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WellCare Health Plans, Inc. (WCG)

Q3 2016 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to the WellCare Health Plans 2016 Conference Call. All participants will be in a 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, ma'am.

Angeline C. McCabe
Vice President-Investor Relations, WellCare Health Plans, Inc.

Thank you, Denise, and thank you, all, for joining us this morning for a discussion of WellCare's third 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, and our quarterly report on Form 10-Q for the quarter ended June 30, 2016, may materially impact those statements. While these risks and uncertainties may cause our future results to differ from today's statements, we're not undertaking any obligations to update or revise any forward-looking statements.

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

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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 Generally Accepted Accounting Principles or 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, WellCare Health Plans, Inc.

Thank you, Angie. Good morning, everyone, and thank you for joining us today as we review our third quarter results and provide our outlook for the remainder of 2016. We are again pleased to deliver another strong quarter and increase our full year 2016 guidance.

This morning, I'll discuss some of the key items from the quarter and recent developments that give us confidence in our ability to achieve our multi-year commitments. Drew will provide more detail on our financial performance and revised 2016 guidance as well as our early view on the headwinds and tailwinds for 2017.

Throughout this year, we've consistently demonstrated our ability to execute on our multi-year plan to achieve our margin targets while positioning the company for growth. We continue to realize the benefits from investments we've made in people, programs and technology over the past couple of years. Today, we reported adjusted earnings per diluted share of $1.63 for the third quarter of 2016, with an adjusted net income margin of 2.1%, a 70 basis point increase from the third quarter of last year.

All three lines of business performed well during the quarter, particularly our Medicare Health Plans segment. This morning, we raised our full-year 2016 adjusted EPS guidance to a range of $5.35 to $5.45 from our previous guidance range of $4.95 to $5.05.

We are in the early stages of our multi-year growth plan. As evidenced by our selection to continue participating in the Missouri HealthNet Managed Care Medicaid program, our recently announced agreement to acquire Care1st Arizona and the upcoming implementation of our new Nebraska Medicaid contract.

We are very pleased that we received a Notice of Award from Missouri to continue serving Medicaid beneficiaries in the state. We currently serve approximately 117,000 Medicaid beneficiaries in 54 counties. Services under the new contract are expected to begin on May 1, 2017. Under this new contract, we will continue serving TANF and CHIP beneficiaries, but the program will expand statewide, so we expect to see growth in this market next year. Importantly, we scored the highest among the four bidders, an affirmation of the progress we've made strengthening our business, our development team, and our bid approach.

Turning to Nebraska. We are on track for a successful launch of our participation in Heritage Health, the state's integrated Medicaid program on January 1, 2017. One of our core competencies is providing integrated, coordinated care for Medicaid beneficiaries, especially those with complex needs. We continue to engage with all stakeholders, from providers to community-based services to deliver on our commitments to the Medicaid beneficiaries in Nebraska.

We also look forward to welcoming Care1st Arizona to our family of health plans. Care1st is a well-regarded, quality health plan that has served Medicaid and Medicare beneficiaries in Arizona for more than a decade. Through this acquisition, we will expand our footprint into an attractive, growing market. Care1st is aligned with our

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approach, focused on community-based relationships and the integrated delivery of medical care and social services to improve health outcomes for members.

Let's now turn to a discussion of our business segments. Our Medicaid Health Plans segment performance this year remains on track with our expectations. We continue to see the benefit from clinical initiatives designed to improve our members' health. You may recall that on last quarter's earnings call I discussed our field-based care management program that is now operational across all of our Medicaid markets.

This program delivers cost efficient and personalized care to our most complex members through in-person interaction with our care managers. It also enables us to address care gaps and connect members to much needed medical behavioral and social services. This integrated field-based model is consistent with the expressed goals of many of our state customers, to deliver a coordinated care and value to Medicaid beneficiaries with complex needs.

Moving now to our Medicare Health Plans segment, we are very pleased with its performance thus far in 2016. Membership increased sequentially from the second quarter, and the MBR improved 330 basis points year-over-year. This improved performance demonstrates our disciplined financial, operational, and clinical execution. This is the second year where we are benefiting from a more rigorous bid process designed to produce improved margins.

In addition, we are realizing the benefits of our improved care model, including our field-based care program and strengthened utilization management. Results from these initiatives are reflected in an improved MBR and over time, will drive improvements in quality. As we look forward to next year, our 2017 Medicare Advantage bids focused on achieving further margin expansion, with some modest membership growth.

I'd now like to turn to a discussion of our star ratings. We are disappointed in our plan year 2017 star ratings. 7 of our 12 Medicare Advantage contracts received an overall star rating of 3.0, and 5 of our contracts received overall ratings of 2.5. The 2017 plan year star ratings largely reflect activities performed in 2015 that were planned in 2014. We improved markedly on operational measures, such as customer complaints and appeals, and we continue to keep pace with the industry on HEDIS-based measures, but our overall scores declined, driven by our CAHPS and HOS scores. CAHPS stands for Consumer Assessment of Healthcare Providers and Systems Survey, and HOS stands for Health Outcomes Survey. We know we must improve our star ratings.

As many of you know, last September, Mike Radu joined WellCare to lead our clinical operations and business development efforts. Under his leadership, we created a physician-led team that works with leaders across the organization to improve our quality scores. Our team has developed a multi-year quality improvement plan with a more rigorous quality governance structure. Star measures are now managed under five categories, with a business owner responsible for end-to-end process improvement. Within these categories, every single star measure also has an individual owner responsible for driving results.

In 2017, we will utilize a significant portion of the ACA holiday to expand our investment in quality. For example, we're expanding our quality practice advisory program, which pairs nurses with providers to help better coordinate our members' care.

Our partnerships with providers are critical to driving quality for our members. We will continue to invest in value-based provider relationships that align reimbursement with quality and financial performance. For those providers who are either unwilling or unable to bear financial risk, we will continue with our pay-for-performance programs aimed at achieving specific quality outcomes, and closing gaps in care.

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Improving our star ratings is a multi-year companywide effort, and it's a top priority for me and the entire organization. We are attacking this initiative with the same energy, discipline and commitment that we brought to bear on our multi-year margin expansion strategy.

Turning now to our Medicare Part D segment. It again delivered strong results in the quarter, primarily as a result of our 2016 bid strategy and our improved pharmacy cost structure. We've made significant progress in improving the performance of our PDP business over the past couple of years. Our PDP core competencies strengthen our Medicare and Medicaid lines of business. We have a national PDP presence that allows us to leverage pharmacy pricing across our portfolio of businesses.

We've built strong momentum as we begin to close out 2016 and enter 2017. Like our first and second quarter performance, our third quarter results demonstrate the tangible progress we are making toward achieving our multiyear strategic plan. All lines of business are producing consistent results. Margins continue to improve. We successfully retained our Georgia and Missouri Medicaid contracts. We recently announced the Care1st Arizona acquisition, and we closed our acquisition of Advicare in South Carolina.

WellCare is well positioned for continued success. And as Drew will discuss, the strength of our balance sheet positions us to take advantage of the many opportunities that will fuel our growth in the coming years. While there is still much more work ahead, 2016 is shaping up to be a very successful year for WellCare.

I'll now turn the call over to Drew for a discussion of our financial results and outlook. Drew?

Andrew Lynn Asher

Chief Financial Officer & Senior Vice President, WellCare Health Plans, Inc.

Thanks, Ken. Let me spend a few minutes on the results and metrics from each of our business segments related to Q3, then I'll round out the 2016 guidance elements and provide insights into headwinds and tailwinds for 2017. For the third quarter of 2016, our adjusted EPS was $1.63. This compares with $1.04 of adjusted EPS in the third quarter of 2015 representing a 57% increase year-over-year.

The strong performance was well distributed across our businesses. While there's certainly still room for improvement, 2016 is shaping up to be a very good year for WellCare. Let's go through each segment. For the third quarter of 2016, our adjusted Medicaid MBR was 90.9%, basically consistent with 90.7% in Q3 2015.

With the year-to-date MBR in Medicaid of 89.2%, we are right on track for our full year 2016 guidance range of 89% to 89.5%. Let me go over a few of the Medicaid-related items that impacted this quarter. In Q3, we received payments related to the Florida retro revenue that we discussed on the second quarter call, therefore, during the third quarter we recorded an additional $7.8 million of retro revenue, virtually all of which related to 2015 and prior. This is in addition to the $18.7 million we recorded in the second quarter. This totals $26.5 million which we have recorded and collected to date. When you examine our reported results for year-to-date 2016, it is important to note that $15.5 million or $0.22 in adjusted earnings per share of this retro revenue relates to periods prior to 2016.

Looking ahead in Florida, we received an approximate 7% rate increase effective September 1, which included compensation for the change in hepatitis B authorization criteria. It included certain pass-through's and Revenue Code changes as well as normal trend. Staying on the theme of rates, you will recall from the second quarter earnings call that effective July 1, we received a rate decrease of approximately 3% across our Kentucky Medicaid business, the effect of which is embedded in our third quarter results.

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Beyond our current Medicaid footprint, we're very pleased with the tangible signs of growth in our Medicaid business. We look forward to the official launch of our 10th Medicaid state, Nebraska, which we won earlier this year through an RFP process focused on capabilities and experience. And last month, we announced our 11th Medicaid state, Arizona, which we'll enter through acquisition. As Ken mentioned, we are pleased with the opportunity to serve both Medicaid and Medicare beneficiaries in Arizona. We expect the transaction to close by the first quarter of 2017 with annualized revenue of approximately $400 million. This is a well run health plan and we expect Care1st Arizona to add approximately $0.10 of accretion to adjusted EPS in the first year post closing.

Staying on the theme of Medicaid growth, as Ken noted, we are very excited to be the highest scoring winner for Missouri's expanded Medicaid program expected to commence May 1, 2017. With the expanded geography, this will be another 2017 revenue and membership growth driver for WellCare.

Moving to Medicare Advantage. Similar to the second quarter, we are very pleased with the continued progress in our Medicare Advantage business posting a year-over-year MBR improvement of 330 basis points.

We also grew 7,000 members sequentially or 2% during the quarter. We continue to see improvements from our enhanced care model, clinical initiatives, increased engagement with our members, and a more disciplined bid process. Accordingly, we are lowering our 2016 MBR guidance 50 basis points at the midpoint.

Our PDP business performance was ahead of our expectations in the quarter with a year-over-year MBR improvement of 120 basis points. Our PDP business continues to perform well driven by cost structure and execution. With a year-to-date MBR of 78.1%, we are lowering our full year MBR guidance to a range of 77.5% to 78.5%. As a reminder, as we reached these levels of performance, we have an increased risk corridor payback to CMS, which results in a meaningful reduction of GAAP revenue given the accounting for risk corridor paybacks as a contra revenue item. Accordingly, we are forecasting 2016 PDP revenue to a full-year range of $800 million to $850 million. Rounding out the third quarter results, our adjusted SG&A ratio in the third quarter was on track with our expectations, and our revised guidance is now at the high end of our previous range at approximately 7.9%.

Remember that the fourth quarter includes a steep transitory increase in spending with the annual enrolment period and other late year spending such as Nebraska implementation. For example, last year, Q4 adjusted SG&A was 9.0%. Favorable prior-year development was $41.4 million in the quarter. DCP at 49.2 days is stable to Q2 and up 3.6 days from the prior-year quarter.

As you can see, our parent cash balance grew to $888 million, despite paying down $100 million of our outstanding revolver. We have earmarked $157.5 million of this balance for our Care1st Arizona acquisition. The remainder of our capacity is available for future growth opportunities.

On our cash flow statement, we benefited from an extra CMS payment in the quarter on the last day of September. This payment totaled $683 million and it will reverse in the fourth quarter. This does not impact our parent cash balance we just discussed, but does positively affect our balance sheet and cash flow statement.

Based on our Q3 performance and our outlook for the remainder of this year, we are raising our full-year 2016 adjusted EPS guidance by $0.40 at the midpoint to a range of $5.35 to $5.45. While we still have one quarter left in 2016, we are focused on taking actions that will drive performance in 2017 and beyond. We are still working on our official 2017 plan and intend to issue 2017 guidance the week of December 19.

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But for now, let's go through the 2017 headwinds and tailwinds we currently see as we sit here today. Starting with headwinds, as I stated earlier, 2016 includes $0.22 per share of Florida retro revenue related to 2015 and prior. So, right off the top, you should remove that from the baseline for the bridge to 2017. As mentioned earlier, this year's 3% rate decrease in Kentucky has created a headwind for our $2.4 billion in revenue Kentucky contract.

In Georgia, while we were pleased to be selected earlier this year for the new Medicaid contract effective July 1, 2017, the addition of the fourth carrier will cause membership attrition in the back half of 2017 in Georgia as the new carrier is allocated a critical mass of membership. And in our PDP business, we bid to a low-80%s MBR for 2017 similar to this year, and while looking back we were able to outperform our bid so far in 2016. We won't assume that as we enter 2017.

In the category of tailwinds, we expect to see continued improvement in Medicare Advantage margins in 2017. The Florida rate increase, we just received effective September 1 will flow into 2017 and we have a number of revenue drivers for 2017. As I discussed earlier, we expect our Care1st Arizona acquisition to be a contributor at both revenue and adjusted EPS for the post-closing period in 2017. And we have a couple of organic wins in 2017. Nebraska Medicaid expected to be effective January 1 and the expanded program in Missouri, effective May 1.

Capital deployment should also be a tailwind as we look ahead, in other words, converting our dry powder to new sources of accretion. While we are pleased with our performance in the third quarter and the momentum we have built in 2016, we are not satisfied. We still have work to do, most notably in Medicare Advantage, including actions we will take over the next five quarters to improve long-term star ratings. And while we are very excited about the near-term growth drivers in Nebraska, Arizona, Missouri, we are going to seek out and seize additional growth opportunities that will be available in the government program space.

Operator, we will now open the call for questions.

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QUESTION AND ANSWER SECTION

Operator: We will begin the question-and-answer session. [Operator Instructions] We have a question from Peter Costa from Wells Fargo Securities. Please go ahead. Mr. Costa, is your line muted?

Peter H. Costa
Analyst, Wells Fargo Securities LLC

Q

Hello. Sorry about that. Nice quarter, guys. Congratulations. One question that I have, in terms of your guidance, you pushed out SG&A guidance. Is that for planned expected spending in the fourth quarter that's now increased for perhaps star scores and things like that for next year, or more marketing for next year, is that why you've pushed that number?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President, WellCare Health Plans, Inc.

A

Yes. It's the top end of the previous range of 7.8% to 7.9% with another quarter under our belt and you're absolutely right, Pete, as we look ahead, and we're spending already in the fourth quarter, we look at having the capacity to make additional investments. Some of those investments will show up in MBR, the quality related ones, but some of them will be in SG&A, and that's why we went to the high end of the SG&A guidance range.

Peter H. Costa
Analyst, Wells Fargo Securities LLC

Q

So without that increase, your performance would have actually been better, in terms of your overall earnings per share guidance increase?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President, WellCare Health Plans, Inc.

A

Well, you're isolating one element in a vacuum, but, yes. If we didn't go to the top of the range, our guidance would have been a little bit better.

Peter H. Costa
Analyst, Wells Fargo Securities LLC

Q

Thank you.

Operator: Our next question is from Kevin Fischbeck from Bank of America Merrill Lynch. Please go ahead.

Q

Hi. This is [indiscernible] (26:56) on for Kevin Fischbeck. One of the questions we have is that you guys have a lot of capacity to build, kind of, what does the pipeline look like for you guys? And Tenet indicated that they're getting out the health plan business, any interest in those assets?

Kenneth A. Burdick
Chief Executive Officer & Director, WellCare Health Plans, Inc.

A

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Okay. This is Ken. I heard most of that question, but can you just repeat the portion about getting out of the health plan business? What was the reference?

Q

Tenet.

Kenneth A. Burdick
Chief Executive Officer & Director, WellCare Health Plans, Inc.

A

Oh, Tenet, Tenet. Okay. Well, we won't comment on specific transactions. What I will tell you is that the pipeline is building, as we have increased the resources applied to our business development effort and we're now actively sourcing new opportunities, as opposed to simply waiting until somebody begins a process. So, the pipeline is going to become more robust in the coming months, and we feel there are sufficient attractive opportunities out there that Care1st would be a great example of the types of assets that we see available in the coming years.

Q

Just one more additional question. Would Medicare and Medicare Part D MLR coming in below expectations, since you guys bid for 2017, should we be kind of looking at it? I think recently, like on the call, you just said that you guys were not expecting to have your 2017 be, even though you beat this year. Was just wondering, kind of like, should we still take it as a good sign for 2017 MLR in these products, since you're apparently bidding off, kind of, like a higher 2016 cost base?

Kenneth A. Burdick
Chief Executive Officer & Director, WellCare Health Plans, Inc.

A

Yeah. At this stage of the year, we think it's prudent that we're going to plan and guide for 2017 consistent with the bid. So, I think you ought to take it as good news for 2016, but as it relates to 2017, we would need to see development over the months before we would guide to anything other than exactly where we submitted our bid.

Q

Okay. Thank you so much.

Operator: Our next question is from Matthew Borsch from Goldman Sachs. Please go ahead.

Matthew Borsch
Analyst, Goldman Sachs & Co.

Q

Yes. Just couple of things; on the Florida retro revenue, are you done with that, or is there going to be a little bit more in the fourth quarter?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President, WellCare Health Plans, Inc.

A

That's to be determined, Matt. There is another amount that purely relates to 2014 and 2015. But that additional amount requires legislative appropriations. And so, that needs to play itself out, and that may take a little bit

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longer. But if and when we get that amount, whatever that amount may be, we will provide transparency to investors, and it'll really – should really be viewed as an amount that relates to years prior to 2016.

Matthew Borsch
Analyst, Goldman Sachs & Co.
Q

And just on a couple of items for the fourth quarter. Can you just comment, directionally, are you expecting a significant uptick in your Medicare drug plan MCR relative to the very low level that you had this quarter? And then also on the tax rate, if you can comment on where you were this quarter, versus where you sort of expect to be?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President, WellCare Health Plans, Inc.
A

Yeah. On PDP, interestingly, and this was similar last year but less pronounced. Whereas going back in the past of PDP, you'd expect a sort of this linear drop. We actually have a slight sort of uptick in Q4 relative to Q3, and Q3 ends up being the trough. That has to do with the interplay of the positioning deep into the risk corridor payback and how pharmacy rebates impact that calculation. So we do expect, as you can infer from our guidance, an uptick in Q4. But still ending the year sort of right around 78% plus or minus, per our guidance.

On the tax rate, it's interesting. The tax rate fundamentally doesn't really change that much but the distribution between core earnings and a fixed ACA fee is what causes the aggregate tax rate guidance to change. And so, as we outperform, our previous guidance, you have to sort of blend those two things together, and that's why the tax rate drops as the core earnings of the company improves.

Matthew Borsch
Analyst, Goldman Sachs & Co.
Q

Okay. So it just really depend on where you come out in the fourth quarter. And then the last question I had, just on the Missouri contract starting on May 1, I think you characterized that more as a tailwind and a headwind, but wouldn't you expect to start that out somewhat unprofitable in the first year?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President, WellCare Health Plans, Inc.
A

Well, the MBR is typically higher on newer populations. But given that we've got infrastructure and an existing health plan and this is really just rolling in a couple of new territories, it shouldn't be like a new population in a new state that's never had managed care, so, that's how we'd look at it.

Matthew Borsch
Analyst, Goldman Sachs & Co.
Q

Okay. Thank you.

Operator: The next question is from Ana Gupte from Leerink. Please go ahead.

Ana A. Gupte
Analyst, Leerink Partners LLC
Q

Yeah. Hi. Thanks. Good morning. My questions were on the margin outlook for 2017 for each of your segments. The first one on Medicaid, when you contemplate all the puts and takes with the rate increase in Florida, but you

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may have some start-up pressures or otherwise in Nebraska and elsewhere. Net-net, are you expecting margin expansion in Medicaid for next year or MLR improvement [indiscernible] (33:08)?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President, WellCare Health Plans, Inc.

A

Yeah. On this call, we laid out some obvious headwinds and tailwinds that we wanted to identify for you. We look forward to the week of December 19 laying out specifics including what we expect 2017's Medicare MBR range to be.

Ana A. Gupte
Analyst, Leerink Partners LLC

Q

Okay. Thanks. On the PDP, the high-70%s loss ratio, at least whatever I've seen from your peers, this is quite extraordinarily outperforming. So what is driving that? Is that the PBM contract? And you talk a little about it may be flat to maybe deteriorating a little next year. What are the factors or drivers that influence where you are now and where you might go going forward?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President, WellCare Health Plans, Inc.

A

Well, you'll recall from last year, we reported a 78.7%. So this is the second year in a row in the high-70%s. I do agree with the assertion that, that is unusually good because, when you're in the high-70%s you're well into the risk corridor or you're paying back the lion's share of outperformance to CMS. And so as we look ahead, when you have visibility in that outperformance, like we did going into the 2017 bids, you basically have to bake that into your bids and it becomes a benefit, so, paying it back to CMS becomes a benefit for the members and your positioning and your competitive positioning. So that's why we think – and we bid to a low-80%s MBR as I mentioned in my script.

Ana A. Gupte
Analyst, Leerink Partners LLC

Q

Okay. Thanks. So that's kind of a balancing act, if you will. And finally on Medicare Advantage, you say very confidently you'll expand margins next year. You're using, though, you say the [ph] hist (35:11) reprieve largely on quality. Will that be also falling to the bottom line? And how are you thinking about how this all plays out into 2018, when this may not be renewed if you will and what this all does in for 2018?

Kenneth A. Burdick
Chief Executive Officer & Director, WellCare Health Plans, Inc.

A

So, when we think about Medicare Advantage, as we said in our prepared remarks, we feel good about the progress that's been made. But let me be clear, by no means have we hit our stride and performed at the level that we're capable. So, there is still runway in 2017 and 2018 as we prove our underlying performance.

So, you've heard us talk about things like stronger utilization management, this field-based care model, those things will continue to get refined and improved upon. So, we've got capacity for improved performance and we look forward to demonstrating that in both 2017 and 2018.

Ana A. Gupte
Analyst, Leerink Partners LLC

Q

Okay. So, run rate improvement.

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Kenneth A. Burdick
Chief Executive Officer & Director, WellCare Health Plans, Inc.
A

Correct, correct.

Ana A. Gupte
Analyst, Leerink Partners LLC
Q

Thank you. Great quarter.

Operator: Next question is from Chris Rigg from Susquehanna Financial Group. Please go ahead.

Chris Rigg
Analyst, Susquehanna Financial Group LLLP
Q

Good morning. Just wanted to add about the Florida rate increase. Seems a little higher that I would have expected. Is there anything unusual embedded within that that it sounded like there might have been some puts and takes with regard to pass-through payments? I'm just trying to get a sense for how much kind of just falls through to the bottom line versus has to be paid out to the hospitals or some other provider?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President, WellCare Health Plans, Inc.
A

It's a good question and I've listed a few of the elements that are embedded in the 7%, because at the end of the day when you back those out, like now there's a match. You remember we talked about the mismatch last quarter. Now, there's a match between the hepatitis C cost because of the relaxed criteria change and the revenue. So, that is compensation for that additional cost.

There are also elements. There's physician compensation increases. There's Revenue Code changes. So, there's always a lot of these – a number of these elements that either are passed through directly or intended to match revenue and cost. And then beyond that, there's a normal trend increase embedded in the 7%.

Chris Rigg
Analyst, Susquehanna Financial Group LLLP
Q

Okay. Great. One thing in the quarter, it looks like you raised the ACA fee revenue guidance by $8 million to $10 million but did not take up the expense amount by a similar level. What's causing the difference there?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President, WellCare Health Plans, Inc.
A

Yeah. While on the expense side, it is factual. I mean, you know that pretty closely in advance, and we wired $228.4 million to the IRS so that on the expense line that is a fact. The reimbursement process from states, while there's commitments from each of our states, there's a gross up for taxes and so you have to work those calculations out with each state, and we had a true up in one of our states and so we adjusted that.

You should think of that as $60.5 million each quarter would be sort of a straight-line amount, and then you're right, there's an extra $7 million more than that in the third quarter, about $0.10 if you isolate that item. But it's related to 2016. It's just a true up of the prior couple quarters.

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Chris Rigg
Analyst, Susquehanna Financial Group LLLP

Q

Got you. Okay. Thanks a lot.

Operator: Next question is from Scott Fidel from Credit Suisse. Please go ahead.

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

Q

Thanks. First question, just interested what you've been seeing sort of over the last six months on core Medicare utilization. We've at least been seeing in our hospital trackers just some really low hospitalization trends in Medicare and just wondering if you've been seeing that as well and have a sense of maybe what's driving these lower Medicare cost trends, if you're seeing them?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President, WellCare Health Plans, Inc.

A

We are seeing low inpatient trend and that certainly, some of that is the unique opportunity here with the work we've been doing around utilization management and our clinical programs. So, our very low inpatient trends are aided by our healthcare quality initiatives.

On the flipside, outpatient trend is higher and there's a shift – sort of an ongoing shift from inpatient to outpatient which is good. So, there's a balance there, but if you're talking specifically about inpatient, we're observing that as well, although we believe we're influencing that to some degree.

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

Q

Okay. So, you think it's really just a combination of the long-term shift from inpatient to outpatient that we've been seeing and then, some of your action that you've been taking that there's nothing sort of unusual that's also playing out here on the inpatient side of Medicare this year?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President, WellCare Health Plans, Inc.

A

That's what we attribute the drivers to.

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

Q

Okay. Just had a second question too just on – I know you spiked out the prior year development from the 3Q results, do you have an estimate, Drew, just what the full year prior year development is that's flown through for 2016? And then, sort of looking at the development, would you say that sort of all this is just, you know that you've now taken a more conservative approach to how you establish reserves and sort of assume margin for average deviation or are there any unusual type of prior period developments that you've seen in 3Q?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President, WellCare Health Plans, Inc.

A

Yeah. We try to provide transparency into the gross prior year development. And so, we don't attempt to estimate what might have been theoretically replenished, but when you look at DCP, you can sort of make a judgment on

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that. I will say that, in a year where you have a pretty abrupt positive turnaround in the business, like our Medicare business for instance, and even to some extent Medicaid as we finished out 2015 and enter 2016, probably going to have a little bit more than you would otherwise in a steady state.

But, as you noticed, we didn't list it as a specific headwind at this point in the year. I would expect the prior-year development to subside pretty meaningfully as we get into Q4, but we'll have to see how that plays out.

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

Q

And do you just have the updated estimate for the year-to-date prior-year development?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President, WellCare Health Plans, Inc.

A

It's $140 million year-to-date.

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

Q

Okay, great. And then just had, just one last question and sort of going back to a similar question, I know had been asked more specifically about Tenet. But actually, just maybe wanted to ask about that more generally as it relates to the pipeline, and we've definitely seen a lot of the provider-owned plans getting pretty roughed up at this point.

A lot of that has to do with the exchanges, but does seem like we've seen some pressure on some of these provider plans too, on some of the Medicaid business lines as well. As you guys think about sort of the quality of assets in terms of the pipeline, how do you guys think about, sort of, the provided-owned assets and the opportunity there, as compared to sort of some of the classic health plan assets out there?

Kenneth A. Burdick
Chief Executive Officer & Director, WellCare Health Plans, Inc.

A

Well, it's a good observation. As we build out our pipeline, we absolutely see that more than would have been the case three, five or more years ago. These provider-sponsored assets look like they could become available, both in Medicaid and Medicare. And if you recall, the Advicare acquisition would be an example of that. So yes, we think that is a part of the increasingly robust pipeline that we look to build over the coming quarters.

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

Q

Okay. Thank you.

Operator: Your next question comes from the line of Josh Raskin from Barclays. Please go ahead.

Joshua Raskin
Analyst, Barclays Capital, Inc.

Q

Hi. Thanks. I just want to make sure I got that right, Drew. The starting point for 2016, take out the $0.22, you're just similarly assuming that PPRD next year runs at a typical level, is that the way you guys will give guidance, including some favorable development?

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Andrew Lynn Asher
Chief Financial Officer & Senior Vice President, WellCare Health Plans, Inc.
A

Yeah. That's correct.

Joshua Raskin
Analyst, Barclays Capital, Inc.
Q

Okay. And then, you made some comments around capital deployment being a potential tailwind. And obviously, we've seen some of the M&A pick up and it sounds like the pipeline's robust, but you didn't talk about sort of other methods and maybe specifically around repurchases. Is that an attractive area of capital deployment for you guys where the stock is, et cetera?

Kenneth A. Burdick
Chief Executive Officer & Director, WellCare Health Plans, Inc.
A

Well, given that we're a growth company and we're solely dedicated to government programs and what the – not just the opportunities that we believe we can generate in M&A, but if you look at the pipeline of organic opportunities in Medicaid, the penetration opportunity in Medicaid as well as Medicare, for the foreseeable future, we do not intend to buy back shares or issue a dividend. We will invest in our business and use it for growth.

Joshua Raskin
Analyst, Barclays Capital, Inc.
Q

Okay. Right. That makes sense. And then, just on Medicare specifically, I know you talked about that also being a tailwind for next year, and we've seen the MLRs, both on PDP and MA, improve in the second half. And I think about sort of the bid process first week of April, you were probably submitting that – sorry, first week of June – you were probably submitting that at some point in May and things have just gotten better and better.

So, should we think of margins being towards targeted levels? I mean, is there a possibility that some of this upside we've seen in 2016 carries over to 2017, or I heard the comments from Ken about not being fully satisfied where we are, et cetera. But is 2017 a year where potentially we do get to those targeted margins?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President, WellCare Health Plans, Inc.
A

Well, I'd look at PDP and MA differently. PDP, as you can infer from how we performed in 2015 and as far as into the risk quarter as we were, we were producing a pretty good margin. And so, our goal with that is to sort of produce a reasonable loss ratio. Once again, we bid in the low 80%s, and that's what our initial guidance would be predicated on, and then hope to show a little bit of growth there.

In MA, look at that differently, because of all the levers that we have had, and continue to have, in terms of improving that business. And so our multi-year plan, you think back to Investor Day in February of 2015, our multi-year plan is to improve margin, and we're comfortable at this point, even though we haven't completely finalized our 2017 plan, making the assertion that Medicare Advantage margins will improve next year. That would be part of our plan.

Joshua Raskin
Analyst, Barclays Capital, Inc.
Q

Okay. But not quite a target, is that the idea?

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Andrew Lynn Asher
Chief Financial Officer & Senior Vice President, WellCare Health Plans, Inc.
A

We think there's more runway over the next few years.

Joshua Raskin
Analyst, Barclays Capital, Inc.
Q

Right. Perfect. Thanks.

Operator: And our next question is from Gary Taylor from JPMorgan. Please go ahead.

Gary P. Taylor
Analyst, JPMorgan Securities LLC
Q

Hey. Good morning. Kind of hit around most of my questions, so just a couple of quick follow-ups. First, just looking in the core Medicaid business where the MLR was down in the first half of the year, up slightly this quarter, it looks like all of that more than explains why the Kentucky rate reduction and in fact, you probably would have been down maybe 50, 60 basis points year-over-year in that segment without the Kentucky rate cut. Is there anything else in kind of the core Medicaid MLR to worth talking about outside of the Kentucky rate cut?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President, WellCare Health Plans, Inc.
A

Well, we have a portfolio of Medicaid contracts and businesses across 9 states, soon to be 11, and so, there's always plusses and minuses in terms of quarterly progression in any single contract within the Medicaid state. So, but no, I think you're hitting on the major driver of Q3, not just a 3% rate decrease, but remember there's also positive trend in our business.

And so, that's pressuring Kentucky given that rate decrease, however, good news is we have a portfolio and we have much better balanced performance across our portfolio than as I look back to 2014 or even parts of 2015 in terms of having a portfolio that has less variation around the mean.

Gary P. Taylor
Analyst, JPMorgan Securities LLC
Q

Great. Just two quick follows on Medicare heading into next year. So, you talk about the importance of star rating in improving your performance there, and I presume that will involve some investments in spending. But when you talk about margin improvement in MA business next year that would be inclusive of that star rating investment?

Kenneth A. Burdick
Chief Executive Officer & Director, WellCare Health Plans, Inc.
A

That's correct.

Gary P. Taylor
Analyst, JPMorgan Securities LLC
Q

Okay.

Kenneth A. Burdick
Chief Executive Officer & Director, WellCare Health Plans, Inc.
A

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And as I said, we, in 2017, will start to use a significant portion of that ACA holiday to give our efforts a shot in the arm as we embark on our multi-year improvement in star scores.

Gary P. Taylor
Analyst, JPMorgan Securities LLC

Q

And last piece. Just as we look at Medicare heading into next year, it does look like to us, at least outside of Florida, benefits relatively flat, maybe some reduction. We know you exited the May enrollment in California. Should our expectation be similar to this year where enrollments down and margins up? Is that – are you ready to make that call on enrollment at this point?

Kenneth A. Burdick
Chief Executive Officer & Director, WellCare Health Plans, Inc.

A

Well, we're not ready to make the call yet. We will do that as part of our guidance, the week of December 19. But I think what you can expect generally is that we're still sort of trending toward margin expansion in our MA business and that will likely yield to very modest growth in the MA business in the short term.

Gary P. Taylor
Analyst, JPMorgan Securities LLC

Q

Great. Okay.

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President, WellCare Health Plans, Inc.

A

Let me add to that since you brought up service area reductions. We did exit five counties in California and a couple of other areas, so we have 13,000 member service area reduction to jump over. But that's much better than the 20,000 service area reduction coming into 2016.

Gary P. Taylor
Analyst, JPMorgan Securities LLC

Q

Great.

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President, WellCare Health Plans, Inc.

A

And as Ken noted in his script, we still expect modest growth despite having that 13,000 intentional service area reduction.

Gary P. Taylor
Analyst, JPMorgan Securities LLC

Q

Okay, great. Thank you.

Operator: This concludes our question and answer session today, as well as the call. Thank you for attending today's presentation. You may now disconnect your lines.

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