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ANTM - Q4 2015 Anthem Inc Earnings Call

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OVERVIEW:

Co. reported 2015 operating revenues of $78.4b and GAAP EPS of $9.38. 4Q15 GAAP EPS was $0.68. Expects 2016 GAAP EPS to be greater than $10.35 and adjusted EPS, excluding any benefits or transaction costs associated with pending Cigna acquisition, to be greater than $10.80.

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by and welcome to the Anthem conference call. At this time, all lines are in a listen-only mode. (Operator Instructions). As a reminder, this conference is being recorded. I would now like to turn the conference over to the Company's management.

Doug Simpson - *Anthem, Inc. - VP, IR*

Good morning and welcome to Anthem's fourth-quarter 2015 earnings call. This is Doug Simpson, Vice President of Investor Relations. With us this morning are Joe Swedish, Chairman, President and CEO and Wayne DeVeydt, our CFO.

Joe will offer an overview of our fourth-quarter 2015 financial results and will walk through the financials and provide the details of our initial 2016 outlook. We are then available for Q&A.

During the call, we will reference certain non-GAAP measures. Reconciliations of these non-GAAP measures to the most directly comparable GAAP measures are available on our website at antheminc.com.

We will also be making some forward-looking statements on this call. Listeners are cautioned that these statements are subject to certain risks and uncertainties, many of which are difficult to predict and generally beyond the control of Anthem. These risks and uncertainties can cause actual results to differ materially from our current expectations. We advise listeners to review the risk factors discussed in today's press release and in our Quarterly and Annual filings with the SEC. I will now turn the call over to Joe.

Joe Swedish - *Anthem, Inc. - Chairman, President & CEO*

Thank you, Doug and good morning. We're pleased to announce fourth-quarter 2015 adjusted earnings per share of $1.14. On a GAAP basis, we reported earnings per share of $0.68. For the full-year 2015, adjusted earnings per share was $10.16, representing year-over-year growth of 8.7% and GAAP earnings per share of $9.38. It's important to note that our results include roughly $0.04 of assessments associated with the state of Colorado dissolution of their co-op, an expense that was not expected when we last stated our full-year earnings outlook.

I'm very pleased with our 2015 performance, and I believe the growing diversification of our Company and the complementary nature of our pending Cigna acquisition will position us well to capitalize on market growth opportunities over the next several years. We remain focused on improving healthcare affordability, quality and choice to a growing membership base.

I'm going to start with some overview comments on our fourth-quarter and 2015 results and then move to discuss our 2016 outlook in more detail. Fourth-quarter results capped a successful 2015 with underlying fundamentals that track well versus our expectations. The fourth quarter represented the lowest quarterly adjusted earnings per share during 2015, which reflected our evolving business mix and the timing of medical utilization and operating expenses.

As expected, this included lower margins in our commercial and government businesses due to a higher benefit expense ratio and an increase in investment spending. Both fully insured and self-funded membership tracked ahead of expectations and we ended the year with 38.6 million members, a growth of 1.1 million lives, or nearly 3%, since 2014. Our fourth-quarter performance creates a favorable starting point for 2016 enrollment. In particular, during the quarter, we saw better-than-expected membership growth in our large group and Medicaid markets.

As expected, we ended the year with 791,000 individual public exchange lives, a decrease of 33,000 from the third quarter. During 2015, we added a total of 84,000 lives in public exchanges. Our small group enrollment declined by just north of 100,000 lives in the quarter to 1.2 million lives as we saw higher-than-expected lapses in plans that had previously early renewed with a December 1 benefit start date.

During the quarter, medical cost trends continued to come in favorably versus our stated range. Our 2015 medical cost trend came in at the lower half of our previously guided range of 6.5% to 7.5%. For 2016, we anticipate local group medical cost trends will be slightly higher, in the range of 7% to 7.5%.

Operating revenue was $78.4 billion during 2015, an increase of $5.4 billion, or 7.4%, versus 2014, reflecting strong enrollment growth in the government business, additional premium revenue to cover overall cost trends and increased fees associated with healthcare reform.

Also contributing was the growth in administrative fee revenue as a result of our strong self-funded membership trends. This was partially offset by fully insured membership losses in our commercial business. The full-year 2015 benefit expense ratio was 83.3%, an increase of 20 basis points from the prior year. The year-over-year increase reflected the change in our business mix towards the government business division and a higher benefit expense ratio in the individual exchange business.

Our SG&A expense ratio came in at 16% for the full-year 2015, a decrease of 10 basis points from the prior year. This was driven by the changing mix of our membership to the government business and a continued focus on administrative expense control, reflecting the need to ensure that we have the right cost structure for our public exchange membership outlook through 2016.

Supporting the strong quality of our earnings during 2015, we reported operating cash flow of approximately $4.1 billion, or 1.6 times net income, with cash flow in the fourth quarter of $949 million. While we're pleased with our run rate cash flow performance, our 2015 results included the benefit of approximately $500 million in timing items related to government and vendor payments. These items are simply timing and accelerated our 2015 cash flow, which we originally expected to be in 2016. Including the impact of these timing items, we expect 2016 operating cash flow to be greater than $3 billion.

Commercial operating margins in 2015 were 7.6%, reflecting year-over-year improvements in all lines of business with the exception of individual. As we have previously discussed, operating results on the public exchanges have lagged expectations during the year as membership was more than 30% behind our original expectations. As expected, commercial fourth-quarter margins represented the lowest of the year, reflecting the timing of benefits expense and our evolving mix of business.

Our government business continued its strong year into the fourth quarter with an ending operating margin of 4.8%, an improvement of 130 basis points versus 2014, along with better-than-expected membership results. In particular, our Medicare and Medicaid margins improved meaningfully versus 2014.

We're very encouraged by the turnaround plan put into place by our Medicare team, now finishing the second year of a three-year plan. Their recent performance is an encouraging next step towards driving meaningful long-term earnings growth. We expect margins will continue to improve in 2016 towards our expected long-term sustainable level and we have positioned our portfolio to grow enrollment in the right markets with the right products in 2017.

For Medicaid, our team has built a process that is focused on the basic blocking and tackling aspects of managing our members' total cost of care and quality. We're leveraging our assets to provide industry-leading solutions for our government partners to help control their populations' healthcare cost without sacrificing the quality of care. While this year's margin performance is above our long-term expectations, we feel confident in our team's ability to continue to outperform on a wide variety of care management and performance metrics.

Regarding our balance sheet metrics, we have included a roll-forward of our medical claims payable balance in this morning's press release. For the full-year 2015, we experienced favorable prior-year reserve development of $800 million, which was moderately better than our expectations. While the favorable development was higher than what was recognized during 2014, it resulted in offsetting adjustments for the risk stabilization programs from healthcare reform. We continue to maintain our upper single-digit margin for adverse deviation and believe our reserve balance remains consistent and strong as of December 31, 2015.

For the 3Rs related to the 2015 benefit year, we continue to book reinsurance as appropriate and continue to expect to be in a net payable position of risk adjusters and in a net neutral position for risk orders. We continue to record a valuation allowance against the risk order receivables in certain markets as we do not believe those receivables will ultimately be collected. We believe our estimates are prudent given the dynamic nature of available information.

Our days in claims payable was 42.7 days as of December 31, an increase of 0.4 days from the 42.3 days as of September 30, 2015. The increase was primarily due to changes in the timing of claims payments between periods. As previously discussed, we do still expect days in claims payable to come back down closer to 40 over time.

Our debt to capital ratio was 40.8% at December 31, 2015, down 40 basis points from 41.2% as of September 30, which reflects the impact of reducing our outstanding balance in commercial paper during the quarter. We ended the fourth quarter with approximately $1.4 billion in cash and investments at the parent company. And our investment portfolio was in an unrealized gain possession of approximately $368 million as of December 31.

Turning to our 2016 outlook, we currently expect operating revenues to grow to a range of $80 billion to $81 billion, which is light of the long-term projections we laid out at our Investor Day in early 2014. The shortfall is primarily due to our individual exchange membership being meaningfully behind our projections as we've discussed with you previously.

In commercial, we expect relatively steady enrollment during the year. We expect growth of over 300,000 lives for national accounts in 2016. We have strong momentum in securing new contract wins and exceeding our retention expectations. We also expect growth in large group self-funded enrollment reflecting new contract wins.

While we expect strong growth in ASO, our commercial fully-insured enrollment will be pressured. We expect membership declines of approximately 300,000 in our individual business as we aren't experiencing the overall market growth on the public exchange that we projected when we laid out our 5-year plan and unsustainable pricing in some markets is hurting our historic marketshare.

We're encouraged that early indicators of the open enrollment activity are slightly better than our muted expectations. Recent actions taken by CMS to begin addressing the special enrollment period challenges, as well as the elimination of the health insurer fee in 2017 are important first steps towards improving affordability for our customers. You can be assured we are contributing to the dialogue to form a long-term sustainable and affordable marketplace.

We also expect local group fully-insured membership losses of approximately 250,000 as members continue to transition into self-funded product offerings. It is important to note that while this trend is in line with recent history, we now do not expect a meaningful offset to this trend from growth on the private exchanges. Additionally, we expect continued pressure from the impact of higher levels of attrition due to the ending of insurance policies that were early renewed by our clients before the implementation of the Affordable Care Act.

For government, we expect another strong enrollment growth year. We expect Medicaid to add more than 350,000 lives, reflecting the addition of new business in the state of Iowa, as well as continued organic growth in core and expansion products. We continue to see states gravitate towards managed care to be the solution for more complex populations and services and we expect to be front and center supporting these states' initiatives.

Within our Medicare business, we continue to expect enrollment to be relatively steady as growth in our existing markets will be mostly offset by membership losses as we finalize the repositioning of our book in certain markets as part of our turnaround plan.

Turning to financial metrics, we expect relatively stable margins in 2016. We currently expect an MLR midpoint of 83.6%, an increase of 30 basis points versus 2015. This reflects the impact of a change in the mix of our business as we expect strong growth in Medicaid, a business with a higher MLR than the consolidated average.

Related to cost trend expectations, again, we expect 2016 local group medical cost trends to be in the range of 7% to 7.5%. We expect our SG&A ratio in 2016 to be 15.4% at the midpoint. This reflects the impact of the changing mix of our business, strong growth in Medicaid and the impact of the administrative efficiency initiatives our management team is taking to work through the challenging public exchange environment.

Below the line, we expect investment income of approximately $650 million and interest expense of approximately $630 million. Note that our interest expense projection does not include the costs we expect to incur related to the bridge loan financing we have in place for the pending Cigna acquisition.

We also currently expect our tax rate to be in the range of 43.5% to 45.5% for the year. We expect some benefit from the impact of capital deployment activities next year. While we suspended share repurchases after the announcement of the Cigna acquisition in 2015, we plan to resume our capital deployment program in 2016, subject to market conditions, albeit at a lower level than in recent years. As a result, we currently expect our share count for the year to be in the range of 266 million to 270 million shares.

We remain committed to at least maintaining our current dividend. We plan to review our capital deployment strategies at our next Board meeting in February and we expect to make an announcement on our first-quarter 2016 dividend shortly thereafter.

To conclude, our 2016 GAAP earnings-per-share estimate is greater than $10.35. Our adjusted earnings-per-share outlook is greater than $10.80. The difference between these two estimates is the exclusion of the amortization of deal-related intangibles. It's important to note that our 2016 outlook does not include any benefits or transaction costs associated with the pending acquisition of Cigna, which we continue to expect will close in the second half of the year. With that, operator, please open the queue for questions.

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions). AJ Rice, UBS.

AJ Rice - *UBS - Analyst*

Thanks, everyone. I noticed on your guidance you're forecasting your medical cost trend to a range of 50 basis points. Traditionally, you guys have always used 100 basis points in forecasting that. I'm just curious on your thinking of narrowing that. Obviously, the stepup sort of seems similar to what you assumed last year and you came in at the low end, but I'm just curious of the thinking behind that.

Wayne DeVeydt - *Anthem, Inc. - EVP & CFO*

Essentially the thinking was that, the last several years, I think it's fair to say there's been a lot of volatility regarding the exchanges, the Affordable Care Act, a number of new specialty drugs coming in. From our perspective, we generally have a point of view that's within 50 basis points. We've been hanging pretty tight to that.

And so it was more just to make sure that you understood that, in fact, we were raising our trend assumptions and our pricing going into this year and to try to tighten that bandwidth in a 50 basis point range, as we're getting better clarity now on the underlying activity associated with our commercial book, as well as the new drugs that are coming in.

AJ Rice - *UBS - Analyst*

Okay. And then just to follow up on the -- I know at a conference earlier in the month, you guys had made some comments about where you were at with your PBM and I don't assume there's no assumptions in anything in the guidance related to this, to any kind of changes in that contract, but is there any update on what you are thinking there and what the opportunity might be?

Joe Swedish - *Anthem, Inc. - Chairman, President & CEO*

Nothing's changed since our statements last month, or earlier this month at the conference. And nothing's been included in the materials regarding the PBM dialogue that we've had thus far, so I guess more to come later. But nothing is embedded at the moment.

Operator

Josh Raskin, Barclays.

Josh Raskin - *Barclays Capital - Analyst*

Thanks. Good morning. First question, just wanted to ask about the CMS sanctions at Cigna and I just want to see how does that fit with your understanding. When did you guys find out about it? Did you know about this as part of the diligence and does this change anything in terms of your outlook, your financial outlook, for the combined entities?

Joe Swedish - *Anthem, Inc. - Chairman, President & CEO*

First, let me clearly state we have two separate companies and obviously activities of that nature are within their company. We do not have line of sight of, nor should we, I think. And we are kind of considering it, as you would expect. But, at the moment, we really don't have enough line of sight to pass judgment on what effect it may have, if any, for that matter. So we will be vigilant and I'm certain that as time marches on, we'll learn more. But quite frankly at this stage, there's really nothing for us to say regarding what impact it may have regarding Cigna.

And with respect to the transaction itself, we are clearly unwavering with respect to our commitment to the deal. This does not have an effect on the deal process and obviously as we learn more, we will certainly feather it into our considerations. But, at this stage, we just do not believe it has a material effect on our transaction.

Josh Raskin - *Barclays Capital - Analyst*

Got you. That's what I was looking for. And then just on the commercial business, the MLR, I think in the past you guys had been attributing the increase at least last quarter to the individual business. Now you're adding local group into that discussion for the MLR drivers. So just trying to figure out what's driving that increase? Did the individual business deteriorate more, or is this now more of a small group issue? And as we look about the overall margin for the commercial segment this quarter being just over breakeven, is it fair to assume you're losing money now, obviously in individual, but also on the local group side as well?

Wayne DeVeydt - *Anthem, Inc. - EVP & CFO*

No, Josh. Let me clarify. There's normal seasonality that we see in all books of business as deductibles are met throughout the year, so I want to emphasize that, relative to the group business, no concerns at all. The primary MLR drivers are mixed in the quarter and as we've been talking about the public exchanges. So again, I don't want to create any alarms there.

Trend finished at the low end, or lower half of our range, as we said earlier and the metrics remain strong. One thing I would like to highlight though for each of you on the call is that we tried to maintain a conservative posture on the 3Rs as well while maintaining our reserve balance sheet strength with our high single digit margin for adverse deviation at year-end.

So when you look at our run rate individual business, we still made a very slight -- I would call it closer to break even for the year -- but keep in mind that's with us maintaining a very conservative position on the 3Rs as well. And going into 2016, we are still assuming we will be profitable on our individual and exchange business, albeit below our targeted 3% to 5% margins as we continue to see those markets hopefully begin to harden around pricing.

Operator

Kevin Fischbeck, Bank of America.

Kevin Fischbeck - *Bank of America Merrill Lynch - Analyst*

Great, thanks. I understand the concept of mix shift impacting the MLR and the SG&A ratios, but it looks like, given that you're growing earnings faster than revenue, you're looking for actual margin expansion next year. Can you point to the one division that you would point to as seeing stronger margin improvement year-over-year?

Wayne DeVeydt - *Anthem, Inc. - EVP & CFO*

Kevin, the primary thing I would highlight is a lot of the initiatives we took was to take the G&A deleveraging out across the organization, that if we weren't going to see the membership growth that we expected on the exchanges and then more importantly, I think as Joe has said, he's committed to us driving towards the $14 in 2018 and so we've had a very aggressive G&A initiative, which allows both margin maintenance, as well as some expansion in all lines of business as that effort was an enterprise-wide effort.

Kevin Fischbeck - *Bank of America Merrill Lynch - Analyst*

So it's on the commercial side that you would say is where more of the margin expansion would be?

Wayne DeVeydt - *Anthem, Inc. - EVP & CFO*

Yes.

Kevin Fischbeck - *Bank of America Merrill Lynch - Analyst*

And I guess as far as that comment about the 2014 number, I guess last quarter you said, hey, individual membership is coming in below what we might have thought and [over] our long-term targets, that could be a drag towards hitting that. Are you saying now that you found some offsets that are still going to -- that we'd be comfortable with hitting $14 on a standalone basis before Express, or is that still a risk in your view?

Wayne DeVeydt - *Anthem, Inc. - EVP & CFO*

Kevin, I would say that relative to the revenue line item, if the individual membership fully insured market doesn't ramp up over the next several years, I think that $100 billion in organic revenue will be at risk. I think relative to the $14 of earnings per share, as we've been able to show in 2015 going into 2016, there are many levers that we can pull and Joe has aggressively pushed the management team to pull those levers with a high degree of confidence hopefully in our ability to execute against them.

And so I think, at this point, I would tell you -- and I'll let Joe say it for himself -- he's committed and this management team is committed to driving towards the $14, but we may get there different than we had laid out two years ago.

Joe Swedish - *Anthem, Inc. - Chairman, President & CEO*

Yes, I'll just reiterate and emphasize we recognize $100 billion might be somewhat flexible in terms of where we may end up in 2018 on that metric. However, we're incredibly committed to the $14. We believe there are certainly a lot of variables in the equation that will map to what the ultimate revenue capture will be. But nonetheless, all parts and pieces are going to line up, we believe, very effectively for us to make that $14 commitment. And so, again, we've got all actions in place regarding matters like the G&A controls and a variety of other puts and takes on the management side that will get us to the $14 target.

Wayne DeVeydt - *Anthem, Inc. - EVP & CFO*

Kevin, as we've said previously too, the PBM and rising interest rates both serve as hedges against other risks that we see in the business and potential opportunities for upside as well.

Kevin, one other item I want to highlight is you had asked about other businesses with margin. In addition to G&A, the Medicare improvement, as Joe laid out, our efforts over the last two years have been quite substantial and the results have been very promising and so we will see very nice margin improvement in Medicare going into 2016 as well.

Operator

Gary Taylor, JPMorgan.

Gary Taylor - *JPMorganChase - Analyst*

I had one question and one follow-up. Just in terms of your cost trend guidance for 2016, would you care to kind of go through components of that -- so hospital, inpatient, outpatient, physician, pharma? Even just qualitatively in terms of expectations would be helpful.

Wayne DeVeydt - *Anthem, Inc. - EVP & CFO*

We won't break it down necessarily, although I can tell you that we expect very little change in the physician aspects of it. It's very much driven more towards the specialty pharma being one of the primary drivers. We are expecting an increase in utilization on inpatient. Whether or not that plays out will remain to be seen. But it's primarily utilization and then it's unit cost on pharma that are the drivers.

Gary Taylor - *JPMorganChase - Analyst*

Okay. And then just a clarification on the reported operating gain for the commercial segment for 4Q, it's $56 million; it's at 0.6% margin. Is that figure normalized, excluding the California franchise tax ruling, or is that -- is there a pretax number that's weighing upon that reported operating income margin?

Wayne DeVeydt - *Anthem, Inc. - EVP & CFO*

No, the only item that is of a unique nature that would be in there from an operating gain perspective is our desire to maintain a strong balance sheet associated with the 3Rs, and that has a direct impact on that. I'd like to be optimistic and hope there will be upside there, but it appears even in the last year our conservative nature on some of these 3Rs has proved to be prudent and so we've decided to take that same posture in the fourth quarter and strengthen even further some of the 3R assumptions.

Based on the public data available, it would imply we're conservative, but, at the same time, that data would have implied that last year and that ended up not being the case. So we tried to strengthen even further and of course that hits the commercial segment directly.

Gary Taylor - *JPMorganChase - Analyst*

That's primarily a risk adjustment number we will see in the 10-K?

Wayne DeVeydt - *Anthem, Inc. - EVP & CFO*

Both risk adjustment, as well as a position that we don't see value in the corridors and assumed a 100% valuation allowance, as well as on the reinsurance, we have stuck with strictly what the law currently says we're entitled to, not what maybe excess funding may be in the pool. And so those are the three positions we've taken a conservative posture in.

Gary Taylor - *JPMorganChase - Analyst*

Okay, great. Thank you.

Operator

Ralph Giacobbe, Citi.

Ralph Giacobbe - *Credit Suisse - Analyst*

Thanks, good morning. I may have missed this; I'm not sure if you gave it. Did you say where you ended the year in terms of exchange enrollment and maybe what's embedded into expectations in terms of exchange enrollment for 2016? And then just extending on that, maybe where you're at in terms of on versus off-exchange for your individual book?

Wayne DeVeydt - *Anthem, Inc. - EVP & CFO*

We ended the year just shy of 800,000 members on the exchange enrollment, around 791,000, which was below our planned expectations by about 30% and we now are looking at the book in a more fungible way. We look at on-exchange and off-exchange now because it's becoming quite fungible between the two as grandmothering is moving away. And so for next year, we have individual declining by another 300,000 lives all in going into 2016, at least that's our assumption.

As Joe said in the prepared remarks, the early enrollment application is encouraging against that assumption, but it's very important that we wait and see how lapses actually occur because we'll know who ultimately pays and doesn't pay. We won't know that answer till the end of this month. So again, the applications to date would imply that we may be conservative there, but until we see actual payments and disenrollment, it's hard to declare.

Ralph Giacobbe - *Credit Suisse - Analyst*

Okay. All right, that's helpful. And then just on the ASO book, you continue to show nice growth there. Are you seeing and capturing existing ASO business, or are you maybe seeing a continued shift from risk to ASO? Are you seeing more penetration downstream to mid or smaller employers? Just trying to get a sense of the dynamics at play.

Wayne DeVeydt - *Anthem, Inc. - EVP & CFO*

It's a little bit of both. Clearly, on the national accounts, those were a lot of new wins for us, obviously some very sizable wins, including the Bank of America account. So from that perspective, I would say a big chunk of the ASOs is really new membership and new lives to us.

When you look at the shift from ASO -- I'm sorry -- from fully insured to ASO, that shift continues. I wouldn't call it at an accelerated pace anymore. It seems to have slowed down, but nonetheless it is still occurring. And so we are retaining a lot of that membership moving from fully insured to ASO, but, as you know, on a revenue basis, that really dampens the revenue if you are not getting the offset through either the public exchanges or for that matter what we thought would have been a faster pace in the private exchanges, which we believe is a much more muted pace now.

Operator

Dave Windley, Jefferies.

Dave Windley - *Jefferies & Co. - Analyst*

Good morning. Thanks for taking the questions. So on the premium number, Wayne, that you were just hitting on, the guidance relative to expectations is, call it, $2.5 billion, $3 billion light. The ASO shift accounts for some of that, but maybe less than half. I'm wondering if you believe you are getting -- if there's anything in mix that would be affecting yield and are you getting full premium yield relative to the cost trend expectations you are expecting for 2016?

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Wayne DeVeydt - *Anthem, Inc. - EVP & CFO*

Great question. Let me first highlight that this revenue shortfall is almost predominantly associated with the lack of growth on the public exchanges. I can't emphasize that point enough. And ultimately, that would be the one area I would say, while we're projecting profitability still in 2016, clearly at margins below what we think are the long-term margins for sustainable program and product. So that would be the one area I would point to relative to yield. We are still able to cover our cost of capital on them and be profitable, but we're looking forward to some of the structural changes that I know the administration is looking at to make these programs even more viable in the long term.

But our revenue issue is really a fully insured public exchange issue at this point. The rest of the book of business is performing well versus our five-year expectations we've laid out.

Dave Windley - *Jefferies & Co. - Analyst*

Okay. My follow-up would be, on -- a follow-up on the PBM. Would you guys be willing to comment on how the analysis bridged from the $500 million to $700 million number that you talked about say mid to early second half of 2015 to the $3 billion number that you've now talked about in January of 2016?

Joe Swedish - *Anthem, Inc. - Chairman, President & CEO*

Let me comment on that. Going back in time to 2015 at earnings day, we did land on the $500 million to $700 million as a proxy statement regarding what may be possible related to market check analysis, etc. Then fast-forward to today. We've gone through a very deliberate analytical process. We've vectored toward an answer related to multiple checks in the marketplace and that brought us to the $3 billion finding that we believe is very, very credible. And obviously, having made that statement, which we believe kind of recalibrates the number from that $500 million to $700 million is something that we believe is much more realistic.

So what we said back in 2015 is that we would update you in 2016, actually hoping to communicate I guess call it a solution to you regarding our PBM inquiry regarding what we would have to do to reposition ourselves to get to the end of the contract in 2019. So having made a statement about $3 billion, our market check expectations, we believe we've set the table now for conversations in and around the possibility of recasting our pricing relationship with ESI. So all I can tell you at this stage that dialogue will continue and we're hopeful that still in 2016 we will reach a resolution to this matter that we're engaged in with ESI.

Operator

Christine Arnold, Cowen.

Christine Arnold - *Cowen & Company - Analyst*

I'm looking at the MLR and as of third-quarter 2015, you expected the full year to be 82.9% plus or minus 30%, and you were above that range at 83.3% for the full year. So was individual entirely the shortfall on that loss ratio?

Wayne DeVeydt - *Anthem, Inc. - EVP & CFO*

Individual was substantially the shortfall; that's correct. And again, it's important to recognize that some of the balance sheet strengthening we've done would all flow through that as well regarding not only the 3Rs, but maintaining that high single digit for adverse deviation, so I would point you almost solely to that. Medicaid enrollment was a little bit stronger in the quarter than we had anticipated as well, so that has a little bit of an MLR mix shift to it. But it's predominantly individual and in the strengthening we did on the 3Rs.

Christine Arnold - *Cowen & Company - Analyst*

Okay. And first half of the year, we were looking at a 3% to 5% margin. Second half of the year, we're looking at breakeven, so we've completely erased that 3% to 5%. Yet the bids were due in May and June, so can you help me understand how, when you didn't know about this 3% to 5% erosion in profitability, you are confident that this is going to improve next year? Thanks.

Wayne DeVeydt - *Anthem, Inc. - EVP & CFO*

Christine, it's a really great question and it's one of the reasons that -- the issue we had though on our margins this year was the inability to deleverage G&A quick enough. So we were still assuming a 3% to 5% margin, but we were also assuming a 30% growth rate. As we started seeing that growth rate not only not occur, but begin to see some attrition in the latter part of the year, we realized it was imperative to get the G&A out, and I can tell you that those initiatives have occurred. Those actions around headcount and other costs have already been taken out now and we'll get the run rate effect going into the year. So from that perspective, we feel fairly confident.

And again, I would emphasize the public data that we're getting regarding risk adjusters from Wakely, regarding how 3Rs settled up on reinsurance last year, etc., would imply we're being conservative in that outlook, but we've chosen to take that posture in 2015 and that's part of the reason of getting close to breakeven.

Operator

Ana Gupte, Leerink Partners.

Ana Gupte - *Leerink Partners - Analyst*

Appreciate you taking the question. The question firstly is around the catcher's mitt strategy that you had articulated. Now we're at two years into exchanges. As you are looking at your small group, that $800 million EBIT headwind -- sorry -- $800 million to $400 million that you had articulated, when you look at it across, firstly, is that stemmed at this point and when you look at it across small group and individual, are you coming out net positive? Is it net neutral? Or is it continuing to be a headwind and how do you expect that going forward into 2016 and then 2017?

Wayne DeVeydt - *Anthem, Inc. - EVP & CFO*

Thanks for the question. I would say the catcher's mitt strategy itself is working as we would've expected as we are clearly seeing attrition in lines of business. Small group alone lost over 100,000 lives in the fourth quarter. Clearly, we're picking those lives up elsewhere as we were able to exceed our membership targets for the year.

I would say the part of the strategy that's not coming to light at this point isn't about capturing the member now, but where exactly that member is caught and the revenue associated with that member. And I think at this point, when we built our five-year plan, we fully expected more of these lives to be picked up in the public exchanges as a fully insured, and we're finding that some of those lives now are actually getting employed and more in an ASO market and -- or we're picking them up on Medicaid, which in some cases is a lower PMPM we would've gotten on the public exchange.

So ultimately I would say the strategy of the catcher's mitt itself is working in terms of getting the customers and continuing to grow membership, but I would say the mix of membership and how it translates to revenue is not panning out as we had anticipated.

Ana Gupte - *Leerink Partners - Analyst*

And then following up on that, just now on the public exchanges, but your decline in individual from the third quarter to the fourth quarter, was that mainly the special enrollment period [slope] that did that? And as you are looking out into 2017 as reinsurance goes away, do you think the policy changes that the administration is making would still allow you to remain on exchange and be profitable into 2017, just again part of your catcher's mitt?

Joe Swedish - *Anthem, Inc. - Chairman, President & CEO*

Let me comment on the continued engagement that we envision in the exchanges. Yes, we are certainly very observant to shifts and changes that the administration is enacting, especially paying a lot of attention to special enrollment period. Very thankful the administration has made some changes. I suspect there may be more changes in the near future, which we want to consider very carefully so that we can judge the sustainability of the exchange marketplace and how well we can engage in that marketplace going forward.

So we're very observant regarding these moves and changes. We feel that, as Wayne pointed out a moment ago, we're extremely well-positioned with respect to matters like G&A that allows us to perform in this space reasonably well. Notwithstanding member deterioration, it's presumably stabilized given what we're observing regarding some uptick in membership for 2016, which obviously, as Wayne pointed out, we'll probably know more within the month.

But, nonetheless, we're really carefully observing it, looking at special enrollment in terms of its potential impact and again, we're very hopeful that some of the issues will be ameliorated in terms of the risk and we will have a much more sustainable marketplace to engage in.

Operator

Scott Fidel, Credit Suisse.

Scott Fidel - *Credit Suisse - Analyst*

First question, just if you can give us an update on how the implementation of Iowa Medicaid is coming along and just interested just in the context of the state having removed well care from the contract, what your updated enrollment expectation is for Iowa and then what type of losses you're building in and expecting? Obviously United did increase their PDR for Iowa as a result of that, so just interested in how you're approaching this.

Wayne DeVeydt - *Anthem, Inc. - EVP & CFO*

First of all, relative to Iowa, we continue to be optimistic about this program in the long term and that it will have the similar trajectory of we expect to lose money in year one, get closer to breakeven in year two and then return to profitability by year three. We got an update from the team yesterday, actually Joe and the senior leadership team got a full deep dive on where things are progressing, and things are moving exactly as we would've expected at this point. We're very close to starting that implementation on 3/1.

We don't have line of sight of what membership we may or may not get. As you know, there are a number of appeals that have been filed both by the one individual that was selected that has been told they were being removed, as well as others that were not selected in the first round. So we have not included any of that and we want to see how that pans out.

That being said, if you were to look at Medicaid all in, both margin compression that we're receiving throughout the year that we expect, plus we're assuming even further margin pressure in the back half of 2016 from states, as well as expansion, there's about a few hundred million dollar headwind baked in. But I would tell you that Iowa is less than 25% of that, so it gives you kind of a gauge of how we're envisioning year one to evolve and then migrate more to year two and then from there to the normal profitability we would have in these programs.

The delay of two months is part of the reason for that level of loss in year one because ultimately we've got the G&A float happening, but we don't have the revenue yet.

Scott Fidel - *Credit Suisse - Analyst*

Got it. Okay. And then just had a follow-up question just on small group and actually a number that I don't think we've talked about for a few quarters, but just interested -- remember a couple years back, you had talked about how small group would potentially have to absorb maybe a $400 million EBIT hit from ACA as thinking about both margin rebasement and then enrollment attrition. And just interested if you can give us an update on how you're tracking relative to that number? Obviously there has been some recent attrition, but just interested if we're sort of at that number or still some ways to go, or just where we stand relative to that?

Wayne DeVeydt - *Anthem, Inc. - EVP & CFO*

So relative to the $400 million, Scott, which was more about margin reset, I'd say we have taken our medicine on that $400 million over the last couple years. Now it becomes a question of will small group continue to migrate to other lines of business over time around just pure membership. But we have taken that sizable hit.

As we saw in the fourth quarter, a very sizable chunk of that membership migrated away from fully insured and the question is will we recover that either through the public exchanges and open enrollment or others. Again, our early open enrollment data would imply we are recovering it, but we want to see what actually converts to a pay by the end of the month. But I would say in terms of the margin compression, we've taken a substantial portion of that $400 million.

Scott Fidel - *Credit Suisse - Analyst*

Okay, thanks.

Operator

Matthew Borsch, Goldman Sachs.

Matthew Borsch - *Goldman Sachs - Analyst*

Good morning. If I could just go back to the exchanges for a moment again. A couple questions there. When you talked about the unsustainable price competition and also the lack of market growth, should we read that the decline that you're expecting of 300,000 is all about the unsustainable price competition since, if the market didn't grow, then maybe you would expect it to be flat?

And my follow-up question to that is, as we look to 2017, how much favorable impact do you think you'll get from the risk pool as grandmothering plans work their way into the exchanges? Albeit I know that's not going to be the case for your two largest markets -- California and New York.

Wayne DeVeydt - *Anthem, Inc. - EVP & CFO*

A couple thoughts or at least insights. One is, yes, we are assuming that some of the pricing that we continue to see in our markets, our 14 states, is still well below what we think appropriate rates are for a sustainable environment. I think the fact that we're closer to breakeven in 2015 and a profit margin that's below the targeted 3% to 5% in 2016 I think is a good indication of our price point isn't wrong as much as others need to strengthen their price point.

So we're going to assume that that strengthening is not occurring. In fact, we know in many states it hadn't occurred and that we will continue to attrit members. That being said, we're starting to see individuals start to recognize the problems in their books. They are starting to strengthen their pricing quite meaningfully. We are seeing co-ops struggle in the moment with more than half those now insolvent.

And so the question becomes will the market start to harden going into 2017, which has really two effects for us. One is we no longer have the diminishing membership base, but more importantly we should be hopefully a net recipient of that and hopefully start getting some of that revenue back that we had talked about in our original five-year outlook.

And then relative to 2017, Matt, to your comment with grandmothering, it's really hard to say at this point. The behaviors of the dynamics of what will the market look like in 2017, not just the exchanges and how grandmothering, but just what's the global economy and the US economy doing and what implications does that have as well. But the theory of what you laid out would imply that you're going to get more of those lives in that are a healthier population and should help improve the overall profitability of the book as well.

But as you indicated, in our largest markets, we did not allow grandfathering in many cases and we migrated already, so it won't have as big if an impact, but if the market has hardened, it should improve for us.

Matthew Borsch - *Goldman Sachs - Analyst*

Thank you.

Operator

Peter Costa, Wells Fargo.

Peter Costa - *Wells Fargo Securities - Analyst*

Thanks for the question. A couple years ago and through the last few years, we've talked about the consumerization of healthcare and the growth of private exchanges and we really haven't seen that come through in a significant way. Here we are a second year with that not delivering much membership growth to you. Can you tell us how you're evolving your strategy on consumerization in private exchanges?

Joe Swedish - *Anthem, Inc. - Chairman, President & CEO*

Thanks for the question. Yes, I think private exchanges have had a slow uptake probably for a few reasons, but I think it was considered as sort of an offset to the Cadillac tax exposure and other necessities that business and industry considered in terms of moving their employees into a private exchange marketplace. It didn't materialize to the level or the speed that anybody anticipated in the early going. And our position at the moment is that we're kind of taking a more muted response to the private exchange formation and execution.

Nonetheless, we're going to be ready if and when it does accelerate and it may very well do so in the future. But, at this stage, it really is a sort of muted response to that strategy and we believe what you are seeing nationally is sort of an in-market standard in terms of private exchanges just simply not picking up the speed that folks had originally anticipated.

So we're basically waiting -- wait and see -- and we're positioned -- in fact, we do have a private exchange membership that is not a substantial part of our membership, but certainly we are in the space. I guess bottom line is affordability is still the key and remains critical to long-term positioning on the part of the employers and as private exchange presents itself as a solution, we're ready, willing and able to engage in a meaningful way. But again I think our response at this stage is fairly muted given it's just been such a slow uptake.

Peter Costa - *Wells Fargo Securities - Analyst*

Okay, thanks. And just a follow-up, if you don't mind. Can you talk about the premium tax issue in California and your exposure to that in terms of the litigation against your Company?

Wayne DeVeydt - *Anthem, Inc. - EVP & CFO*

Yes, let me first just highlight that, in California, the tax laws differ based on legal entity, very similar to any legal entity in the United States has differing tax laws. We pay our taxes exactly as the law states within the state of California, as do our competitors that have similar legal entities filed there and the DMHC has actually agreed that we're paying taxes in accordance with the law.

So at this point, I can simply state that it is fully our intention to follow the law, as we've done so far. And it's fully our intention to litigate any action brought against us that would imply otherwise. And so there's nothing more to comment on beyond that other than you should be aware that it is the law that we're following under and the DMHC has supported us in that.

Operator

Chris Rigg, Susquehanna.

Chris Rigg - *Susquehanna Financial Group - Analyst*

Good morning. Just quickly here on the government segment; I know, Wayne, I think you said you're expecting to earn about $200 million less in Medicaid, but grow a little bit in Medicare. Net net, is it going to be flattish or down in the government segment in 2016?

Wayne DeVeydt - *Anthem, Inc. - EVP & CFO*

Good question. It's going to be slightly down, which gives you a pretty good idea of how well our Medicare is actually performing. But it will be slightly down between those. And again, it's important to recognize we thought it was prudent to have a cautious posture on how Medicaid rates make evolve as the year progresses. So not just the rates we know about in October, but what happens in mid-July, as well as next October.

Chris Rigg - *Susquehanna Financial Group - Analyst*

Great. And then just on the reinsurance, can you quantify how much you expect from -- how much you expect to receive in 2015 and would you have lost money without that amount? Thanks.

Wayne DeVeydt - *Anthem, Inc. - EVP & CFO*

Yes. I think the first thing to keep in mind is we're just assuming just slightly over 50%. I don't think you can look at it as whether you would lose money with or without that amount because it's important to recognize we're collecting that premium within our premium base on behalf of the government and then submitting that into the reinsurance pool. So our pricing is baked with an assumption that we will get what the law says we're entitled to get without it. So I don't think you can look at it with or without the program because the pricing is built with that program.

That being said, as you know, there's data points out there that would imply that people may recover as much as 55% to 60%. And again, we're much more aligned with where the law is. When I say slightly over 50%, it doesn't even run up to 51%, so it gives you a little bit of a feel for we're just barely over 50%.

Operator

Andy Schenker, Morgan Stanley.

Andy Schenker - *Morgan Stanley - Analyst*

Thanks. Good morning. Could you maybe talk a little bit more on Medicare? Obviously seeing significant improvements in 2015; calling for continued improvements in 2016; but how should we think about how much room is left beyond that, as well as maybe the level of investments currently in Medicare for the repositioning and will some of that start winding down in 2016, 2017? Thanks.

Joe Swedish - *Anthem, Inc. - Chairman, President & CEO*

Since I joined the Company a few years ago, we really put a stake in the ground that we were going to reposition ourselves in the Medicare space very aggressively. We established, as I said a moment ago, a three-year plan and we're well into that three-year plan realization in terms of our targets.

The margins we expect to expand over time, and we do believe that we're really heavily focused on medical cost management capabilities. And we have an increased focus on our administrative cost structure as being a key contributor to margin improvement. So when you put all that together, we're witnessing a substantial -- I would call it even a turnaround in our Medicare book that really gives us cause for optimism going forward.

We really do remain very pleased with the success that we've created with the team, and I'm hopeful that as we get through 2016 and well into 2017 that we'll be able to report on a trajectory that's on a positive track.

Andy Schenker - *Morgan Stanley - Analyst*

That's helpful. And then just real quick on seasonality here. It's obviously increasingly front-half loaded. Should we view 2015 seasonality as the framework for 2016, or is there any changes that could swing those numbers? Thanks.

Wayne DeVeydt - *Anthem, Inc. - EVP & CFO*

Andy, great question. I would think the seasonality in 2015 will be much more reflective of what you'll see in 2016. Keep in mind the wildcard in all of this is really going to be around how these 3Rs ultimately settle out. From our perspective, again, we believe we've been prudent at booking to a conservative point of view, but as more data comes out on those 3Rs that could create some unique nuances throughout the year. And also how these co-ops evolve throughout the year and how the states plan to solve for that could create nuances into 2016. But generally speaking, 2015 is a pretty good proxy for the seasonality you should expect in 2016.

Operator

Sarah James, Wedbush Securities.

Sarah James - *Wedbush Securities - Analyst*

Thank you. You mentioned some potential headwinds on Medicaid rates for 2016 and you are not the first company to spike out that concern. So what are you currently building into guidance for your blended rates in 2016? What was it in 2015 and can you talk about how you view margins on that business for legacy Medicaid. Excluding Iowa or any new contracts, how do you think about margins developing for Medicaid?

Wayne DeVeydt - *Anthem, Inc. - EVP & CFO*

So good question. One is though I do want to highlight we don't generally give blended rate increases. As you know, it varies by state and because the underlying economics of each state vary dramatically, we prefer not to blend them together in a broad discussion.

That being said though, Sarah, I think it's a fair question to understand that we have margins that are exceeding what we believe are what are long-term sustainable optimal margins, but know that we are still assuming that we'll blend closer to a 5% margin all in going into next year. Now that's higher than what you've typically heard from Medicaid, which would be the 2% to 3% margin range. But it's important to recognize that we do get a gross-up for the health insurer fee as well, so that bumps those margins further.

But we think that the guidance we provided puts us at what hopefully will be a sustainable outperformance margin for us. We believe we should have a better margin because we believe we can execute on this better, and the team that we've brought in from the Amerigroup almost three years now has done an exceptional job in that space, but our pricing assumes slowly landing the plane on those margins to get to more of that sustainable long-term margin.

Sarah James - *Wedbush Securities - Analyst*

Okay. And was there anything moving pieces wise in the quarter for Medicaid, like a flu benefit, or I think in the past you had mentioned the potential for a retroactive premium payment. So is there anything out of period or unusual that we should think about with this quarter's Medicaid performance?

Wayne DeVeydt - *Anthem, Inc. - EVP & CFO*

No, nothing unusual in terms of the actual numbers. Things tied out where we thought they would tie out. What was a little unusual was more on the cash flow. We actually had a couple large vendors and a couple states in particular pay us on the last day of the year for rates we typically get in the first five days of the new year. So it affected cash flow, but it didn't actually affect the underlying economics of what we had assumed.

Operator

Thank you. I'd now like to turn the conference back to the Company's management for closing comments.

Joe Swedish - *Anthem, Inc. - Chairman, President & CEO*

Yes, thank you all for your questions this morning. In summary, we're pleased with our 2015 results and believe the increasing diversification of our business positions us well for 2016 and beyond. As you've heard, our team remains focused on executing on our core business while preparing for the integration of our Cigna acquisition. We expect to close in the second half of the year.

I want to thank you all for being with us today and I especially want to thank our associates for their ongoing contributions and their commitment to serving our 38.6 million customers every day. Thank you all for your interest in Anthem and we look forward to speaking with you soon.

Operator

Ladies and gentlemen, this conference will be available for replay after 11 AM Eastern time today through February 9. You may access the AT&T teleconference replay system at anytime by dialing 1-800-475-6701 and entering the access code 378815. International participants dial 320-365-3844. Those numbers once again are 1-800-475-6701 or 320-365-3844 with the access code 378815. That does conclude your conference for today. Thank you for your participation and for using AT&T executive teleconference. You may now disconnect.