our Chief Information Officer. Darren spent more than 15 years at Anthem and has a broad industry experience. He and his team will leverage our strong technology platform to help drive innovative customer solutions and support company-wide growth efforts.

On last quarter's call, we discussed our growth goals, doubling our revenues between 2017 and 2021, and how we expect to achieve this. There are many growth opportunities in Medicaid and Medicare, particularly with program expansion to include complex populations and a growing M&A pipeline. Nebraska and Advicare are two such examples. We will continue to pursue opportunities where we believe we can add value, complement our existing business, and support our vision to be a leader in government-sponsored programs.

In summary, we are pleased with our first quarter performance, as it reflects our disciplined focus on execution and demonstrates our ability to meet our commitments and deliver consistent results. We've strengthened the business both financially and operationally, and we are on track with our multi-year strategy. We still have much to do. We are focused on delivering on our full year commitments for 2016, launching our new business in Nebraska, integrating our recent acquisition, and continuing to strengthen our capacity and capabilities for the exciting growth opportunities ahead of us.

I will now turn the call over to Drew.

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

Thanks, Ken. Let me spend a few minutes on each of our business segments, both in terms of first quarter performance and our outlook for the full year 2016. Then I'll round out the 2016 guidance elements and cover a few 2017-related topics.

For the first quarter of 2016, our adjusted EPS was $1.06, with an improvement year-over-year in all of our segments. This compares with $0.53 per share of adjusted earnings in the first quarter of 2015. To ensure comparability, both of these periods exclude acquisition-related amortization expense.

Each of our lines of business performed well in the first quarter, and while this is a very good start to 2016, we fully recognize that we are only one quarter through the year. Just like my comments last quarter, this is another quarter of the predictable and stable results that you should expect from WellCare. Not only have we stabilized, but we've meaningfully improved the operational platform upon which we expect to grow in 2017 and beyond, and there is certainly more runway for improvement.

For the first quarter of 2016, our Medicaid MBR was 89.9%, a 20-basis point improvement from Q1 2015, and ahead of our expectations. We are pleased with the early signs of our new Medicaid pharmacy cost structure effective January 1, 2016 as a result of our new PBM contract, and while we did see a pickup of influenza late in the quarter, it abated relatively quickly.

Overall, trends are stable and consistent with our expectations. As Ken mentioned, we've been very focused driving value to our state customers by actively managing trend through medical cost and care initiatives. Given our Medicaid results in the first quarter and our visibility into pharmacy cost performance, we are slightly improving our adjusted Medicaid MBR guidance for the full year to a range of 89% to 89.75%. And as always, we will continue to work with our state partners to ensure sound rate increases.

In our Medicare Health Plan segment, we ended the first quarter at 326,000 members, consistent with the guidance we provided in early January. While we aren't pleased that our Medicare Advantage membership declined by 16,000 members compared with Q1 2015, the actions we took through our 2016 bids were necessary to improve the financial footing of our Medicare products.

In the first quarter of 2016, we reported Medicare Health Plan's MBR of 84.6%, 250 basis points better than our Q1 2015 MBR. This is a satisfying result, which gives us a good start as we continue to drive initiatives to improve our Medicare Advantage business throughout the remainder of the year. So far, we are on track to achieve our 2016 guidance to improve the Medicare Health Plan's full year MBR 130 basis points, similar to the 130 basis point Medicare MBR improvement in 2015. We are building on the initiatives we have implemented to deliver on our commitments for 2016, and expect further improvement in our Medicare performance in 2017. Our PDP business generated an MBR of 94.3% in Q1 2016, compared with 99.5% for the first quarter of 2015, with volume approximately flat to where we ended 2015.

While no single year has the exact slope of the prior year, we are ahead of our plan for 2016, largely due to better than expected pharmacy rebates. Accordingly, we are revising the MBR to a range of 80% to 82%, which is 100 basis points better than our previous guidance.

Rounding out the first quarter results, our adjusted SG&A ratio was right on track for the quarter and was consistent with Q1 2015, at 7.3%. Favorable prior-year development was $65 million in the quarter, and as importantly, DCP is up three full days from the comparable period of Q1 2015. And while DCP is down 1.2 days sequentially, this is solely due to the timing of PDP payables. In other words, Medicare and Medicaid DCP is actually up sequentially as well, and we had over $600 million of parent cash at quarter end as well as $650 million of capacity on our new credit facility.

Based on our performance in the first quarter and an update to our assumptions for the full year 2016, but recognizing that it is still early in the year, we are raising our full year 2016 adjusted EPS guidance by $0.20 at the low end of the range and $0.10 at the top of the range. Therefore, our revised 2016 adjusted EPS guidance range is $4.55 to $4.70, up from our previous guidance range of $4.35 to $4.60.

As I just mentioned, the Medicaid and PDP MBRs are slightly improved from prior guidance. We are also including a provision for Nebraska Medicaid startup expenses in our revised SG&A range which pushed that to range of 7.8% to 7.9%, essentially the upper half of the previous range. And we slightly reduced the high end of the tax rate range, given the improved earnings outlook. All other guidance elements are the same as those we provided in February. Once again, we are pleased with the first quarter results and look forward to delivering on our commitments for the remainder of 2016.

Moving on to a couple of 2017 topics. Last month, CMS finalized the 2017 rates for Medicare Advantage. We were pleased that some of our comments were addressed and our 2017 rates improved approximately 130 basis points from the advance notice, which otherwise would have been slightly negative for WellCare. While this improvement from the advance notice was welcome, it should be put in context for 2017. Excluding typical coding trend and the absence of the ACA fee, the pure rate change in 2017 applied to our Medicare Advantage footprint will be flat to up 1%. We are close to wrapping up the construction of our 2017 bids to make continued progress towards our long-term goals for our Medicare business.

Continuing with 2017 and as Ken discussed earlier in his remarks, we are thrilled to be selected to serve the expanded Nebraska Medicaid program. This program is scheduled to commence January 1, 2017 and implementation preparations are already underway. We continue to seek out new organic growth opportunities, often leveraging our capabilities and experience in serving medically complex populations and we are prepared to seize opportunities through acquisition as well.

On this topic, we expect the Advicare acquisition to close late in the second quarter, which will add approximately $120 million of annualized revenue to our South Carolina Health Plan.

We are working every day to deliver multi-year margin expansion on our existing business as we selectively layer on growth opportunities, organically and through acquisitions. The first quarter 2016 results are another step towards our longer-term goal.

Operator, we'll now open the call up for questions.

QUESTION AND ANSWER SECTION

Operator: We will now begin the question-and-answer session. [Operator Instructions] The first question comes from Matthew Borsch of Goldman Sachs. Please go ahead.

Matthew Borsch
Goldman Sachs & Co.
Q

Yes. Could you just share with us your view on the impact of the changes in the Medicaid expansion rates; at least what you've seen or what you expect to see this year? I know it's been a pressure point for some plans.

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President
A

Yeah. On the Medicaid expansion membership, let me first put in the context. We only have 190,000 Medicaid expansion lives of which 136,000 of them are in Kentucky. And as we talked about a few quarters ago, we got a sizeable rate decrease in Kentucky effective 7/1/2015...

Matthew Borsch
Goldman Sachs & Co.
Q

Yeah.

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President
A

...which has now long been in our run rate. So the rest of the membership is sort of scattered across a few other states, so not a real significant part of our portfolio.

Matthew Borsch
Goldman Sachs & Co.
Q

And as we look ahead, what do you see? And are there specific contracting expansion or new market opportunities that at this point you can point us to for later this year or early 2017?

Kenneth A. Burdick
Chief Executive Officer & Director

A

Matthew, this is Ken. It's hard for us to predict when these new opportunities might emerge. We've talked in the past about a couple of them. I think, by name we've mentioned Oklahoma and North Carolina. North Carolina looks like it will likely slip into 2018 and potentially as far as early 2019, so these are dynamic processes. The sort of new awards for new managed Medicaid markets is just one of the half a dozen long-term growth channels that we have set our sights on.

Matthew Borsch
Goldman Sachs & Co.

Q

One more question, if I could, on the utilization trend. If I understood you correctly and I'm particularly focused on the Medicaid side given some of the pressure on one of your, if you mind, peer companies; I think you described a little bit of upward trend in the first half of the quarter, and then sort of normalizing in the second half. Is that accurate? And it would a little counterintuitive given the flu season which sort of impacted timing in the opposite way.

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

No. I'd say as we look at our trends and go deep into the drivers, very stable and consistent with our expectations. If you isolate influenza, you're right. It was surprisingly tame in the first part of Q1, but consistent with the macro data that we looked at as well, in March it was pretty heavy, but for a short time period. So I sort of set that aside from the fundamental underlying trends which look to be very stable year-over-year and sequentially.

Matthew Borsch
Goldman Sachs & Co.

Q

Great. Thank you.

Operator: The next question is from Tom Carroll of Stifel. Please go ahead.

Thomas Carroll
Stifel, Nicolaus & Co., Inc.

Q

Hey good morning. Yeah, so a follow-up question on your Medicare comments, Drew. MLR improved a lot year-over-year as you intended, but we're not seeing any further improvement contemplated in the guidance. I wonder if you could comment a bit more on that. Are you being conservative? Or do you think kind of all of the improvement that you're expecting is fully baked in there now?

And then secondly as a follow-up, how these results inform your MA bids for 2017? And particularly you commented that you saw 130 bps of improvement last year. You're looking for more of that again this year. Do you believe you're kind of there yet? I mean you mentioned further improvement next year, probably not to the same degree as this year. Maybe give us a finer point on that? Thanks.

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Sure. So the longer-term goal for Medicare Advantage from an MBR standpoint would be low-80% to mid-80%s. And so even with our guidance this year, as you can figure out, the midpoint is 85.88%. So we still have room to go to actually get that to a reasonable margin, which we think will create a very good sustainable product and business for the long haul.

With respect to this quarter, very pleased with what we saw in the quarter. As you know, one quarter doesn't make the year and there's nine months left in the year. So we really hesitate to readjust the Medicare Health Plan's MBR. Certainly, think about past periods where we've had to raise that MBR for various reasons and so I'd just point to the fact that it's early in the year, but the fundamentals underlying the first quarter look pretty good in Medicare. And if you isolate our Medicare DCP, it's actually up sequentially.

Thomas Carroll
Stifel, Nicolaus & Co., Inc.

Q

Okay. So 83% to 85% is probably where we should be thinking as the target for your Medicare Advantage business longer-term?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Low-80% to mid-80%s, correct.

Operator: The next question is from Andy Schenker of Morgan Stanley. Please go ahead.

Andy Schenker
Morgan Stanley & Co. LLC

Q

Hey, thanks. First just to clarify, when you highlight the 50 basis point increase in G&A, [ph] we're to assume the vast (26:18) majority of that is Nebraska, or is there anything else driving that metric?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Yeah. It's completely driven by the start-up cost in Nebraska.

Andy Schenker
Morgan Stanley & Co. LLC

Q

Okay. That's great. And then going back to think about your positioning to Medicare Advantage for next year, can you maybe talk a little bit more about how you plan to deal with the hits or lack thereof for next year? I mean, as we generally assume it's kind of mixed between what falls to bottom-line and what goes back into benefits. Any color there?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Well as you know, we're still working on our bids. We're finalizing them to submit them in very early June. So we're still in the middle of that process. That is one element of the bid construction process. There are many to consider. Obviously, the 0% to 1% pure rate increase is another factor that goes into positioning our products for 2017, with a goal of stability for our members and having attractive benefits, but stable from a member's perspective.

Andy Schenker
Morgan Stanley & Co. LLC

Q

Okay. And then, just one last one here. On the PBM conversion, obviously you've been highlighting that as a tailwind that we were expecting this year. Obviously, you benefited from some of the rebates last year. Can you maybe talk about how that actually trended versus your expectations? It sounds like the rebates continue to outperform expectations, but anything else we should be thinking about, how the PBM transition's been benefiting the numbers- or the MRs; any numbers would be obviously helpful. Thank you.

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Sure. There's both the financial benefit, but then also, as Ken referenced, the operational execution, which was a pretty important. And sometimes gets looked past by analysts and investors, but that is a huge milestone in the company, in terms of delivering and executing operationally on an extremely complex undertaking that we had planned for 11 months.

So, you're asking more about the financial impact of that. And you're right, as of 4/1/2015, we began to benefit from a new rebate arrangement managed in conjunction with CVS. That does continue to improve, and so that's one of the drivers, or really the driver, of the PDP improvement and guidance even as we get into 2016, but then also the actual unit cost. The cost structure, absent rebates, was not effective until 1/1/2016, so we're still only three months into that, in terms of reporting periods. And we like what we see so far on the Medicaid side, which gave us comfort to improve the Medicaid MBR for the full year as well. So it's still early in terms of playing out the rest of the cost structure, but we do like what we see so far.

Operator: The next question is from Dave Windley of Jefferies. Please go ahead.

David Anthony Styblo
Jefferies LLC

Q

Hi. Good morning. It's Dave Styblo in for Windley. Thanks for taking the questions. Maybe just at a higher level and forward-looking. If we look at your guidance this year, it looks like you're on track to 1.4%, 1.5% net margins, based on the updated outlook. I'm wondering if you can talk a little bit more about what inning you're in as it relates to the work needed to get to your 2%-plus goal? Maybe, what are the next key initiatives that will matter most? How much visibility you have to that 2% and then, maybe any additional precision you have about timing?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Sure. As I mentioned, we're on track. We have resisted the temptation to get overly specific about the timing. Suffice it to say that we've made good progress, but we don't view it as if we are close to the ninth inning. There is sufficient runway ahead for improvement, but we're building momentum with each year, and we like where we're positioned through the first quarter of 2016.

David Anthony Styblo
Jefferies LLC

Q

And maybe, just on the next key initiatives that you're working on. Obviously, the rebate here was, I think, something that really helped – helps you get started for the year, but what are the next key areas? If you could maybe shed a little bit more color on that?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Sure. Certainly, the pharmacy has been a strong contributor. As we look forward, it's continued improvement in our execution on the fundamentals, and I'll talk about the work that we're doing around utilization, and specifically in-patient utilization. I see that. While pleased with the progress, I see an awful lot more opportunity in that regard. So I see multiple years ahead for continuing to drive improved execution in that area of our business.

David Anthony Styblo
Jefferies LLC

Q

Very good. And then, could I come back just to Nebraska? How do you expect the profitability of that contract to evolve over those five years? You've obviously got some start-up costs going on this year, but then as you go forward to implementation, is this going to be similar to the other contracts, where perhaps you lose a little bit of money in year one, break even and then make profit in year three and beyond? Or is it a little bit...

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Yes.

David Anthony Styblo
Jefferies LLC

Q

...different because so much of the population was already in managed care?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

You just nailed it with your last comment. Now, none of these are ever exactly the same, but as we look at Nebraska, because the vast majority of this population has already been in a managed Medicaid program, we feel comfortable with the actuarial assumptions that have been developed. They're based on specific data to the beneficiaries in Nebraska. We don't have the rates finalized yet. So we're going to stop short of saying that we've got this buttoned down, but, for the reason that you mentioned, we think this will look much more like an existing piece of business, as opposed to that very difficult 18 months to 24 months, followed by profitability in the out years.

David Anthony Styblo
Jefferies LLC

Q

Very good. And then finally, just on M&A, obviously saw Advicare and the progress that you're making there. I guess you'd call that a tuck-in acquisition to complement your footprint. Is that the sort of M&A we should expect you guys to pursue more adjacent to the markets you're already in, to complement things, or how interested are you in pursuing new markets to start progress either more so on M&A or the case on the Medicaid side?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Sure. Certainly, we have a preference for the tuck-in acquisitions. They're straightforward. They strengthen our position in existing market. They're consistent to our approach of going deep, but we are also open to new markets that fit our strategic profile, both in the Medicaid space and in the Medicare space. And as you can imagine, we remain interested in opportunities that may emerge from the consolidation in the industry and divestitures that may result.

David Anthony Styblo
Jefferies LLC

Q

Very good. Thanks for the questions.

Operator: The next question comes from Josh Raskin of Barclays. Please go ahead.

Joshua Raskin
Barclays Capital, Inc.

Q

Thanks. Good morning. Just one quick one on Nebraska. The start-up costs, should we assume that's $10 million, $15 million and that's incremental costs that were not previously included in guidance but now in guidance? Is that fair?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Well, it's actually 5 bps, the range moved up and so that would be $7 million.

Joshua Raskin
Barclays Capital, Inc.

Q

Okay. Okay. But that wasn't previously. I mean I know you guys have assumptions for RFPs in development but this would be incremental above and beyond?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Yeah, it's correct.

Joshua Raskin
Barclays Capital, Inc.

Q

Okay. And then on the Medicare Advantage membership in Florida and New York to start the year, I guess just those two states specifically, were those product exits or were they just big benefit design changes and losses to competitors? I'm just curious what the drivers of the membership change was?

Kenneth A. Burdick
Chief Executive Officer & Director

A

Two major drivers as we had some significant benefit changes and we had service area reductions.

Joshua Raskin
Barclays Capital, Inc.

Q

Okay. So there were actually – and do you know how many – of the reduction, how much of that was due to service exits?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Well, it was both a combination of service area but more so products within service areas. So we actually – it was about 20,000 members company-wide that we – service area reduced or product reduced, that's the terminology that we use. So now that helped us with respect to our MBR improvement. It was about a third of what we expect to achieve in our MBR progression, but as we look forward which is probably the most important to the conversation, we believe that most of that's behind us. You're always looking at benefit structure and performance in various pockets, but given the last couple of years of pretty big shifts in service areas/product reductions, we're expecting to grow from this point prospectively in Medicare Advantage.

Joshua Raskin
Barclays Capital, Inc.
Q

Okay. That was sort of my next question. And when you say perspective, I know you said through the end of this year, but 2017 even with sort of the 1%-ish rate and with all the benefit design changes behind you, you think 2017 is an MA growth year?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President
A

Yeah. We do expect to grow, probably not yet. We're probably a couple of years away from industry growth rates of Medicare Advantage penetration, but we do expect to turn the corner from this point forward, the rest of the year. And our team will sign up for and get compensated based upon growing – having some growth in Medicare Advantage in 2017.

Joshua Raskin
Barclays Capital, Inc.
Q

Perfect. Okay. Thanks, Drew.

Operator: The next question is from Scott Fidel of Credit Suisse. Please go ahead.

Scott Fidel
Credit Suisse Securities (USA) LLC (Broker)
Q

Thanks. First question just on MA and just the PMPMs looked like they were up pretty nicely year-over-year, around 6% I'm calculating. Just interested, is that all related to the benefit design changes, the product and service changes that you made, or were there any true-ups impacting that as well? Basically I'm trying to understand whether we should think about that as the new run rate for PMPMs for the rest of the year?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President
A

That's a good question because that does fit into the last discussion where – between our bid actions, our product reductions, it wasn't an accident targeting lower-yielding products and areas and given the performance in some of those, and even some of the more product-nuanced decisions about – for instance we have a Part B give back product in Florida where we shrank in that specific product which actually had a pretty yield to begin with. So it was all that mix that did result in – we do expect a mid-single digit yield change year-over-year which as you know is a lot higher than the actual statutory Medicare rate change because of that mix.

Scott Fidel
Credit Suisse Securities (USA) LLC (Broker)
Q

Got it. Okay. And then just my follow-up question just around Part D and appreciate the long-term targets you gave us on the MA margins. Part D, you've generated an extremely strong margin here. Starting last year I think you had around a 10% EBITDA margin. Looks like you expect that strength to continue this year. Most competitors sort of cite this as being like a 3% to 5% type margin business, so just interested sort of where you think you can sustain your Part D margins long-term?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Yeah. When we look at margins we focus on net income because EBITDA can be misleading with the ACA fee in the lack of tax deductibility and other factors. So we are totally focused on net income, which then drives EPS. With respect to the PDP business, the low-80%s we believe is a good resting spot, long-term, for the MBR and PDP which balances achieving a reasonable net income margin with the ability to ultimately grow that business. Even though we don't have the same penetration opportunity that Medicare Advantage does, we should still be able to slightly grow that business over time and so that would be the balance given the risk corridor design elements of PDP.

Scott Fidel
Credit Suisse Securities (USA) LLC (Broker)

Q

Okay. Thank you.

Operator: Your next question is from Kevin Fischbeck of Bank of America. Please go ahead.

Kevin Mark Fischbeck
Bank of America Merrill Lynch, Inc.

Q

Great. Thanks. Maybe just kind of following up on that question. With the rebates, I guess, coming in better than what you thought this year, is that something that you would expect to hold on to until next year, or is that something that you would say while we're going to use the upside to kind of re-price and grow that business?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Well there's dozens and dozens of factors that go into the construction of the bid, not the least of which is your trailing performance, and more importantly, how you expect to perform prospectively. So that's one of many inputs into a pretty complex bidding process and strategy, which we'll be wrapping up in the next month or so.

Kevin Mark Fischbeck
Bank of America Merrill Lynch, Inc.

Q

Okay. And I guess I think you said there were $65 million of development in the quarter. I assume that was a gross number. Is there a net number that you'd point to?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Yeah. That is the gross number. That's the actual development from prior year. And so let me put this in historical context. In 2013, the company had $3 million positive, 2014 minus $48 million. And then as we started to perform better and execute better, $78 million for the full year of 2015 of prior year development. So the $65 million in the quarter, in a steady state really should get the majority of the prior year development early in the year, so in the first quarter. And so that is the gross number. And you're right. I can't tell you until three or four quarters from now what the actual net would be, but the same processes and approach that we used to set reserves at the end of 2014 and the end of 2015 were in place Q1 2016.

Kevin Mark Fischbeck
Bank of America Merrill Lynch, Inc.

Q

Okay. Let me ask just last question. I guess, I just wanted to clarify when you said that, I guess, that the upside in the quarter was on the pharmacy side. So we would kind of think about the guidance range kind of being largely attributed to that specific dynamic with everything else more or less in line with what you're looking for?

Well, the guidance change would've been Medicaid performance, including the pharmacy cost structure, so that was an important element. In the PDP business, the improvement in net MBR in the guidance was driven by rebates separate from the cost structure, but still pharmacy-related. And then the offset would be the 5 bps of SG&A and a little bit better tax rate, which is really just the math of the blend between your core operating earnings and the ACA fee.

Kevin Mark Fischbeck
Bank of America Merrill Lynch, Inc.

Q

Okay. Great. Thanks.

Operator: The next question is from Ana Gupta (sic) [Ana Gupte] (42:35) of Leerink Partners. Please go ahead.

Ana A. Gupte
Leerink Partners LLC

Q

Yes. Thanks. Good morning. So the first question, I just wanted to go back to the Medicare utilization. We had a couple of hospital companies that pointed to Medicare volumes being the driver of the accelerated utilization and/or case mix and med tech has been doing quite well. So how confident are you with your first quarter results that there might not be an uptick going forward in any kind of knock-on impact of CMS now to mixing this to midnight rule later in the year from fee-for-service to Medicare Advantage?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Well Ana, there's a lot to worry about in this chair in terms – forward trend being one of the most significant drivers of the company's performance. So we're not satisfied and we're not complacent with respect to the trends which is why we've got some pretty significant initiatives that we've been after for the last year and a half and there's still a pipeline of those. So it's our job to manage and bend that trend, but with respect to the first quarter specifically, relatively stable in terms of what we're seeing when we look at drivers on a rolling basis historically.

Ana A. Gupte
Leerink Partners LLC

Q

Okay. So nothing new or disturbing in the first quarter, right? That's helpful to know. On the second question – sorry.

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

I was going to say that's right.

Ana A. Gupte
Leerink Partners LLC

Q

Second question was about coding. The coding change that you talked about and as well as the star improvement, I thought you said it was flat to 1% on your book, which seems conservative. Is that what you netted out finally? How did that all play out with the 80/20 full duals, partial duals 60/40 that we had talked about? The first quarters there was a lot of optimism. Obviously February didn't pan out as well as expected but your book of business is probably as levered to this [ph] and (44:36) to the upside.

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Yes. Certainly, given our footprint with full duals versus partial duals, as you would expect, when CMS sets the revenue more precisely that would track with our membership. Now having said that, you'll recall that the advanced notice we had calculated at a slight decrease year-over-year in terms of revenue, largely driven by the fee-for-service normalization factor. And so when the final notice came out, there were some corrections made especially to that mechanic, which improved it, but didn't flip it all the way to a positive with respect to the fee-for-service normalization factor. So we went from slightly negative, up 130 basis points to that 0% to 1% positive range, with respect to the pure rate change. That excludes typical coding trend and that excludes the impact of the ACA holiday.

Ana A. Gupte
Leerink Partners LLC

Q

Okay. All right. So it's flat to 1%, but below the line on coding and on the tax holiday. Got it. Then the final question...

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Right.

Ana A. Gupte
Leerink Partners LLC

Q

... I had was on your – I think you were out of Iowa after winning. In Nebraska, I think you won after a protest on fee-for-service claims payment or some other factor, I believe. So, what have you learned from these two experiences? And as you look out into the pipeline that's coming out for other complex behavioral populations and long-term support services and so on. How confident do you feel that WellCare is positioned well to win some of these contracts, like Virginia or Pennsylvania or whatever?

Kenneth A. Burdick
Chief Executive Officer & Director

A

Well, Ana, the Nebraska, there was one particular section of the scoring that looked like there was an anomaly. So that was the significant area of protest, and one that the state agreed with. They went back, rescored using the instructions that had originally been provided, and that resulted in a win for us, and we were able to supplant two of the incumbents. As it relates to Iowa, we talked about that at a fair amount of length, there were certainly some lessons learned in terms of responding to the spirit of the question, as opposed to sort of a more literal interpretation of the question.

We have done an awful lot to strengthen our business development team. And when you hear me talk about people, processes and tools, I actually think all three of those investments apply quite nicely to the new business development team. So we strengthened the team. We have some new processes in place where we can better mind our experience and our data and our proof points. And we've provided better tools for them to work with, so that we can quickly turnaround some of that best practice and build that into our bids going forward. So I think we are well positioned. We have no allusion that these are highly competitive bids, but we are confident in where we stand right now.

Ana A. Gupte
Leerink Partners LLC — Q

Great. Thanks for the color. Appreciate it.

Operator: The next question is from Sarah James of Wedbush Securities. Please go ahead.

Sarah James
Wedbush Securities, Inc. — Q

Thank you. I'm wondering if you guys have looked into the new socioeconomic factors and star ratings, and how that would specifically impact you? So if you were to re-run the calculations, how much of a lift would that have created for 2016 ratings?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President — A

Yeah. You won't be surprised to know that we have done exactly that. We've modeled these changes. And if I break it up into two buckets, there's the changes relative to the HCC risk scoring, and those have some real tangible benefit going forward. While we are pleased with the recognition of the health disparities as it relates to star scores, when we did that modeling, it had a fairly minimal impact on the star ratings, which is why, in my prepared remarks I said, it is a victory that there's an acknowledgement of the reality of the socioeconomic disparities, but the solution, while a appreciated first step, we've got more work to do so that it fully and adequately reflects the difference in serving this population.

Sarah James
Wedbush Securities, Inc. — Q

Okay, that's helpful. And then last quarter, you spoke about really refocusing on M&A starting at the end of 2015. There was another acquisition in one of your core markets in New York. Is that something you guys considered? And can you give us any sense of scale of how robust the pipeline of opportunities is as a whole, or kind of what the landscape of opportunities size-wise looks like, in general for M&A in the sector now?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President — A

Sure. Let me see if I can give you some insight into the process. We are looking to build a robust pipeline. We want to be proactive in pursuing potential opportunities, but let me be clear. We're going to be very disciplined about only ultimately acquiring those assets that we think can be complementary, where we can be profitable, and fit our strategic blueprint. So there are many, many more that we will look at than that we will actually move forward with a purchase.

Sarah James
Wedbush Securities, Inc.

Q

Anything on the scale of opportunities out there, whether you compare it to what you've seen available the last few years, or however you think about how robust the opportunity landscape is?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Well, I'm not going to get too specific about the opportunities. From our perspective, we took a forced hiatus from this activity as we built out our infrastructure, as we developed some real momentum around our margin progression, so it wasn't until we had that in hand that we even started to embark on growth opportunities, specifically acquisitions. So we're relatively newly back in that space, starting with sort of the back part of 2015. We like the level of activity that we're starting to see, but it's a long-term proposition. And we believe there will be both Medicaid and Medicare M&A opportunities in the years to come.

Sarah James
Wedbush Securities, Inc.

Q

Thank you.

Operator: The next question is from Chris Rigg of Susquehanna Financial Group. Please go ahead.

Chris Rigg
Susquehanna Financial Group LLLP

Q

Hi. Good morning. You've touched on this subject a fair amount. But I just wanted to make sure I understand, when I'm thinking about Medicare Advantage growth, whether it's for 2017 or even beyond, when we're thinking about slow growth or marginal growth next year, should we think about that sort of same-store, no new counties, no new regions? And then at what point, and maybe it is next year, do you think you'll be ready to start progressing to newer parts of the country? Thanks.

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Yeah. We're already looking now at expansion because of the lead time that's necessary for filings, for network development is more than six months obviously. So we've already got a team looking on expansion for the future. We're going to be – start out cautious, and then we're going to ramp that up. And then also, depending on what assets are available for acquisition that will play into our calculus in terms of expansion opportunities as well, but you're right. That's more of 2018 and beyond discussion in terms of executing on new markets, but we're looking at that already.

Chris Rigg
Susquehanna Financial Group LLLP

Q

Okay. And then just a quick one here. Did you see any noticeable impact from the leap year? Thanks.

Kenneth A. Burdick
Chief Executive Officer & Director

A

Well, it's noticeable, right. The good news is we knew it was coming. So we were able to plan for it. So yeah, you can trace it back just factually. If you look at a calendar, there's an extra Wednesday in Q1 2016 versus Q1 2015. You'll notice that it was noticeably absent from our comments because it was planned for.

Chris Rigg
Susquehanna Financial Group LLLP

Q

Okay. Great. Thanks a lot.

Operator: The next question is from Gary Taylor of JPMorgan. Please go ahead.

Gary P. Taylor
JPMorgan Securities LLC

Q

Hi. Good morning. A couple questions. Just going back to the final MA rates, and make sure I understand that. So for 2017 you are saying slightly down, but you say it improved 130 basis points and now you're saying flat to plus 1%. What would be the scenario with the rate's only flat next year?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Well, it's a range that depends on the mix of our business. And so we think a 1% range is sort of the right way to frame that for investors.

Gary P. Taylor
JPMorgan Securities LLC

Q

Okay. And obviously you'd said that's before coding trend and health industry fee, are you expecting Medicare margins to improve in 2017 versus 2016?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Yeah. Consistent with our multi-year plan, we would expect continued progression. I mentioned that in my remarks. We absolutely are planning on continued improvement in Medicare Advantage until we get to a reasonable and sort of sustainable for the long run margin for that business.

Gary P. Taylor
JPMorgan Securities LLC

Q

Okay. And then just on the star rating, just following-up on Sarah's question. I guess what you're saying is based on the final rule, it would not have changed any of the star ratings for any of your existing plans?

Kenneth A. Burdick
Chief Executive Officer & Director

A

Gary, that might be a bit of an overstatement.

Gary P. Taylor
JPMorgan Securities LLC

Q

Okay.

Kenneth A. Burdick
Chief Executive Officer & Director

A

There were minimal changes in just a couple of plans. So, there was a tiny bit of movement, but didn't really move the dial much which is why we've characterized this as a step in the right direction, but much more work needs to be done in collaboration with CMS and others to more fully reflect the disparity due to socioeconomic status.

Gary P. Taylor
JPMorgan Securities LLC

Q

Okay. And then last question. On the $60 million or so of cost that are excluded as non-recurring from G&A, one of those is a PBM transition cost. Can you break out how much that is and then tell us how much longer we should expect PBM transition cost to be – or non-recurring costs to be impacting the P&L?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Yeah, good question. Q1 will be last quarter for both the PBM transition cost being outside of adjusted earnings as well as Iowa. And so what we're left with is any remaining tweak of the Sterling transaction item which would likely be pretty immaterial, and then ongoing amortization of acquisitions consistent with the industry, and then the investigation and legal costs which are continuing until that's resolved.

Gary P. Taylor
JPMorgan Securities LLC

Q

Okay. Perfect. Thank you.

Operator: There are no additional questions at this time. This concludes our question-and-answer session. The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.