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WellCare Health Plans, Inc. (WCG)

Q2 2016 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to the WellCare Health Plans Second Quarter 2016 Earnings Conference Call. All participants will be in listen-only mode. [Operator Instructions] Please note this event is being recorded.

I would now like to turn the conference over to Ange McCabe, Vice President, Investor Relations. Please go ahead.

Angeline C. McCabe
Vice President-Investor Relations

Thank you, Gary, and thank you all for joining us this morning for a discussion of WellCare's second 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 March 31, 2016, may materially impact those statements. While these risks and uncertainties make 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. 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

Thank you, Angie. Good morning, everyone, and thank you for joining us today as we review our second quarter results and provide our outlook for the remainder of this year. We're very pleased to report a strong second quarter and an increase to our full year 2016 guidance.

This morning, I will discuss some of the key items from the quarter that demonstrate we continue to deliver on our plan to drive improved operational and financial execution, while we position the company for long-term growth. Then, Drew will discuss the specifics of our second quarter financial results and our revised 2016 guidance.

Our continued focus on business fundamentals resulted in improvement across all three lines of our business: Medicaid, Medicare and Medicare Part D in the second quarter. Earlier this morning, we reported adjusted earnings per diluted share of $2.23.

As Drew will discuss in more detail, these results include additional Medicaid revenue related to underpayment in Florida or call. Even so, our results reflect the benefits we are beginning to realize from our investments in people, processes and tools over the past couple of years.

During the second quarter, we closed the Advicare transaction giving us a greater Medicaid presence and a new large provider partner in South Carolina. We're also making excellent progress ramping up our Medicaid operations in Nebraska, in advance of the January 1, 2017, program launch date.

Let's now turn to a discussion of our business segments. I'll begin with our Medicaid Health Plans business, which performed well in the quarter, producing strong year-over-year MBR improvement. It continues to benefit from a better pharmacy cost structure than what was in place a year ago and ongoing clinical initiatives focused on improving outcomes for our members.

One program in particular that I want to highlight is our field-based care management program. This was rolled out across all of our Medicaid markets over the past 18 months and extended to nearly all of our Medicare Advantage markets in the first half of this year. With nearly 400 field care management associates supporting it, this program is designed to deliver personalized cost-effective care for our most complex members, including those with multiple chronic illnesses and behavioral health issues.

This program utilizes face-to-face interaction to more quickly identify barriers to care and more effectively coordinate care through an integrated multidisciplinary care team. We are pleased that this program is gaining momentum and beginning to produce favorable results.

In Nebraska, we are one of three managed care plans selected to participate in the state's Heritage Health Medicaid program. The state is combining its existing physical health, behavioral health and pharmacy programs into a single comprehensive and coordinated system. It is also expanding the program to cover more dual eligible and age blind and disabled beneficiaries. All stakeholders have been actively engaged and highly collaborative.

We look forward to partnering with them for many years to come and improving access to quality care for this population, beginning with this more integrated program that will launch on January 1, 2017.

In Georgia, last Friday, we learned that the Commissioner of the Department of Administrative Services denied the protest appeal of the three protesting bidders. While this decision is an important milestone, it is subject to appeal to the courts. In early July, the Department of Community Health advised us that they intend to exercise the second of two six-month Medicaid contract extensions, thereby extending our existing contract through June 30, 2017. The new program is expected to begin on July 1 of next year.

Turning now to our Medicare Health Plans segment, we are extremely pleased with its performance this quarter. Consistent with our expectation, membership increased sequentially and the MBR improved 220 basis points year-over-year. On last year's second quarter earnings call, we outlined some of the initiatives that would improve the performance of our Medicare business.

In 2015, we brought in new Medicare leadership, implemented a more disciplined bid strategy, developed a rigorous process for utilization management and enhanced our sales and marketing efforts. These actions are beginning to deliver tangible results. While there is still much more work to do to improve the performance of our MA business, we're beginning to reap the benefits of the multi-year strategic road map we implemented last year.

We remain committed to delivering on the three goals we outlined more than a year ago: number one, improving health outcomes for our members; number two, achieving a reasonable net margin; and number three, growing profitably. We've made substantial progress and remain laser-focused on the work required to continue our momentum.

The strong year-over-year performance of our Medicare PDP segment reflects both an improved pharmacy cost structure and strong operational execution. With regard to our 2017 PDP bids, our goal was to grow membership while achieving a reasonable margin.

Last Friday, we received the preliminary outcome of the bids and we're very pleased to learn that we were below the benchmarks in 30 CMS region and within the de minimis range in three other regions. As a result, we are optimistic about our ability to achieve profitable growth in our PDP business in 2017.

Our second quarter performance demonstrates another positive step toward achieving our multi-year plan. 2016 is shaping up to be a successful year for WellCare. And while there is still much more work to do, we've made tangible progress in strengthening our foundation and positioning the company for growth in the coming years.

We've said previously that our goal is to double revenue between 2017 and 2021. We see many opportunities, both organic and through M&A that will fuel our growth. Advicare and Nebraska are just two examples of this.

As we look forward, we remain focused on serving our members, delivering value to our state and federal government partners, adding industry talent and executing on our short-term and long-term commitments.

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

Andrew Lynn Asher

Chief Financial Officer & Senior Vice President

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

For the second quarter of 2016, our adjusted EPS was $2.23. This compares with $1.38 of adjusted EPS in the second quarter of 2015, representing a 62% increase year-over-year. Each of our businesses improved year-over-year, producing another quarter of predictable results. There are many satisfying elements contributing to our strong results; and to be balanced, as always, in the government programs business, there are manageable challenges as well. Let's go through each segment.

For the second quarter of 2016, our adjusted Medicaid MBR was 86.7%, a 210 basis point improvement from Q2 2015. This is a combination of fundamental year-over-year improvement coupled with a large premium revenue item, which is worth about 70 basis points in the second quarter adjusted Medicaid MBR and 18 basis points on the full year.

As you saw in our press release, we recorded $18.7 million or $0.27 of revenue related to underpayments in the Florida Medicaid program. Approximately $8.5 million of the $18.7 million is related to 2015 calendar year. Essentially, Florida had incorrectly classified Supplemental Security Income, or SSI, members over 55 years old as Temporary Assistance for Needy Families, or TANF, members which have a much different rate.

Florida's Agency for Health Care Administration owes us more and is working with the State Legislature to obtain budget appropriations for a portion of what they owe us. Until that is satisfied, we've only recorded $18.7 million of associated revenue of which Florida has actually paid approximately $8.2 million to-date.

Excluding this item, our Medicaid business still demonstrated year-over-year improvement and remains on track, driven by continued momentum in operational execution and our improved pharmacy cost structure. We're pleased with the overall performance of our Medicaid business as it demonstrates our continued focus on disciplined execution.

There are, however, inherent, but manageable challenges in this business. For example, the State of Florida recently relaxed its authorization criteria for hepatitis C drug treatment effective June 17. We are working with the state and providing real-time data to attempt to get the resulting increased hep C drug costs into our rates prior to the next rate increase that is scheduled for September 1.

Another example; in Kentucky, we received a rate decrease of approximately 3% effective July 1. While we were appropriately cautious with our prior outlook, this rate decrease was a little more negative than we expected.

However, factoring in all of what we know today about our Medicaid business including Q2 performance and these two items, we are improving our full year 2016 adjusted Medicaid MBR guidance by bringing down the top end of the range by 25 basis points to a range of 89% to 89.5%. We're also ahead on Medicaid revenue including the addition of the Advicare acquisition. Therefore, we are increasing the Medicaid revenue range by $125 million at the midpoint.

Moving to Medicare Advantage, we're very pleased with the progress in our Medicare Advantage business posting a year-over-year MBR improvement of 220 basis points. We can see the results of our focus on execution in multiple areas, including clinical services, our model of care, increased engagement with our members and a more disciplined bid process. Membership also grew by 5,000 members sequentially.

Given this improved performance, we are slightly improving our Medicare Advantage MBR guidance by 25 basis points at the midpoint. This year-over-year improvement is the result of 18 months of focus and great work by multiple teams across WellCare. Our PDP business performance was ahead of our expectations in the quarter with a year-over-year MBR improvement of 410 basis points in the second quarter.

Our PDP business continues to benefit from our improved pharmacy cost structure and very good execution by the clinical and pharmacy teams. We're lowering our full year MBR guidance by 100 basis points to a range of 79% to 81%. As we reach these levels of performance, we have an increased risk corridor payback to CMS, which results in a reduction of revenue given the accounting for risk corridor paybacks as a contra revenue item. Accordingly, we are forecasting revenue to a slightly lower range of $900 million to $925 million.

We had visibility into this outperformance when we filed our 2017 bids in June; and, as Ken indicated, we're very pleased with the auto-assign positioning for 2017 with 30 regions under the benchmarks and three regions de minimis. The last two years have seen a substantial turnaround in our PDP business. This is driven by improved execution and a substantially improved cost structure that we were able to reflect in our bids for 2017, as opposed to running a large risk corridor payable.

Rounding out the second quarter results, our adjusted SG&A ratio in the second quarter was right on track and we are maintaining our previous full year guidance of 7.8% to 7.9%. Favorable prior year development was $34 million in the quarter; and DCP is up 6.3 days from the prior year and up 3.4 days sequentially. Importantly, we had over $800 million of parent cash at quarter end, as well as $650 million of capacity on our credit facility.

Based on our performance in the first half of this year and our outlook for the remainder of the year, we're raising our full year 2016 adjusted EPS guidance by $0.40 at the low end of the range and $0.35 at the top of the range. Therefore, our revised 2016 adjusted EPS guidance range is $4.95 to $5.05, up from our previous guidance range of $4.55 to $4.70.

As I just mentioned, our Medicaid, Medicare Advantage and PDP MBRs are all slightly improved from prior guidance. We refined our view of depreciation slightly upward to reflect our run rate from past investments. Also, you can see the reduction in the tax rate range which is a function of the improved earnings outlook relative to a fixed nondeductible ACA fee. If you examine our improved earnings outlook, absent the nondeductible ACA fee, you will see our underlying tax rate remains consistent.

We are pleased with our second quarter performance and momentum for the rest of the year. This strong performance creates the capacity in the enterprise to embark on growth opportunities. There are always areas to drive operational and financial improvements; and we continue to remain diligent in our focus to deliver on our commitments, including margin expansion.

And while we are pleased with the first inning of our return to growth with the Nebraska win and Advicare acquisition, there are many opportunities ahead; and we look forward to accelerating growth over the next few years, while we continue to deliver on margin expansion on the existing business.

Operator, we will now open the call for questions.

QUESTION AND ANSWER SECTION

Operator: We will now begin the question-and-answer session. [Operator instructions] Our first question comes from Tom Carroll with Stifel. Please go ahead.

Thomas Carroll
Stifel, Nicolaus & Co., Inc.

Q

Hey there. Good morning. So I wonder if you could comment on Aetna's divesture of Medicare Advantage lives to Molina, specifically as it relates to WellCare. Particularly, I mean, do you guys believe that more divestitures might be required? And if not, what does WellCare intend to do with the capital that you've raised that was earmarked for MA purchases?

Kenneth A. Burdick
Chief Executive Officer & Director

A

Good morning, Tom. This is Ken. With respect to the specific transactions you're referencing, we're not going to comment on that, we typically don't on that – I apologize for some of the feedback. Here's what I'll tell you, we have strengthened our M&A team. We have multiple opportunities that we're currently pursuing, and that's going to only build going forward.

As it relates to our acquisition strategy, I think the most effective thing I can convey is the following. We're looking at many acquisitions and they will need to satisfy three objectives: number one, aligned with our core capabilities;

number two, they must fit within our broader strategic framework; and three, with each and every one, we must be able to see a path to profitable growth and a sustainable competitive position.

So we will continue to pursue M&A opportunities. We look forward to sharing those with you when the transactions are closed. And, of course, we are also very, very interested and expect to pursue much of the organic opportunities that are out there over the next several years. So we see a robust pipeline of new business opportunities; and that's how we would intend to deploy our capital.

Thomas Carroll
Stifel, Nicolaus & Co., Inc.

Q

Okay. That's great. Just as a quick follow-up on your Florida comments, it sounds like there will continue to be catch-up payments until Florida redoes their rate structure in September. Do you think those kind of – I mean if they're [ph] padding (22:39) to a budgetary process, do those continue on for a number of quarters? I mean any idea on the process and timing there? Thanks.

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Sure, Tom. Florida effectively made the correction beginning in May to the underlying – to the membership attribution to get that straightened out. So that's about $2.5 million to $3 million a month sort of prospectively in the run rate. And what we're talking about including the almost $19 million that we reported in the quarter and then any amounts beyond that that are owed to us, those would be for past periods. And we would spike those out transparent to investors so they could evaluate which portion of that related to prior years versus current year.

Thomas Carroll
Stifel, Nicolaus & Co., Inc.

Q

All right. Thanks for that. Great quarter.

Operator: The next question comes from Sarah James with Wedbush Securities. Please go ahead.

Sarah James
Wedbush Securities, Inc.

Q

Thank you. You mentioned that 2017 PDP is expected to have profitable growth, but 2016 has been an above average year, so how do we think about the margin change year-over-year? And then given that offset with enrollment growth, does it net to dollar earnings growth for the PDP product?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Well, we need to wait until we get closer to the end of the year to formulate all of the components of the guidance for 2017, but we do expect, based upon our positioning in the benchmark, to grow and effectively looking at the margins that we targeted. And we've talked about sort of a low-80%s MBR would be sort of the right long-term landing spot. That would be incremental profit growth, given that we're coming off of a year where we've got 17 regions below the benchmark, moving up to 30.

Sarah James
Wedbush Securities, Inc.

Q

And then can you give us any color on the pipeline of deals that you're evaluating? Is it evenly split or reflective of the current business mix of WellCare or is there one segment, Medicare and Medicaid, that you're more interested in deploying additional capital?

Kenneth A. Burdick
Chief Executive Officer & Director **A**

Sarah, I would say it's really balanced. We're looking at increasing our business within our existing portfolio. And we have an eye on both Medicaid and Medicare opportunities with a preference for those that would be of a tuck-in variety within existing market. But we're also looking at and interested in acquiring businesses that would open us up to new markets and new states.

Sarah James
Wedbush Securities, Inc. **Q**

Thank you.

Operator: The next question comes from Chris Rigg with Susquehanna Financial Group. Please go ahead.

Chris Rigg
Susquehanna Financial Group LLLP **Q**

Good morning. I just want to make sure I understand the Florida situation clearly here. So the $2.5 million to $3 million per month that is sort of the assumed catch-up amount, that's not in the new guidance at all at this point?

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

Yes. That would be in it, as well as the amount that we reported which was the $18.7 million in the quarter. So all of that is in the guidance. What's not in the guidance is any further payments that we expect from Florida retroactive to the beginning of this year and then the prior year-and-a-half.

Chris Rigg
Susquehanna Financial Group LLLP **Q**

Okay. Okay. And then you talked about M&A. But just on the organic front, particularly in the Medicaid side, sometimes RFPs sort of fly below the radar. Can you give us a sense for what might be near-term for you guys in terms of opportunities if there is any specific to highlight?

Kenneth A. Burdick
Chief Executive Officer & Director **A**

Well, I'll start with, Chris, the ones that are sort of right in front of us and currently active. So we've got Missouri, where we just submitted the bid last week and that would be for a May 1, 2017 effective date. It's a expansion of the existing program where we're currently an incumbent, so this is for TANF and CHIP. And we would expect that with this program, the overall is now statewide. So we're looking at maybe 490,000 members, growing by about another 20% or so.

Pennsylvania, we said before, so I'll mention again, that we have a bid in for the MLTSS, Managed Long Term Services and Supports. That covers the dual and non-dual population. We expect an answer on that within the next few weeks. And then while we have a fairly lengthy list of other opportunities, I'm really only comfortable disclosing ones that we've already talked about.

So we've shared North Carolina in the past. It looks like that could be as far down the road to 2019. We've mentioned Oklahoma in the past. But for competitive reasons, I'm not looking to disclose all of our cards at this juncture. You'll have to trust us that we do have our eyes on multiple other opportunities and currently have people on the ground in multiple other states.

Chris Rigg
Susquehanna Financial Group LLLP

Q

Okay, great. I'll leave it there. Thank you.

Operator: The next question comes from Matthew Borsch with Goldman Sachs. Please go ahead

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Matthew Borsch
Goldman Sachs & Co.

Q

Yes. Could you just talk about the earnings outlook for the back half of this year? And I'm sorry if you've covered this, so your guidance I think implies about $1.70 at midpoint for the back half which looks low relative to our model. Do you see upside potential to that guidance, number one? And number two; is that reflecting the Kentucky rate action in part?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Yes. Everything we know today is reflected in the guidance, including the momentum that we have through the first half of the year. But as you could appreciate, we're always cautious when you only have half of the year under your belt as we look at ahead. But then also things like a little bit of breakage in hep C between what we're getting paid by Florida and the emerging cost, as well as known rate changes and forecast changes as well.

So we formulate all of that in our forward guidance and we do reflect back on – we take very seriously when we raise guidance. And so, we want to make sure that we can put milestones out there that we can deliver on. And so, that works into the calculus. Fourth quarter is always typically a low EPS quarter with the SG&A spend. Medicare MBRs are always the highest in the fourth quarter, part of that is because of the voluntary spend that we like to make in terms of investments and quality that manifest themselves in MBR. So all of that's formulated into our guidance for the full year; and you can sort of [ph] back then to (30:15) what the back half would be.

Matthew Borsch
Goldman Sachs & Co.

Q

And one other question on a different note. Looking further ahead, do you have a calculation; I'm sure you do. But can you share it with regard to how many Medicaid lives you think you might pick up in the event that post the election in 2017, let's say, all of the additional 19 states opt in to the Medicaid expansion?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

We certainly have that as one of our six channels of growth. Obviously, that's one we influence less than the other five. But there are four states of ours where we currently do business that have not adopted ACA expansion: Florida, Georgia, South Carolina and Missouri. And so, we've done calculations, but it's sort of speculative at this point. So we don't want to put those out publicly. But, yes, that's something we've thought about as we have formulated various [ph] paths (31:22) to double the revenue of the company by 2021.

Matthew Borsch
Goldman Sachs & Co.

Q

All right. Thank you.

Operator: The next question comes from Joshua Raskin with Barclays. Please go ahead.

Joshua Raskin
Barclays Capital, Inc.

Q

Hi, thanks. I think [ph] it was kind of a better time here on (31:34) doubling of revenues. As we think about the trajectory there of what's probably got to be high-teens to low-20%s growth, should we think about 2017 with the acquisition you guys did this year plus the PDP growth and Nebraska. Should we think about a growth rate approaching the compound annual growth that you have to get to for 2021?

Kenneth A. Burdick
Chief Executive Officer & Director

A

Yeah, Josh. The way I would think about it is, we are now ramping up. For the last couple of years, we made a decision that we needed to fortify our foundation, strengthen our people, strengthen our processes, strengthen our tools and technology. And so, we are now leaning into that for 2017, and you've got to see that ramp up sort of with increased momentum in that period; 2017 to 2021.

Joshua Raskin
Barclays Capital, Inc.

Q

Okay. So the growth rate will start a little slower, obviously, and then ramp up by the time you get to 2021. That's helpful. And then what's the long-term net margin for your business, assuming similar mix as to what you have now?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Well, on our existing business, our goal is [ph] to pierce 2% (32:50). Then if you think about layering on growth opportunities, at any given year depends on the maturity of that piece of business or, for instance, a new state that's implementing managed care as we've all seen in this industry, there's a ramping of achieving the target margins. So it would depend on the stage of the growth layered into sort of the foundation of the company and our existing business with the multi-year plan to achieve 2% net income.

Joshua Raskin
Barclays Capital, Inc.

Q

Right, okay. So 2021 you've got 2% on the $14 billion today, but we don't really know how much ramps how quickly I guess over the next couple of years?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Right, right. If you add a new piece of business in 2020 or 2021 that you were implementing, then you wouldn't expect to get to your ultimate margin in that first year.

Joshua Raskin
Barclays Capital, Inc.

Q

Got you. And then just lastly on the PBM contract, it seems like you guys have seen a real significant benefit moving to CVS. I assume you can confirm that this is come in better than your expectations. But, more importantly, are there any true-ups or sort of reconciliations or anything that can change over the next couple of years in that contract or is this just you guys are benefiting from their scale and you get to keep what you earn?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Yeah. There are all sorts of guarantees and measurements. Those are reflected in our run rate, though. And we entered into a three-year agreement intentionally, so that we would not have to rely on a market check. We can rely on a full-blown RFP process towards the end of that time period to make sure that we can sustain the benefit and improve on that as we look out to three years beyond that.

Joshua Raskin
Barclays Capital, Inc.

Q

Got you. And this is smart way to do it. Okay. Thanks, Drew.

Operator: The next question comes from Andy Schenker with Morgan Stanley. Please go ahead.

Cornelia Miller
Morgan Stanley & Co. LLC

Q

Hey. This is Cornelia in for Andy. Just coming back to the PDP MLR in the quarter, it looks pretty well and then the guidance implies that it's going to climb in [indiscernible] (35:01) normal seasonality would suggest it would be down. Can you just talk about that dynamic a little bit?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Yeah, right. I mean the sloping of the PDP business is often slightly different from year-to-year. And so, even though the year-over-year looks a lot better than the guidance increase, every month we reforecast the trajectory of PDP and pleased to lower the MBR guidance for the full year, which is the most relevant when you're talking about PDP down to 79% to 81%.

Cornelia Miller
Morgan Stanley & Co. LLC

Q

Okay. And then just separately, you referenced there is much more work to do on some of the initiatives that you've put in place last year. Can you just give us an update on where you are in some of those IT and medical management initiatives?

Kenneth A. Burdick
Chief Executive Officer & Director

A

Sure. With IT, we really spent the back part of 2014 and beginning of 2015 planning [indiscernible] (36:01) capital investment for upgrading our tools and technology. 2016 will likely be the high point of our capital investment. We'll start to [ph] taper that (36:17) back in 2017 as some of these projects come up online. So I would describe us as about at the midpoint in terms of our significant IT projects and the use of our capital.

Cornelia Miller
Morgan Stanley & Co. LLC
Q

Great. Thanks.

Operator: The next question comes from Kevin Fischbeck with Bank of America Merrill Lynch. Please go ahead.

Kevin Mark Fischbeck
Bank of America Merrill Lynch
Q

Okay. Thanks. I just want to go a little bit more into kind of what was really driving the upside in the quarter. I mean obviously you've got the Florida adjustment, but beyond that. Because I think a lot of the commentary has been kind of year-over-year how pharmacies improved results, but obviously you've had the pharmacy agreement in since January 1. So if we think about kind of what was really driving the upside versus your previous guidance, can you go a little bit more into the drivers there?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President
A

Sure. You can look at our Medicare Advantage business. And while we only improved the MBR 25 basis points at the midpoint for the full year, we were very pleased at what we're seeing emerging based upon all the work that the teams have done over the last 18 months; and I mentioned a few of them, like our clinical operations and the whole bid process. And so, as you get further into the year, you get more comfortable with the performance of the business for that year. So I would say Medicare Advantage was positive this quarter, obviously, PDP being able to re-forecast that at 100 basis points lower. And then you mentioned the Medicaid item – Medicaid performed well, but included that $0.27 item in the quarter.

Kenneth A. Burdick
Chief Executive Officer & Director
A

Kevin, the commentary that I would add to what Drew shared is, I think what you're starting to see is a more balanced performance. So we mentioned that all three lines of our business are performing. What's not as visible to you is we're seeing more balanced performance across our various geographies. And it's really that we are beginning to realize the benefits of that discipline that we began a couple of years back. It's an operational discipline, it's a financial discipline; and some of this is now sort of paying dividend.

Kevin Mark Fischbeck
Bank of America Merrill Lynch
Q

I guess maybe just going to the PDP side, why did you re-forecast 100 basis points, is it that the pharmacy agreement actually is coming in better than you thought or is there something else driving that side of it?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President
A

Yes. Largely the cost structure, since it's only a pharmacy benefit – then the cost structure is entirely our pharmacy cost structure. So, yes, that is largely the driver of the improved performance. And as I mentioned in the script, we were able to see that and importantly think about reflecting that in our 2017 bids as opposed to sitting at the end of 2017 with a significant payback to CMS because of the risk corridors. We'd rather sort of balance that better and deploy that into our bids when we would otherwise sort of have to pay it back anyhow at the end of the year.

Kevin Mark Fischbeck
Bank of America Merrill Lynch

Q

I guess that makes sense. I guess then if we think about the improvement that you've had so far this year, I guess what more do you have to do, what are the biggest areas of improvements still to come to get to where you need to be?

Kenneth A. Burdick
Chief Executive Officer & Director

A

Well, I would say we still have improvement in both Medicare and Medicaid. This field-based care management that I described, we have rolled it out. We're continuing to refine it, enhance it, tweak it, based on our experience. So we see quite a bit of runway remaining as we look to continue to improve the execution of our business.

So clinical would be one, obviously, the technology that I talked about. Some of those things are coming online this year, some will come online until 2017. So we're going to use that to both improve our productivity, improve the accuracy of what we do by automating our processes. And then thirdly, quality. We will continue on the path that we started at the back half of 2015 to focus day-in and day-out on improving our quality performance.

Kevin Mark Fischbeck
Bank of America Merrill Lynch

Q

All right, great. Thanks.

Operator: The next question comes from Peter Costa with Wells Fargo. Please go ahead.

Peter Heinz Costa
Wells Fargo Securities LLC

Q

Sort of a similar question, but looking forward instead of backwards. You improved the year's guidance by $0.37, $0.38, the midpoint, and you beat the quarter by about $0.83. So I'm trying to back into sort of what got worse in the back half of the year. I heard you talked about the Georgia rate decrease being worse and the Florida hep C decision. I calculate the Georgia rate to maybe 40% of the difference in terms of the balance of $0.46 of revenue [ph] that you drove or (41:23) EPS that you didn't increase. So I'm kind of trying to figure what else was a factor in there? Is it just that we modeled you wrong for the second quarter or are there other negatives that we should be thinking about?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Yeah. I think you mentioned part of it in terms of the modeling. Since we don't give quarterly guidance, I can't really respond to your sole estimate of the quarter. But we do look at it on a full year basis, and I think you were talking about the Kentucky rate decrease. That's the one we mentioned, not Georgia.

Peter Heinz Costa
Wells Fargo Securities LLC

Q

All right. Sorry.

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

But, yes, that's embedded and that was a little bit more severe than we had expected. So that's now embedded in our guidance. But we also looked at the momentum. And so, we're pretty pleased that being halfway through the year and we increased Q1 – coming out of Q1, we increased guidance $0.15. And you have to put a lot of thought into increasing guidance after the first quarter. But we did so and we're delivering on that; and then another $0.375. But we're only halfway through the year. So I do look forward to playing out the rest of the year as we think about sort of running the business on a year-to-year basis.

Peter Heinz Costa
Wells Fargo Securities LLC

Q

So mostly modeling other than anything – really other than the two items that you picked out there were negative, nothing else that we should be thinking about that's negative in the back part of the year?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Well, you can think through what we did to each of the MBRs. We improved each of the MBRs for the full year basis. And that's sort of what I should – that's what I need to direct you to.

Peter Heinz Costa
Wells Fargo Securities LLC

Q

Okay. Thank you.

Operator: The next question comes from Ana Gupte with Leerink Partners. Please go ahead.

Ana A. Gupte
Leerink Partners LLC

Q

Yes. Thanks, good morning. So the first question – I'm not sure if you've covered this in your prepared remarks, but you said that you were in early innings on the Medicare Advantage margin outlook. So can you talk about the drivers of potential future margin expansion? Where do you think this will settle out and how you're thinking about the ACA fee, the moratorium, next year in terms of your bids?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Sure, sure. I think I've said we're in the first inning of our growth agenda. But, nonetheless, we do feel like we've got continuing runway to improve Medicare Advantage, including some of the clinical initiatives that Ken mentioned. While we're really pleased with what we've been able to do with the clinical team, there's a lot of investment that we've made in initiatives including our field care management program which should bear fruit over the next couple of years; and really increased engagement with members too, which improves outcomes in quality. So there's those levers in improving Medicare Advantage.

A disciplined bid process while we made a big leap coming into this year, we'll continue to do that and improve incrementally. And you're right the absence of the ACA fee next year was one of the inputs to the 2017 bid process as we looked at benefit structures, increasing investment and quality, as well as sort of the formulation of the entire bid for each of our contracts.

Ana A. Gupte
Leerink Partners LLC

Q

So it's an optimize between margin and membership you think for next year, so you let some of it fall to the bottom line?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

So we've stated sort of what our multi-year margin goals are in all of our business, and there's a lot of inputs into that for Medicare Advantage. Quality is one of the ones Ken mentioned, which is a longer term input in terms of achieving that 2% margin. But, yes, we think about that and balance out having an attractive benefit structure and creating stability for our Medicare Advantage members.

Ana A. Gupte
Leerink Partners LLC

Q

Got it. Okay. Thanks. That's helpful. And on Part D, I was listening a little bit and I'm not sure I entirely got it on your risk corridor. You talked about a payable. I remember you had this huge receivable at one point with hep C; and what exactly happened there. And then you guys – I don't know if you've seen what MedPAC was suggesting where generally the tone from CMS has been that the pharma companies are using the reinsurance, which is very generous, and has been increasing pretty dramatically on their budget to just to kind of subsidize their huge price increases. And if that does go away, how would you think about your bidding strategy and the achievability of this tremendous loss ratio that you have right now with the CDS contract and all?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

So let me unpack that a little bit. As we look at 2017, we bid thinking to optimize the balance between a reasonable margin and creating attractive benefits for our members, which then leads to growth. And so, because we've improved our cost structure substantially that's now going to be reflected in our 2017 bids. We didn't have – obviously we didn't have sort of the commencement to look at the data when we submitted our bids for 2016, because most of the cost structure commenced 1/1/2016.

So that's driving some of the outperformance this year, which then you accrue a large payback when you get to that point in the risk corridor [ph] and at (46:51) the contra revenue item. So instead of running a large payable next year, we're able to sort of use that cost structure the way it's intended to be used, which is to reflect it in the pricing of the product.

Ana A. Gupte
Leerink Partners LLC

Q

Okay. And any thoughts on if that's changed on the reinsurance, how will companies like you and, of course, your peers respond to the bidding process on the potentially lowered reinsurance. Does this really change benefit design to accommodate that?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Well, the design of the program is set for 2017. That's what we all bid on. And so, we would have to react to any modifications in outer years to the extent any are made to the reinsurance portion of this product.

Ana A. Gupte
Leerink Partners LLC

Q

Got it. One last one, if I may. On the Aetna announcement on Molina this morning, did any part of this have to do with your – how you view yourself in the long-term, whether maybe you view yourself as a stand-alone player or if, let's say, one or both deals doesn't go through, especially in this case if Anthem-Cigna doesn't, then acquiring some of those divestitures might actually make it harder for you to be a part of any transaction with those two larger players. Or just broadly, if you can tell me if you think about yourself as a stand-alone player with all the success that you've had and you've had tremendous success in the last 12 months on turnarounds. Or do you still view yourself at some point as a target?

Kenneth A. Burdick
Chief Executive Officer & Director
A

Ana, this is Ken. The way I would answer that is that, first, as I mentioned at the beginning, we won't comment on this specific transaction, nor do we ever comment on a specific MA opportunity. But to your question, we come in every day focused on improving outcomes for our members, running this business more effectively. And, as I mentioned, we will continue to pursue growth, not just in Medicaid, but now that we've seen some really nice progression on our Medicare business and its margin, we are equally bullish about pursuing growth both organic and inorganic for our Medicare business.

So what I can tell you is that this management team feels like we are finally making some good tangible progress. We have a lot of runway left. And that's our entire focus, building out a strong company based on a much healthier, stronger foundation that we had just a couple of years ago.

Ana A. Gupte
Leerink Partners LLC
Q

Great. Thanks, and great job.

Operator: The next question comes from Scott Fidel with Credit Suisse. Please go ahead.

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

Thanks. First, just wanted to follow-up on the PDP margin discussion and sort of thinking about some of the dynamics for next year. Drew, I know on the first quarter call you had talked about sort of 82% to 83% as a good sort of long run target on the PDP MLR. And how do you think about that I guess in the context that – so you've continued to have very strong outperformance on PDP this year, so then MLRs come lower. At the same time now, you're going to be growing again and particularly on the LIS side, which traditionally has maybe had some more PDP MLR volatility associated with it when there's a lot of growth. So I guess sort of thinking about all those different factors, do you still view 82%, 83% as a good jumping off point for next year?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President
A

Well, if you go back to our guidance, you referenced when we came out in February with the guidance, we've guided to 81% to 83%. And you're right low-80%s is how we would characterize what we think the right balancing point is for the PDP business.

And then, like this year, hopefully you sort of have an opportunity to do better than that. But as you think about sort of resetting each year in our bid process and then balancing that with our cost structure and growth, especially with the unique mechanism in PDP, which I know you understand well, the risk corridors and how much goes back to CMS based on performance after a certain point.

So it really does encourage you to build in your cost structure into your bids and then try to target that low-80%s. So we still stand behind that ballpark of what we think a long-term sustainable and reasonable margin would be as we think about year-to-year. But, of course, any year can play out differently than that; and the last two, since we've imposed a fair amount of discipline, have turned out pretty well.

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

Q

Got it. Then just I had a follow-up question just on the industry fee delay and how that plays on the Medicaid side. Obviously, we've all been digging a lot into when talking about the MA dynamics. It's been a bit more quite around the Medicaid side. How is that working out with the states? Like when we see the 3% cost coming out of Kentucky, is that sort of partially factoring in the delay in the industry fee or are there separate – sort of a separate process going on with the states on the industry fee delay for 2017?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Yeah. Those are separate. And so, rate changes are sort of independent of changes in the ACA fee. And there is a pretty good disciplined reimbursement process, whereby the states reimbursed us [indiscernible] (52:29) for the lack of tax deductibility; and we're able to trace that through separate from, call it, the business fundamental rate changes driven by trend and other factors in the Medicaid business. So I'd consider it separate.

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

Q

Got it. So bottom line, though, it looks like it's all tracking [ph] that it should (52:47) sort of net out to neutral, right, in terms of the industry fee delay on the Medicaid side for next year?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Yeah. That would be our expectation.

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

Q

Okay. Thank you.

Operator: The next question comes from Gary Taylor with JPMorgan. Please go ahead.

Q

Hi. This is [ph] Tim (53:02) on for Gary. Just a quick one on the hep C adjustment for Florida Medicaid. Is that something you sized? Is it low-single digit exposure there in terms of rate?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

Well, it was just implemented on June 17 and we get data on a daily basis and we share that with the state weekly. And so, that will be ramping up and we've factored that into our forecasts. But the key is with whether it's hep C or other changes in programs, state-based programs, is getting the revenue to match the cost; and that's what we're focused on. And so, it's already embedded. This temporary breakage of the increased cost is embedded in our guidance.

Q

Okay. And then one quick other one just following up on some of the MA discussions. So given the outperformance that you guys have experienced so far this year, when you're going to the bid process for 2017, considering the deployment of the ACA fee holiday, is there exposure at this point to hitting the ceiling on on margins in terms of 85%; or is there still plenty of ramp to go before that would be an issue for you guys?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

There's still plenty of ramp to go for most of our [indiscernible] (54:25) contracts, which are the contracts between the payer and CMS. Because of the calculations that go into the minimum MBR and how you treat taxes and those adjustments to both the numerator and denominator, as laid out in the regulation. So while we're pleased with Medicare Advantage progress, please do not interpret that as a satisfaction because we have a lot more that we can do in terms of driving improvements in the business and then also turning to the point where we're growing that business like we did in the last quarter by 5,000 members.

Q

So you mentioned low-80%s target MLR on PDP. Is it the same neighborhood for MA or would it be slightly higher?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

It would be slightly higher.

Q

Okay. Thank you.

Operator: The next question comes from Dave Windley with Jefferies. Please go ahead.

David Howard Windley
Jefferies LLC

Q

Hi, good morning. Thanks for taking my questions. The first one is on Florida rates, and I'm curious now that we have this correction on the categorization of these members which resulted in these catch-up payments, do you think that will have any influence on the Florida rate? I think it's a September 1 update?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

It's tough to tell exactly how many things will go into that rate discussion. But clearly, looking at the run rate of the business across the payer portfolio is something that states and our actuaries look at. But this was sort of a correction of classification and we're pleased that the state has corrected that prospectively, including their commitment to pay us for the past amounts as well.

David Howard Windley
Jefferies LLC

Q

I assume that – go ahead, I am sorry.

Kenneth A. Burdick
Chief Executive Officer & Director

A

And just a few things to think about. What we said in the last couple of quarters is the September 1 increase last year was a significant step in the right direction, but really wasn't sufficient for us to achieve the reasonable margins that we expect. So we still have that outlook. On the one hand, we've got this underpayment that starts to cloud the picture; and then on the other side of the coin, we've got a change in hep C policy. So all those things are going to go into play for September 1 and they don't all cut in the same direction. So we continue to believe that there ought to be some type of increase coming our way for September 1 of this year.

David Howard Windley
Jefferies LLC

Q

And so, you would still view Florida rate as not quite up to the standard of actuarially sound?

Kenneth A. Burdick
Chief Executive Officer & Director

A

Well, the actuarially sound standard has some range to it. So I won't come out and state that they're not actuarially sound, but I would state that in a state where we believe we are operating in a highly effective fashion, the current rates, while better than the year before, are still insufficient for us to achieve the type of margin that we would expect and [ph] need (57:49) for the long-term sustainability of the program.

David Howard Windley
Jefferies LLC

Q

Got it. Okay. And then a separate question. In Georgia, I believe you have added competition there and I think that began to be implemented maybe earlier, or about a month ago. Do you have visibility on how kind of membership allocation is falling out as a result of that?

Kenneth A. Burdick
Chief Executive Officer & Director

A

Yeah. So, Dave, you're about a year ahead of time, because the Department of Community Health has filed for two six-month extensions with CMS and has notified us that the current program will operate through June 30 of next year. So at this point, we are operating under the assumption that it will be July 1 of 2017 before this new contract is in place; and with that new contract, we are expecting that a fourth player would be added. But none of that is very visible at this point, given the extended delay.

David Howard Windley
Jefferies LLC

Q

Okay. And then final question is kind of an version of Peter's, which is in addition to this kind of reconciliation of your full year guidance, you're also including these $2.5 million to $3 million payments for the balance of the year in the new guidance which kind of increases the spread in the bridge. And I guess I just wanted to kind of reiterate or re-ask the question of what might be the offset to those positives, the upside in the 2Q, the benefits from the Florida catch-up payments and then not flowing all of that through to the full year?

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

The only Florida catch-up payments we've recognized and included in guidance, the retro payments would be the $18.7 million. So to the extent that there are more to come, which we expect, those would be additives to our forecast at this point. And I did mention we've got a portfolio of nine states soon to be 10 states in Medicaid. And like Ken, I'm really pleased to see a more balanced performance across those. And so, in each state, you have some businesses that are accelerating their performance and some that are retracting a little bit in margin. And mentioned Kentucky, that would be the most obvious one with a 3% rate decrease; a little bit more than we had anticipated.

And then you have a little bit of breakage in hep C in Florida. So those are the bigger ones I wanted to point out, so that we present a balanced view of our execution and performance as its manifesting itself in the numbers, but then also the reality of balancing a portfolio business and pointing out a couple of the slight headwinds that we have accounted for in our guidance for the full year.

David Howard Windley
Jefferies LLC

Q

Got you. Thanks. If I could just clarify on that. So $18.7 million, I thought I understood was through May. $2.5 million $to 3 million prospectively for May on and both of those were included in guidance. So this is what I thought I understood before.

Andrew Lynn Asher
Chief Financial Officer & Senior Vice President

A

That's correct.

David Howard Windley
Jefferies LLC

Q

Okay. All right. Thanks.

Operator: This concludes the question-and-answer session, and the conference has also now concluded. Thank you for attending today's presentation. You may now disconnect.