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PRESENTATION

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Please stand by for streaming text

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. Later there will be a question-and-answer session, instructions will be given at that time. (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

Good morning and welcome to Anthem's first-quarter 2016 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 first-quarter 2016 financial results and will walk through the financials and provide some incremental commentary around our updated 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 the 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

Thank you, Doug, and good morning. We are pleased to announce first-quarter 2016 adjusted earnings per share of $3.46 with membership tracking above our previous expectations. On a GAAP basis, we reported earnings per share of $2.63. I am pleased with our first-quarter results which represent a solid start to 2016 as the Company continues to benefit from the growing diversification of our businesses. The complementary nature of our pending Cigna acquisition will allow us to further advance affordability and quality for our members.I am going to start with some overview comments on our first-quarter 2016 results and then we will discuss a few of the key details of our updated 2016 outlook. First-quarter results reflect business performance that tracked well versus our expectations. Specifically, membership membership is exceeding our expectations and we reported strong quality of earnings metrics while maintaining appropriate conservatism on our balance sheets to reflect the dynamic nature of the marketplace that exists today. Within membership, both fully insured and self-funded membership are tracking ahead of expectations. We ended the first quarter with 39.6 million members reflecting growth of 1 million lives or 2.6% since year-end 2015.Specifically, we ended the quarter with 975,000 lives from the individual public exchanges, an increase of 184,000 from year-end 2015 and ahead of our initial expectations. Our self-funded business grew by 906,000 lives or 3.8% in the quarter to 24.6 million members which was also ahead of our expectations as the Company experienced higher than expected in group change in current contracts and BlueCard enrollment. Our local group insured enrollment declined by just north of 200,000 lives in the quarter and serves approximately 4 million members as of March 31. In particular, we saw higher than expected lapses in plans residing in states that transitioned the 51 to 99 key group size into the small group market place.Operating revenue was $20.3 billion in the first quarter of 2016, an increase of $1.5 billion or 7.7% versus the first quarter of 2015 reflecting strong enrollment growth in the government business and additional premium revenue to cover overall cost trends. 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 first-quarter 2016 benefit expense ratio was 81.8% which increased versus prior year as expected. The 160 basis point increase reflected the impact of an extra calendar day during the quarter from the Leap Year, a higher benefit expense ratio in the Medicaid and individual businesses as well as a change in our business mix towards the Government Business division which carries a higher than average benefit expense ratio. While we do not include a reserve role forward table in our first-quarter press release, it is important to note that year-end 2015 reserves have developed moderately better than our expectation so far in 2016. However, we do not believe our first-quarter 2016 financial results benefited from that reserve development and we have maintained an appropriate level of conservatism on our balance sheet as of March 31, for the higher than expected individual enrollment.Our SG&A expense ratio came in at 15.8% in the first quarter of 2016, a decrease of 90 basis points from the prior year. This was driven by a continued focus on administrative expense control in light of better than expected enrollment trends as well as the changing mix of our membership towards the Government Business. Supporting the strong quality of our earnings in the first quarter, we reported operating cash flow of approximately $1.3 billion or 1.9 times net income. We continue to expect 2016 operating cash flow to be greater than $3 billion. It is important to note that operating cash flow exceeded our expectations in the quarter which is encouraging.Turning to discuss the first-quarter financial performance of our business units, let me say that in our Commercial Business, we reported strong membership trends that came in well above our conservative expectations, increasing by 880,000 during the quarter. In particular, we saw strong self-funded membership trends in both our national and local group businesses and better than expected individual enrollment on the public exchanges. This contributed to the better than expected operating revenue during the quarter which increased by 1.5% versus the prior year to $9.5 billion.Operating margins were relatively flat compared to the prior quarter at 13.6% which reflects the impact of a higher benefit expense ratio offset by a lower SG&A expense ratio as expected. We were diligent with respect to pricing our exchange product offerings for 2016 as this remains a dynamic marketplace. We believe we have taken a conservative posture in the first quarter regarding our expectations for the profitability of this book of business for 2016. We believe we are well-positioned for continued growth in exchange lives as this market stabilizes to a more sustainable level over time.Relating to national accounts, we are pleased that the team has been able to secure some wins recently that should grow membership in both 2016 and 2017. As we said earlier, local group membership was down slightly year-over-year and we continue to see funding mix shift away from fully insured. We recognize it is vital to offer affordable products with the right network and benefit design in our markets and our team is focused on improving the historical trends of this book of business.Our Government Business segment had another solid quarter, adding 123,000 members and growing year-over-year revenue by 13.9% to $10.8 billion. It is important to note that our results do not yet include an impact from the addition of the Iowa contract aside from start-up costs occurred incurred in the quarter ahead of the contract launch where the implementation was delayed from March 1 to April 1. Operating margins for the Government Business in the quarter came in at 3%, a decline of approximately 40 basis points which was driven by lower gross margins in the Medicaid business. As we communicated previously, we continue to expect Medicaid margins to compress from 2015 levels to a more normalized level and we are monitoring the performance of this business appropriately.Within Medicare, I am pleased with the progress the team continues to make as our first-quarter margins reflect continued improvement versus last year. We continue to expect margins to improve as the year progresses 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.The pipeline of opportunity for our Medicaid business remains substantial. We expect $68 billion of new business to be awarded by the end of 2020, split about evenly between traditional Medicaid and new populations in specialized services. We continue to believe our experience in footprint positions us very well to continue our growth as we help states address the challenges of rising healthcare costs and improving quality for their residents.Regarding our balance sheet metrics, our days in claims payable was 43.4 days as of March 31, an increase of 0.7 days from the 42.7 days as of December 31, 2015. The increase was primarily due to the timing of claims payments driven by the new membership that came online during the quarter. As previously discussed, we expect days in claims payable to come back down closer to 40 over time.Our debt to capital ratio was 40.2% at March 31, 2016, down 60 basis points from the 40.8% as of December 31, which reflects the impact of an increase in shareholder equity and the reduction of our outstanding balance in the commercial paper during the quarter.We ended the first quarter with approximately $2.2 billion of cash and investments at the parent company and our investment portfolio was in an unrealized gain position of approximately $639 million as of March 31. For the three Rs related to the 2015 and 2016 benefit years, we continue to book reinsurance as appropriate and continue to reflect a net payable position for risk adjusters and a net neutral position for risk corridors. We continue to record a valuation allowance against the risk corridor 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. Turning to our financial outlook, we have increased our operating revenue expectation for 2016 by $1 billion to between $81 billion and $82 billion. This increase reflects higher projected membership due to the strong enrollment results seen through the first quarter as we have discussed. Fully insured membership is now expected to be approximately 14.9 million members at the midpoint of our range at year-end, 250,000 higher than our previous outlook which reflects stronger than previously expected results in the individual and Medicaid businesses.Self-funded membership is now expected to be approximately 24.5 million members, at the midpoint of our range at year-end, also 250,000 higher than our previous outlook. Taken together, we now project our total membership to be approximately 700,000 to 900,000 lives higher than we ended in 2015. We continue to expect our 2016 medical loss ratio to be 83.6% plus or minus 30 basis points and now expect our SG&A ratio to be 15.5%, plus or minus 30 basis points on a GAAP basis which includes the impact of Cigna related transaction costs incurred during the first quarter of 2016. We continue to expect 2016 local group medical cost trends to be in the range of 7% to 7.5%. We are encouraged with first-quarter operating cash flow and we continue to project operating cash flows to be greater than $3 billion in 2016.Regarding capital deployment, we raised our dividend during the first quarter by $0.025 per share and declared our second-quarter dividend of $0.65 per share. This represents an annualized dividend of $2.60 per share and continues our track record of increasing our dividend every year since it was implemented in 2011. Our 2016 outlook does include some benefit from the impact of capital deployment activities throughout the remainder of the year. While we did not repurchase any shares through the first quarter, we plan to resume our capital deployment program subject to market conditions albeit at a lower level than in recent years.To conclude, our 2016 earnings per share outlook is greater than $9.65 on a GAAP basis and our adjusted earnings per share outlook is greater than $10.80. Our outlook continues to take an appropriately conservative posture around the expected financial performance on the public exchanges and the expected year-over-year margin compression in the Medicaid business.Our outlook does not include the adoption of new accounting guidance related to employee share-based payments which we expect to implement in 2017. For context, we estimate the impact in the first quarter of 2016 would have been a benefit to GAAP and adjusted earnings per share of approximately $0.10. Our outlook does include an adverse impact of $0.03 for the additional assessment in 2016 associated with the state of Colorado dissolution of their co-op.It is also important to note that our 2016 outlook does not include any additional benefits or transaction costs associated with the pending acquisition of Cigna beyond those incurred in the first quarter of 2016. We continue to expect this acquisition will close in the second half of this year. It also does not include any benefit from lower pharmaceutical pricing which we continue to believe we are entitled to under our current contract with DSI.With that, operator, please open the queue for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). A.J. Rice, UBS.

A.J. Rice

Thanks. Hi, everybody. I figure I might as well just jump in on the public exchanges and ask you a broad question there, three parts to it I guess. Obviously you had good enrollment this open enrollment season. Can you give us any thoughts on what you know so far about the risk profile of those sign-ups and how you feel about that? Second, I know last year your issue really wasn't in terms of the dip in profitability on exchanges and the MLR issue was rather a G&A issue and you have made some adjustments there. Can you update us on what you did there? And then finally on the exchanges, the 2017 early outlook in light of some of the commentary from some of the others in the sector?

Joe Swedish

A.J., thank you for the question. This is Joe. First of all, let me just tell you that we are really pleased overall with how our team has been able to navigate the very challenging landscape that has evolved over the last couple of years. As I stated in my remarks, we are really glad to now be serving 975,000 members across all of our markets whichAs I stated in my remarks, we are really glad to now be serving 975,000 members across all of our markets which I think really highlights an incredibly meaningful value proposition to the customers that have chosen to align with us. Over time, we do believe we are well-positioned for continued growth in the exchange marketplace if the market stabilizes to a more sustainable level. I think that is a key consideration. Clearly the performance of the exchange marketplace has lagged expectations throughout the industry as some of our peers have recognized. In consideration of that, we are monitoring the market very closely to see that our offerings continue to be number one, very rational, sustainable for the customers but that also is built on a platform that is constructed appropriately with respect to costs that need to drive our presence in that market again at a very sustainable and appropriate level.I think it is really critical for me to underscore that we are actively engaged with our government partners to help build that long-term sustainable model that we believe will ultimately create an affordable marketplace and in doing so, we believe we can continue to develop a rate structure in the marketplace that is adequate for us and appropriate in terms of affordability for members. And for example, I think the elimination of the Health Insurer Fee in 2014 sets the stage nicely as we move into that new year with respect to a rate picture. And I think our combination with Cigna is going to present a meaningful improvement in affordability for our membership. So I think put all that to together, we are very kind of pleased with how we performed this year, we think we are engaged in a fairly sustainable platform that has potential for continuing growth, again underscore, as long as the model that we are engaged in in the marketplace is a sustainable model.Let me close my remarks in that regard by saying that I think there is some really key drivers to building that sustainable affordable marketplace that I mentioned. Some of the key elements include what has already been put in place for 2017 which is the health insurer tax adjustment. And the second thing would be careful consideration of updating the risk adjustment model for the consideration of special enrollment period adjustments and that would narrow the variety and number of special enrollment considerations. And we would like to be able to begin offering some very innovative product designs to the marketplace. Hopefully our government partners will be receptive to some of those creative and innovative models. And finally, I would like to underscore modification of the grace period for nonpayment of premiums to prevent abuse. So when you put all that together in a mosaic, I think maybe a sustainable model can be built and we will continue to perform in the marketplace in a way that continues to maybe try to achieve the membership that we had originally anticipated back when this effort first began in 2014.Wayne, you may want to speak to the MLR question that A.J. put to us.

Wayne DeVeydt

Yes, so A.J., as Joe addressed at least our views on 2017 and beyond, in terms of the membership we received I would say we have a slightly higher silver mix which we think is generally a positive regarding how we price our book and our product. The age distribution and subsidy eligible mix is consistent with those expectations. But I would tell you that we have chosen to maintain a conservative posture in Q1 until we see ultimately how this develops. So we have maintained a conservative posture on risk adjusters despite Wakely data that wouldn't fly that we should be booking more. And we are really not booking to the normal seasonality profitability you would see in this book in Q1 because again, I think from our perspective we would like to seek this membership at least get through 2Q to really understand how the book is performing. So from that perspective, we think it is the prudent thing to do and then as to 2Q evolves we will give more commentary on how it is actually developing.

A.J. Rice

Okay, great. And then maybe on that part just expanding, I know you talked about pulling back on your marketing and trimming your G&A directly related to the exchanges, you have had better than expected enrollment growth. Did you still pull in on those expense items on the G&A side?

Joe Swedish

Yes, we did. I think lessons learned last year 2015 was that we needed to really true up a very nice platform that was appropriately built for the type of market we were dealing with and quite frankly I think we really built a very stabilized platform that helped us move into 2016 to capture this kind of uptake in membership based on a cost structure that I think was very appropriately built out for the marketplace. And so quite frankly our G&A structure I think is well under control, it is appropriately sized and well configured for us to continue growing this space as appropriate.

Operator

Tom Carroll, Stifel.

Tom Carroll

Good morning. Just a quick follow-up on the exchange business, are you seeing any signs of adverse selection at all and maybe could you remind us of kind of the items that you are looking for within that book of business? And then secondly, I would like you to chat a little bit about the Medicaid business. Anthem had a great 2015 and you indicated that the Medicaid MLR was likely going to be up and was up during the first quarter. Was it aligned with your expectations, higher, lower from what you expected? And I wonder if you could comment also on the Medicaid Managed Care regulations that were out on Monday? Thanks.

Joe Swedish

Maybe I can pick back up where I left off regarding A.J.'s question on risk profile which I think relates back to your question on what are we seeing in terms of the membership capture. It is a little early. I think we are going to continue to dig into the risk profile that we have brought on and our sense is that probably somewhere in the 2Q range we are going to be able to get line of sight on risk profile and have more to report to you at the end of 2Q. So it is a little early for us to give you a line of sight on risk profile.

Wayne DeVeydt

So Tom, a couple of other items, so I think as Joe said, we like what we are seeing in early mix but ultimately as this business comes on, we will see how it really develops in Q2. As you know, now a lot of claims activity always has a little bit of a lag when an individual switches to a new carrier and then ultimately that reporting timeline that occurs with the providers ultimately to us. So I think in 2Q we will get a much better feel.What we want you to be aware of is one, we are not seeing any early indicators across our broader book on trend or anything that would have us change our overall trend assumptions. Two is we have maintained a conservative posture going to 2Q around the risk adjuster data not only for what we believe 2015 would true up to be but what we think the impact would be on 2016 in light of this mix. That is not based on just our assumptions but actually using the updated Wakely data we received as well and some recent CMS data. But as you know, ultimate settlement on those would be very dependent upon who owes the risk adjuster and how that will settleout. So we are going to wait and see how that pans out in Q2. But I would say on each of the 3Rs we have maintained a posture that should give us some contingency if the book doesn't develop as we would have expected. And if it does develop as we would expect, then it would give us some upside going into the second half of this year and into Q2.On the Medicaid front, again no real surprise just a reminder that we had a lot of new markets that we are rolling out. We continue to have that book evolve. As you know, Iowa now starts on April 1 as well so we would expect to see MLR pressure there in 2Q as well but consistent with our expectations of new markets that are rolling out and continue to be bullish on the Medicaid topline as well as the bottom line. And as we mentioned previously, we are going to be slow landing those margins down to what we think are more sustainable. And then on the Medicaid regs, no real surprises. We were fine with the new regs that came out.

Tom Carroll

Great, thank you.

Operator

Josh Raskin, Barclays.

Josh Raskin

Good morning. First question, just on the 975,000 exchange lives, could you help us break down how many of those are new to Anthem versus existing previously managed lives last year? And then any sense of how many of the new ones came from other plans versus new to the market? The follow-up would just the on the MLR, up 160 basis points in the first-quarter but guidance up 30 for the year. I understand the Leap Year but what are some of the deltas, what changes as we sort of progress through the year that would make those year-over-year comparisons look much better?

Joe Swedish

Let me take a shot at the first question. We just don't know yet quite frankly in terms of what carryover membership brought over from 2015. Obviously we are going to learn more about that getting into 2Q so it is a rather simple answer to the question. I wish I had more to give you but we just don't know this early.

Wayne DeVeydt

A couple of other items we would highlight though is that generally where we have seen what I would call the unexpected uptick, those have been markets where the co-ops have become insolvent. So I don't think there is a surprise there. I think what we are probably surprised on the uptake though has been that we weren't the next lowest cost carrier and in many cases we were substantially higher than the next or several next lowest cost carriers. So there appears to be a little bit of a flight to safety if you will and security. And so again, it is another reason why we want to see how this ultimately pans out. Our pricing is obviously much higher than what would have been available in the market and so the question will be does that adequately reflect the book that we are inheriting over from the co-ops on that end.Frankly given how 2015 played out, we want to take a more conservative posture earlier this year and see how that develops.

Josh Raskin

And you don't know which lives were Anthem members previously and still signed up?

Joe Swedish

You ultimately get the data but I would say you also have to look at it, we don't look at it as a single member by state. We look at the broad mix both on and off exchange membership and so while we have a feel for some of that, at the same time I would tell you that the majority of new membership growth that we are seeing is obviously new to us and it is coming from other organizations and clearly it is in the co-op states.

Josh Raskin

So do you have like a net sales versus a net lapses number or anything like that even if you don't know they are the same?

Joe Swedish

We do, we do, Josh, but we are obviously not going to disclose that data.

Josh Raskin

And then the MLR year-over-year?

Joe Swedish

Ultimately we show that -- we obviously had the impact of the Leap Year in the year. The thing to keep in mind though is the premium inherently the Leap Year alone, the premium spread over the entire year but you are getting a full day of claims within the quarter so clearly there is a positive effect that happens in the out years as the Leap Year continues. That is one dynamic. I think another dynamic to keep in mind is that when we look at our mix shift and how that is evolving, we actually didn't do the typical seasonality that you would see for individuals. So we have tried to book a little more of an MLR factor in the first quarter. That typically would have been lower and then you would have a higher in the fourth quarter in this case because of new membership. We are doing a little more -- I wouldn't call it straight line but we are trying to get much more of an upfront view and a conservative posture so as that develops. Again, I would basically put it that we are seeing how 2015 played out. We're just trying to take a much more conservative posture earlier in the year and then let that hopefully blend its way down as the year progresses.

Josh Raskin

Thanks.

Operator

Gary Taylor, JPMorgan.

Gary Taylor

Good morning. I just wanted to follow up a little bit and I think, Wayne, your last response kind of gets into my question a little bit so I will be brief. But I guess I am trying to understand where the individual enrollment came. You mentioned a few of these states where the co-ops were insolvent. I was wondering if there was any more detail you could provide than that particularly whether some of this enrollment would be in states like California, New York where I think your experience was better last year?

Wayne DeVeydt

Yes, Gary, it is. New York is obviously clearly one of the markets where the co-ops struggled and we did pick up I would say more than our market share that we typically have relative to the co-ops. California is another market where we did perform well. And in addition, it would be in Colorado and Kentucky, other markets where the co-ops had their difficulties and we have picked up I would say we have picked at more than our market share. So the membership available with their exits were disproportionately picking up market share.

Gary Taylor

As a quick follow, I guess I'm having a little difficulty seeing the degree of conservatism maybe that you are talking about in the book given versus the original expectation of individual being down 300,000, you are now up 200,000, days in claim payable down a couple of days year-over-year, the commercial operating margin was up 10 basis points even though you booked some additional MLR in the individual business. Is the response to that just that this individual seasonality is so skewed to the front end versus the fourth quarter that you still have some modest margin gain year-over-year even though you are booking this additional MLR in the individual book? Is that maybe just the range of seasonality maybe I'm just not appreciating enough?

Wayne DeVeydt

Yes, so Gary, yes, that is one dynamic. Second one is sequentially DCP is actually up since year-end and as we said, year-end to develop favorable to our expectations. I want to emphasize that developed favorable and DCP is up sequentially. Two is I think it is important to recognize that on the 3Rs, the data would imply that we have been conservative on 2015 and so we have neither recognized that conservatism yet. And in addition to that, it would also imply then a run rate that we would have available to us in 2016 based on that data. And again, we have not recognize that as well and it is important to recognize that the 3Rs are not part of DCP so you won't necessarily get to see that added conservatism that we are carrying into Q2 as we move forward.

Gary Taylor

Will you ever disclose 3Rs? Will we ever get that from you?

Wayne DeVeydt

Most likely not. But I will tell you that in 2Q we will give you a gauge though of how it maybe benefited us more broadly in terms of the pieces. I think the thing I want to highlight for the group though is the reason we are being cautious on 3Rs and in particular risk adjusters, which would imply that we would have a nice receivable related to 2015 as well as some run rate into 2016 is, the question is similar to the risk corridor, who ultimately is going to pay that? And if the receivable is due from a co-op, ultimately we don't want to recognize that unless we know the co-op has got the financial wherewithal to pay those receivables. So this is just one of many factors that we believe warrants being conservative until we see final settlements and then how those dollars are actually transferred between companies.

Gary Taylor

Thank you.

Operator

Peter Costa, Wells Fargo.

Peter Costa

I will move away from the individual exchanges for a minute and take you to the PBM and the contract dispute with Express. Can you talk -- not about what you are going to do but how would you bring it in-house specifically if that was the direction this ends up? Give us an idea of the timeframe it would take from when you have to start planning it as well as what sort of options would you use in terms of perhaps using some of the other PBMs or even Express by buying NextRx back or something like that to actually manage it given that you don't have the assets anymore to run a PBM? Can you talk about that a little bit and specifically how that would work if you were to try to bring it in-house?

Joe Swedish

Peter, interesting question. I think it strikes at one of our various options which is to kind of help us all recall where we started this journey. We've talked a lot about optionality and recognized that we had some choices ahead of us. One, bringing in-house as you have just described. Another would be to recast our agreement with ESI. Another would be to go to another vendor, etc. So we are considering a full range of options. I think first I need to preface my remarks by underscoring that we've got probably a couple of years at minimum before we need to make that call and quite frankly these considerations we are actively involved in the various pluses and minuses of each option. So it is really too early for us to comment on specificity. And I think that to your point about bringing it in-house and recognizing it is a complex process to do so, it does have costs associated with it. We recognize that but again, let me underscore it is not a decision that is imminent. We have a journey that we have to administer with respect to our ongoing negotiations with ESI regarding our position that we stated to them clearly and now it is taking the form of a lawsuit. So I would direct you to that with respect to the specificity around our engagement with them at this stage. But optionality again I want to underscore, we are in redevelopment mode on our choices but none of those choices do we have to exercise in any way of an imminent nature and so I would prefer just to kind of maybe delay a response to some future date when that is more of an imminent necessity for us to deal with.

Peter Costa

Okay. Can you talk about the expected savings if you were to bring it in-house? What would that look like relative to the $3 billion that you are seeking from Express on a contract renegotiation?

Joe Swedish

As I said, I think certainly a lot of analytics will go into discerning savings. We haven't actually gone into the depths of administratively how you would build it and the costs associated with building it that then translates to savings. Again, let me restate emphatically that it is too early for us to weigh in on that. And at some future moment in time where it is appropriate, we will certainly bring that to your attention. It is just too early now to give you clear line of sight on savings or an option of that nature.

Peter Costa

Okay, thank you.

Operator

Dave Windley, Jefferies.

Dave Windley

Thank you, good morning. I wanted to go back to Medicaid. The first part of the question would be was the higher MLR in Medicaid a function of just the lower rates that you have anticipated or were there other factors like flu perhaps or population mix acuity of the mix or even rising trend in Medicaid that impacted MLR there? And then second part would be as we look to the second quarter and the start of Iowa, some of your peers at least one I think have established reserves in 2015 in anticipation of pretty significant pressure from Iowa. How should we think about the progression of Medicaid margin into 2Q and the rest of year for Iowa? Thanks.

Wayne DeVeydt

Let me first start with Medicaid. Yes, a significant portion of what you saw in the MLR is a function of what we have been talking around the rate pressure and those rates coming down. I think our outlook for the year from the Medicaid team continues to be consistent with the outlook that we gave when we gave guidance initially and we expect to be at our MLR and trends playing within the levels that we had fully expected within the book. So no real surprises there. Relative to Iowa as you know, we did not book a PDR, we typically expect to have a higher MLR and to lose money early on when a program is rolled out and then ultimately the PDR requires you to look over the life of the contract and we clearly expect to be at profitability over the life of the contract which is why we don't have a PDR booked on it. But because the contract was delayed, obviously the MLR will reflect nine months of activity instead of 10 months which means that your MLR will be a little bit pressured in the current year but only by an additional month. And the fact that it was delayed by a month will create a little bit of pressure this year but obviously we expect that to come down next year. But while we weren't necessarily pleased with membership being delayed and the revenue impact, we actually think that additional month probably played well for the industry in terms of getting its contracts finalized and its networks finalized in a manner that hopefully can make this a very strong profitable book consistent with our historical margins. So we remain optimistic on the program.

Dave Windley

Very good. Thanks for that.

Operator

Kevin Fishback, Bank of America.

Kevin Fischbeck

Great. Thanks. Just wanted to dig into guidance a little bit. You beat consensus expectations for Q1 pretty nicely particularly on the G&A side but you didn't raise guidance for the year. In fact you took your G&A number up and kept your MLR stable even though you seem to be talking bout pressure on the MLR and the individual side at least from a mix perspective. Can you talk a little bit about why the puts and takes ended up the way that they were and why we didn't see upward pressure on MLR and downward pressure on G&A?

Wayne DeVeydt

Let me address a few things. One is, I want to highlight again that we look purely at Q1 and the results, it would have implied that we should have had a raise which I think is a very valid question that you are asking. I can't emphasize enough that we are very pleased with all the metrics in Q1 but with those metrics we really thought it was best to maintain a lot of conservatism that we could have otherwise potentially released in Q1 until we see how this book evolves into Q2. I think it is fair to say that the industry last year and ourselves included got to see a lot more of how things developed as last year progressed. So we are just taking a much more conservative posture until we see more development. The second thing I would highlight is again we did highlight that we are covering another $0.03 of assessments from co-ops and maintaining that guidance as well. Then the last thing I would say is that in terms of the metrics, we like our G&A where it is at and we think with this additional membership this is the SG&A leverage that we should have gotten a year ago with exchanges. As you know, it was a deleverage impact to us a year ago. This year it is going to be a leveragable impact and so we are holding the line on G&A. And again, if the membership plays out with the risk profile we would expect, then that G&A leverage helps improve the margins, if it doesn't then the G&A leverage helps offset any surprises. So I would love to give you a different answer but I mean the reality is we just chose to be conservative in Q1 until we can see how this book of business evolves.

Kevin Fischbeck

Okay. And I guess as you mentioned on the small group business that you saw some pressure particularly in the states that expanded to 51 to 100. What percent of your small group business is in those states?

Wayne DeVeydt

It is actually a decent amount and I would say it is primarily in California. As you know California was one of those states that made the decision as did New York and Colorado so if you were looking at what I would call your typical market, that would be the most significant for us is California of that group. And as a result, not only did your historical small group products no longer be allowed to persist but you actually had to reintroduce all new products and reconsider the product mix of what it would look like as they went to different thresholds for what was defined a small group. So we are not happy about the membership we lost in those markets but we also recognize that not every state adopted the flexibility that was offered them under the Affordable Care Act.

Kevin Fischbeck

Do you think that more states are going to end up doing that? Is that a headwind we would expect to see next year in more states or if you were going to do it, you would have done it by now?

Wayne DeVeydt

I think if you were going to do it, you would have done it by now. The other states have actually maintained the historical small group definition. So I think that is behind us now.

Kevin Fischbeck

Okay, thanks.

Operator

Ralph Giacobbe, Citigroup.

Ralph Giacobbe

Thanks, good morning. Just want to go back to the exchanges. I guess last quarter you had mentioned that the exchange book was breakeven for 2015 and as you've talked about, you expect it to pull G&A and bring it back to profitable levels. Obviously you have done better on the enrollment side so I guess you have talked about your conservatism. Can you help us in terms of what margins are assumed at this point for the exchange or maybe what is embedded in guidance for 2016?

Wayne DeVeydt

Yes, Ralph. In essense I will tell you as we said before, our targeted margins are 3% to 5% and we have built our plan for this year. We were targeting lower than that threshold. We have not adjusted that targeted margin. So my point is that to the extent this membership does have the risk profile we have, you should expect a better margin as a result of the G&A leverage play. And to the extent that those 3Rs in fact not only settle up as we have been notified to date between Wakely and CMS but actually cash flowed as well between the parties that have to settle up, then you could expect margin expansion as well.

Ralph Giacobbe

So I guess I just want to go back to the disconnect to the lack of guidance raised if the assumption is to make still let's call it 1% to 2% margin or whatever that number is on the exchange on a bigger book, maybe to help level set, can you give us insight all of what you have booked for 1Q in terms of a comparable margin on the exchange?

Wayne DeVeydt

As you know historically when you have an individual member, you are very profitable in Q1, that profitability then declines down to ultimately a loss in Q4. What I would say is that from our perspective, we have chosen not to take that profitability in in Q1 but rather book to a breakeven perspective and then see how this book evolves in Q2 and thereafter. So to the extent that it evolves positively, then you will get the margin improvement both from Q1 as well as in the run rate for the year.

Ralph Giacobbe

Okay, that is helpful. And then I think it was asked earlier but I don't think we got to sort of the answer around how you are positioning for 2017. Are there new states or territories that you are going to want to enter? And maybe a sense -- I know it is early at this point, but when we think about target margins, you talked about 3 to 5. Is 2017 sort of an area where you expect to get there, get closer to there, any just general commentary around that would be helpful. Thanks.

Wayne DeVeydt

We are not targeting on a standalone basis any new markets outside of our 14 states. I think our goal is to continue to stabilize the market in those states and start trending towards our targeted 3% to 5% margin. I would not anticipate at this point in time that in 2017 we would necessarily achieve that level of margin but nonetheless, there has been a lot of activity around the regulations and ways to improve and create more stability so we will see. To be fair, it is a little bit early in the pricing cycle so we ultimately need to see how pricing evolves and what the states ultimately approve in the pricing cycle and whether or not we can get there as early as 2017. But right now I would be more cautious on getting there in 2017 and view it more as an 2018 play.

Joe Swedish

Yes, I think the question is interesting the way you put it about expanding to other states. I mean obviously I'm going to be blunt, we precluded Blue Cross Blue Shield presence in our 14 states and really think we should underscore the value we bring to our markets and our brand legacy incredibly well known with respect to the quality as well as affordability. And to Wayne's earlier point, we have witnessed and we really do believe this flight to safety is real and I think flight to safety is very relevant with respect to how folks are connecting back to us in terms of known brand. I think we are going to really seek to leverage that more effectively in every market that we are serving. The last point I will make I think it is very important to underscore is that Cigna will help us with future expansion beyond our 14 states. So that is a story that is not yet told and when it becomes clear that we can, we will express ourselves probably in more depth in terms of the potential to expand to other markets relative to the public exchanges.

Ralph Giacobbe

Okay, great. Thanks. Helpful.

Operator

Chris Rigg, Susquehanna Financial.

Chris Rigg

Good morning, guys. I apologize if I missed this but did you guys say what you are now assuming for the reinsurance coinsurance rate? I know at 4Q you said a little above 50%. There is some data from CMS which suggests it could be more like 60% to 65%. Just want to get a sense for what you are assuming now and whether that has had an impact on guidance? Thanks.

Wayne DeVeydt

Chris, thanks for the question. So we continue to assume a little bit north of 50%. I would tell you that if the CMS data is 60% to 65% goes forward, we will have sizable upside relative to those percentages. We are not so sure it will evolve ultimately to that level but based on the most recent data that has been submitted as well as the Wakely data we received on this, we are at a number below what the data would imply is what I would say and should have some conservatism going into 2Q and beyond. But again, we want to see ultimate settlement. As a reminder on risk corridor is we continue to maintain 100% valuation allowance against any receivables and I would tell you the more sizable upside ultimately would be on the risk adjusters if what we have seen in early data related to 2015 and 2016 is in fact holds true into 2Q and again if it in fact gets monetized by the parties that owe it. So I would say all three areas represent potential upside, corridor being the least. We just don't see the money in the kitty to fund those.

Chris Rigg

Great, thanks a lot.

Operator

Matthew Borsch, Goldman Sachs.

Matthew Borsch

Good morning. I was hoping that you could give us some, your assessment on the group Commercial side, the decline of I think it was 245,000 lives in the quarter was in line with what you had guided to. Can you, I know you referred to some states where they expanded the definition of small group and that was a factor. I assume that there is some ASO conversions. Does some of that also reflect a conservative pricing posture? I know you always try to be conservative but have you needed to be more conservative in the current pricing environment? If you could just talk to that.

Wayne DeVeydt

Let me first start by saying it has some conversions from fully insured to ASO and I think clearly you can see that in how strong our ASO book has done and not just in national but in the large group business as well. I think it is fair to say that at least half of it though represents those markets that did the switch with the majority of that being in California. And I would say we have maintained our pricing discipline in California and it seems that most of that membership went to a single carrier primarily a not-for-profit carrier that we think priced fairly aggressively. And again from our perspective, we will weather that storm as we have in the past and hopefully win those members back in the next year or so. But that I would say it is about a 50 50 split and of the 50 that truly left, it is primarily California.

Matthew Borsch

Thank you. That is very helpful. And also if I could ask, what is approximately the amount by which you need to increase price going into 2017 to reflect the lack of reinsurance? And how much of a problem is that going to be for exacerbating some adverse selection that is already a program-wide problem to some degree in the exchanges?

Wayne DeVeydt

We generally haven't given all the specifics in pricing. I think the reinsurance is one that mathematically people can generally back into a range in the 5% to 6% range of what it could impact on upward pricing by itself. And so I would say that 5% to 6% range that we have had others ask about is a reasonable proxy of what you should expect for the piece of reinsurance that would run off. Relative to all other pricing, we are not necessarily talking to specifics. We are just in the process now of filing with our states but this is clearly one area we are spending time making sure everybody is educated on. And I would tell you insurance regulators understand, they get it and they understand the implications of it and so for competitive reasons, I would like to probably not discuss any further though our rate filings or actions at this point.

Matthew Borsch

Okay, thank you.

Operator

Ana Gupte, Leerink Partners.

Ana Gupte

Thanks, good morning. Following up on the Commercial book but now taking the view into 2017, you had a 2% gain in your Commercial Businesses and I would say it is a mishmash of various things. But as you are looking into 2017.

Joe Swedish

Ana, can you start your question over? We are having trouble hearing you.

Ana Gupte

I was asking about the (inaudible). Is this better?

Joe Swedish

Sorry, you are cutting in and out, it is very difficult to hear you.

Ana Gupte

Better now? So I was asking about the 2017 Commercial outlook and whether or not as you look into 2017 we are likely to see a better operating gain growth rate because the not for profit Blues, Aetna, everywhere they are all losing money on exchanges. And I know you don't overlap directly with the Blues but as you think about Cigna and the post-Cigna world, if the pricing and underwriting spread will get better into 2017?

Wayne DeVeydt

I would say while we haven't given 2017 outlook yet and as you can imagine we want to first want to see how 2016 develops. But what I would highlight is that we would expect to see the margins begin to trend to the more sustainable levels of 3% to 5%. I don't think again we will be there by 2017 but ultimately it seems that the environment is starting to recognize the true cost of operating the exchanges and the membership that resides with it. These are large risk pools so I think the industry is getting to the point where they have enough data to support the pricing that belongs with it and we think that our job now is to continue to educate our regulators on the risk profile of the pools, actions we can take to help drive the cost down for affordability. And at the same time to the extent that we are limited on actions, to make sure people understand the pricing that goes with it. So I think for 2017 today as best we could say it would be our expectation that margins would improve and pricing would continue to improve.

Ana Gupte

Are we talking about the exchanges or Commercial? I was talking about the group business and the spread between trend and pricing more sort of is it likely to be a silver lining on the cloud just because companies are losing money on exchanges so they become more conservative on the commercial pricing?

Wayne DeVeydt

It is hard to know what others may do in their pricing. Clearly in California, we did not seen a player who we know lost money on exchanges necessarily take a more rational pricing on their small group book. So I guess what I would say is when you have seen one market and one competitor you have seen one market and one competitor. So it is hard for us to understand it. I think I would say is this, our philosophy is we've got to cover our cost of capital, we've got to give our shareholders a fair return for the risk that we bear and we price accordingly. And they will just have to weather the markets whatever they bring in the short term as we did on the public exchanges the last couple of years.

Ana Gupte

And then finally on the 51 to 100, once you get past that headwind, is there a reduced tendency to a dumping from employers because exchanges haven't been as stable and there is a lot of volatility there?

Wayne DeVeydt

We think there is. I mean I think it seems like the dumping factor has really moved down and I think this was the last clarification of product description and size under ACA that had to be implemented. So I think from our perspective, we view it as kind of stability and I would say internally we are targeting actually trying to get back to small group growth again now.

Ana Gupte

Thanks for the color. Appreciate it.

Operator

Scott Fidel, Credit Suisse.

Scott Fidel

Thanks. Just had a question on cost trends overall and just interested just within the guidance range that you talked about how trend may be behaving within that range in the first quarter. United had talked about seeing a bit of an uplift in cost trend in the first quarter maybe around 50 basis points. And then just also just specifically whether you have been seeing an increase in surgical volumes year-over-year in the first quarter relative to last year?

Wayne DeVeydt

Thanks for the question. First of all, it is important to recognize that we had assumed the trends would move up this year as you know what we finished last year versus what we guided to this year. So trends have moved up but within our expectations and our pricing. As we look at various factors, I think we would have said earlier on that trend might have been favorably impacted by the flu but the fact that the late-season happened ultimately we think for the full year that that won't have a positive upside to us nor a downside. We think the flu is going to play probably within our expectations. We did expect a fairly sizable uptick in trend in Q1 regarding really hep C and we saw that which is good and the good news is at least on a rolling three month average wev'e looked at it, it seems to be playing right in line with our expectation, slightly better than our expectations but I would tell you that we are not going to bank that yet because we think there may be some warehousing because there is new genotype drugs that are coming out that people may be holding off on until those are available. So I think ultimately when I look at what could be the biggest surprise items like a hep C or a flu or other items, everything seems to be playing pretty well relative to our expectations and where we did expect it to be high in the quarter, it was but within our pricing.

Joe Swedish

Scott, this is Joe. I think probably it is fair to also comment on a lot of what you can't see regarding the internal activity of the Company where we are obviously vigilant regarding trend changes. Internally we are building really robust provider collaboration models, really driven toward value-based contracting that then tries to ameliorate the risk of trend escalation. Our data analytics infrastructure has been a remarkable uplift to the Company with respect to our investments and the resultant insights that we have captured in order to better manage the cost of care. So there is kind of the macro level that you see but the micro level within the Company, it is amazing how well we have positioned ourselves to really address kind of the prevailing winds that come at us in and around trend changes.

Scott Fidel

Got it. And then just on the surgical volumes, are you able to tease out whether what you saw year-over-year there or is it still able bit too early to tell?

Wayne DeVeydt

It is a little early. We obviously look for different areas that might spike. We see a little bit more there but again relative to expectations, I think things are playing okay. So nothing of any specificity that I can provide at this point.

Joe Swedish

Let me just kind of express a thanks to all of you for your questions. In summary, I'm pleased with our first-quarter results and believe that these results position us very well for the remainder of the year. Hopefully you got a sense of that with respect to our commentaries today. We do remain committed to increasing access to high-quality affordable healthcare. Specifically we believe our ability to serve our customers will be advanced by the pending acquisition of Cigna which we still remain of the belief that it is expected to close in the second half of 2016. Also this includes our continued focus on improving matters like drug pricing.I also want to thank all of our associates for their continued commitment to serving our nearly 40 million members and I would like to also again thank all of you on the call for your interest in Anthem and look forward to speaking with you soon. Again, thank you very much. Have a great day.

Operator

Ladies and gentlemen, this conference will be available for replay after 11 o'clock this morning and running through Wednesday, May 11, at midnight. You can access the AT&T Executive Playback Service by dialing 1-800-475-6701 and entering the access code 378816. International parties may dial 1-320-365-3844. Those numbers again, 1-800-475-6701, 1-320-365-3844 with the access code 378816. That does conclude our conference for today. Thank you for your participation and for using AT&T Executive Teleconference Service. You may now disconnect.
