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EDITED TRANSCRIPT

ANTM - Q2 2016 Anthem Inc Earnings Call

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OVERVIEW:

Co. reported 2Q16 GAAP EPS of \$2.91 and adjusted EPS of \$3.33. Expects 2016 adjusted EPS to be greater than \$10.80 and operating revenue to \$81.0-82.0b.



CORPORATE PARTICIPANTS

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

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

John Gallina *Anthem, Inc. - CFO*

CONFERENCE CALL PARTICIPANTS

A.J. Rice *UBS - Analyst*

Josh Raskin *Barclays Capital - Analyst*

Dave Styblo *Jefferies & Co. - Analyst*

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Anthem conference call.

(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 of IR*

Good morning and welcome to Anthem's second-quarter 2016 earnings call. This is Doug Simpson, Vice President of Investor Relations. With us this morning are Joe Swedish Chairman and President and CEO, and John Gallina, our CFO. Joe will offer some commentary on the recent DOJ action, and provide an overview of our second-quarter 2016 financial results, and then John will walk through the financials of our business units 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 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. This morning we announced second-quarter 2016 adjusted earnings per share of \$3.33, with membership and revenue tracking above our previous expectations. On a GAAP basis we reported earnings per share of \$2.91.

Before John and I discuss the details of our second-quarter financials and our updated 2016 outlook I think it's appropriate to discuss our perspective on the latest Cigna developments. I'll start by saying we are disappointed by the US Department of Justice decision to block Anthem's acquisition of Cigna, a combination specifically designed to tackle our healthcare systems' challenges head on and deliver greater value to consumers by expanding access to high-quality affordable healthcare.

To be clear, our Board and executive leadership team at Anthem is fully committed to challenging the DOJ's decision in court. As you may have read in Tuesday's published op-ed, the DOJ has disregarded the issue of access for two of the most unstable and at high risk health insurance markets -- individuals and small businesses. These populations comprise a meaningful portion of the still more than 33 million uninsured Americans who will benefit from the Cigna acquisition through expanded and improved access, affordability and quality.

For example, despite the many and continuing challenges of the health insurance exchanges, Anthem entered into this new and high risk market at its inception. Though several of our competitors have exited this business we now serve 923,000 public exchange members across 14 states where we do business as Blue Cross and Blue Shield plans.

As shared with the DOJ our acquisition of Cigna will help stabilize pricing in this volatile market, enabling Anthem to continue its commitment to the public exchanges and provide the opportunity to expand our participation to nine additional states where neither Anthem nor Cigna currently participate. Additionally, we estimate this acquisition will significantly lower costs for our self-funded consumers with over \$2 billion in medical cost savings that we've passed directly back to them.

Finally, we also note this acquisition will benefit our shareholders and the pension, retirement and investment funds they represent. Specifically 99% of our shareholders voted in favor of this transaction.

Now to discuss the consolidated financials we reported this morning, our second-quarter adjusted EPS of \$3.33 was slightly ahead of our expectations, albeit with mixed financial metrics to get us there. Within membership, both fully insured and self-funded membership are tracking ahead of expectations, as we enter the second quarter with nearly 39.8 million members. This reflects growth of an additional 148,000 lives during the quarter, bringing our year-to-date enrollment growth to 1.2 million lives or 3%.

Specifically, our insured membership increased by 170,000 lives as our Medicaid business grew by a better-than-expected 280,000 lives in the quarter to over 6.3 million members. This reflected better than expected enrollment growth from the implementation of the Iowa state contract which started on April 1, as well as better-than-expected core membership growth within multiple other state contracts.

Within commercial our insured enrollment came in line with expectations. We ended the quarter with 923,000 lives from the individual public exchanges, a decrease of 52,000 from the 975,000 we reported in the first quarter. And local group insured business declined modestly and in line with our most recent expectations.

Our self-funded business was relatively stable during the quarter, which was better than our previous expectations, as we experienced higher-than-expected growth in membership in existing accounts. Our membership results translated into better-than-expected operating revenue of \$21.3 billion. Our second quarter 2016 results represent an increase of \$1.5 billion or 7.7% versus the second 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 second-quarter 2016 benefit expense ratio was 84.2%, which increased by 210 basis points versus the prior year. The year-over-year increase was partially driven by a higher benefit expense ratio in the Medicaid business as our medical cost experience exceeded the net impact of the

annual premium rate adjustments and the impact of growth in membership, which the Medicaid business carries a higher benefit expense ratio than the consolidated Company average.

Further, the benefit expense ratio reflects the impact of higher medical cost experience in the individual business and the timing of higher medical cost experience in the local group business. The increase was partially offset by adjustments to the prior and current year risk adjustment estimates in our ACA compliant individual and small group products.

Our SG&A expense ratio came in at a better than previously expected 14% in the second quarter of 2016, a decrease of 140 basis points from the prior year. This was driven by an intentional focus on administrative expense control, coupled with better-than-expected enrollment trends, as well as the changing mix of our membership towards the government business, which carries a lower than consolidated average SG&A ratio.

We reported operating cash flows of approximately \$2 billion or 1.3 times net income during the first six months of 2016. During the quarter we reported operating cash flow of \$662 million or 0.8 times net income. As a reminder, we did make our first- and second-quarter income tax payments during the second quarter, consistent with prior years.

I'll now turn the call over to our new Chief Financial Officer John Gallina to discuss our business segments' quarterly results and our updated 2016 outlook in more detail. John?

John Gallina - Anthem, Inc. - CFO

Thanks, Joe, and good morning. Turning to discuss the second-quarter financial performance of our business units, we added 290,000 members in our government business during the quarter and grew year-over-year revenue by 9.5% to \$11.4 billion. These results now include the impact from the addition of the Iowa contract which was implemented on April 1.

Operating margins for the government business in the quarter came in at 4%, a decline of 190 basis points versus the prior-year quarter, which was driven by lower gross margins in the Medicaid business. As we communicated previously, we have been expecting Medicaid margins to compress from 2015 levels to a more normalized level. We are monitoring the rate environment for the remainder of the year.

During the quarter we also experienced higher-than-expected claims across Medicaid businesses, with the most notable market being the newly implemented Iowa contract. It is important to note that it is not uncommon to have early challenges in a new market and our team has a long track record of successfully identifying and implementing revenue and cost care initiatives to mitigate issues. We will continue to work collaboratively with our state partner to ensure program stability and high-quality care for Iowa's most vulnerable citizens.

Within Medicare, we are pleased with the progress the team continues to make, and our year-to-date margins continue to reflect improvement versus last year. Our outlook continues to expect margins to improve as the year progresses towards our expected long-term sustainable levels and we have positioned our portfolio to grow enrollment in 2017.

The pipeline of opportunity for our Medicaid businesses remains substantial, with an estimated \$78 billion in contracts to be awarded between now and 2021 in markets that we will consider targeting. A little more than three-fourths of this opportunity is in new and specialized services with the remainder in traditional Medicaid services. We continue to believe our experience and 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.

Switching to our commercial business, our enrollment decreased by 142,000 lives during the quarter, which was slightly better than our previous expectations. Specifically, we experienced second-quarter declines of 86,000 and 51,000 lives in our individual and national businesses, respectively. The better-than-expected enrollment results contributed to a higher-than-expected operating revenue during the quarter which increased by 5.7% versus the prior-year quarter to \$9.9 billion.

Our second-quarter operating margin of 10.9% was 120 basis points higher than the 9.7% we reported in the second quarter of 2015. The increase was driven by adjustments to the prior and current year risk adjustment estimates recorded during the quarter, lower SG&A ratio due to lower

administrative costs resulting from expense efficiency initiatives, and growth in self-funded enrollment which carries a higher-than-average operating margin. This increase was partially offset by higher medical cost experience in individual ACA-compliant products and the timing of medical cost experienced in our local group business.

Within our individual ACA-compliant population, we had previously taken a conservative stance on our balance sheet with respect to various different estimates. This conservatism was very prudent as our current period claims trends have been higher than expected. We have seen higher-than-expected cost from membership with chronic conditions such as renal disease, COPD, heart disease and diabetes, along with signs of pent-up demand among our new members.

We have experienced higher-than-expected payments for dialysis treatments during the first half of the year, which we are in the process of reviewing the drivers of this increase. All in, our updated outlook now expects the individual ACA-compliant business to incur mid single-digit operating margin losses for the 2016 benefit year.

It is important to note that we have assumed the higher-than-expected claims rate experience thus far in the year will continue for the remainder of 2016 in developing our 2017 pricing assumptions. To be clear, we believe our pricing for 2017 fully incorporates our current expectations for 2016 claims and we are focused on returning to profitability in 2017.

Relating to national accounts, we continue to be pleased that the team continues to secure wins contributing to the track record of membership growth in 2017.

Regarding our balance sheet metrics, consistent with our past practice we've included a roll forward of our medical claims payable balance in this morning's press release. For the six months ended June 30, 2016 we experienced favorable prior-year reserve development of \$726 million, which was moderately better than our expectations. We continue to be at the upper end of our range of mid to high single-digit margins for average deviation and believe our reserve balance remains consistent and strong as of June 30, 2016.

Our days in claims payable was 40.6 days as of June 30, a decrease of 2.8 days from the 43.4 days as of March 31. The decrease is in line with our expectations and consistent with the level of decrease seen between the first and second quarter of 2015. As previously discussed, we expect days in claims payable to come back down closer to 40 over time.

Our debt to capital ratio was 39.1% at June 30, 2016 down 110 basis points from the 40.2% at the end of the first quarter, which reflects the impact of an increase in shareholder equity and the reduction in our outstanding balance in commercial paper during the quarter. We ended the first quarter with approximately \$2.1 billion of cash and investments at the parent Company, and our investment portfolio was in an unrealized gain position of approximately \$958 million as of June 30.

For the three Rs we continue to book reinsurance as appropriate and we continue to establish a 100% valuation allowance against any unpaid receivables for the 2014, 2015, and 2016 benefit years for risk corridors. For risk adjusters, the recent information from CMS shows us in a net receivable position, primarily in our small group markets. We have recorded a valuation allowance against certain risk adjust receivables in some of our markets based on our assessment of the financial solvency of co-op organizations that are payers into the risk-adjusted program, due to the belief that those receivables may ultimately not be collected.

As we have said in recent months and in the results we reported this morning, our operating metrics are expected to be different than we previously expected during the last earnings call. That said, we are reaffirming our adjusted earnings guidance and expect full-year 2016 adjusted EPS to be greater than \$10.80, excluding greater than \$1.46 of negative adjustment items. On a GAAP basis our 2016 earnings per share it outlook is greater than \$9.34.

We are raising our operating revenue outlook by \$1.5 billion to a range of \$82.5 billion to \$83.5 billion, reflecting stronger-than-expected enrollment across our businesses, including the contributions from Medicaid as well as the impact of adjustments to both prior and current year risk adjustment estimates. Fully insured membership is now expected to be approximately 15 million members at the mid point of our range, 100,000 higher than our previous outlook, which reflects stronger than previously expected results in the Medicaid business.

Self-funded membership is now expected to be 24.7 million members at the mid point of our range, approximately 200,000 higher than our previous outlook. Taken together we now project total membership to be approximately 1 million to 1.2 million higher than we ended in 2015.

We now expect our medical loss ratio to be in the range of 84.9% plus or minus 30 basis points for the year, reflecting our view that higher than previously expected claims rates in our individual ACA-compliant plans as well as our Medicaid businesses remain at elevated levels throughout the year. This includes the worse-than-expected results in the newly implemented Iowa market.

Reflecting the expected higher paid claims we now expect 2016 operating cash flow to be approximately \$3 billion. To offset the expected increase in our medical loss ratio we're continuing the efforts started last year to ensure we have an efficient cost structure. We now expect our SG&A ratio for the full year 2016 to be in the range of 14.5% plus or minus 30 basis points.

We continue to expect 2016 local group medical cost trends to be in the range of 7% to 7.5%. Our updated 2016 outlook does not include any benefit from the impact of share repurchase activity for the remainder of the year. As a reminder, we did not repurchase any shares for the first six months of 2016.

Our outlook does include the adverse impact of an additional \$0.02 of assessments associated with the dissolution of the Ohio co-op. This is in addition to the \$0.03 of assessments we previously discussed in our first-quarter call associated with the state of Colorado dissolution of their co-op. We have not included any additional assessments beyond those incurred in Colorado and Ohio in our outlook.

It is 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 half of 2016, nor does it include any benefit from lower pharmaceutical pricing which we continue to believe we are entitled to under our current contract with ESI.

With that, operator, please open the queue for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

A.J. Rice from UBS.

A.J. Rice - UBS - Analyst

Thanks. Hello, everybody. First, just to maybe try to clarify a little bit more on the outlook for the year and particularly what you are assuming for the back half, if my numbers are right you're allowing for about a 300 to 400 basis point deterioration further from what we saw first half MLR to back half MLR, and you're getting obviously, as you say, the SG&A leverage. Two parts to this. Is that a normal seasonal pattern or are you allowing for any other contingencies on the MLR assumption in the back half? And would you characterize what you are doing on the SG&A side as something that's sustainable or are these extraordinary measures in light of the MLR pressure you've experienced?

John Gallina - Anthem, Inc. - CFO

Hey, AJ, this is John. Thank you for the question and good morning. A couple questions in there in terms of MLR and G&A. But first of all on MLR, yes, your math is certainly appropriate from the first half to the last half. And, really, what we've seen is that we've got an elevated amount of utilization specifically in the ACA individual compliant plans as well as in Medicaid, and most significantly there in Iowa. And we are at least, for purposes of our outlook, assuming that elevated level is going to continue throughout the rest of the year.



So, while certainly if there's any mitigation factors or medical management initiatives end up being more successful than we are planning, there could be upside. But it really has to do with taking the elevated levels of utilization we've seen and just essentially run rating them for the rest of the year.

In terms of the G&A, I'd say the bulk of the G&A is sustainable. What we've really done is an outstanding job of fixed cost leveraging. We are increasing membership this year between 1 million and 1.2 million members and maintaining our cost structure relatively constant.

We are growing. Our headcount increased in the second quarter but it increased at a far slower rate than our membership increased. Revenue's gone up about \$2.5 billion for the change in guidance from the beginning of the year to today, yet the raw SG&A number is only going up very slightly. So, it really has as much to do with an excellent job of fixed cost leveraging.

Clearly we are looking at some inefficiency and waste in terms of our processes, and continue to look at those very closely on a regular basis and try to eliminate those things. And at the end of the day, the last piece of it really is that we are pay-for-performance company, and as a pay-for-performance company, in order to get our bonus payments we have to hit our targets. And to the extent that we don't hit our targets will reduce our bonus structure. So, that's something that we're looking at very closely, as well.

A.J. Rice - UBS - Analyst

Okay. If I could just do a quick follow-up, Joe, thanks for the comments about the Cigna transaction. I might just ask, do you have any updated assessment of the timeline from here? And then I think the merger agreement goes through the end of this year. Can you just mention to us what happens after the end of the year if we are still in the court dealing with the proposed transaction?

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

Thanks AJ. First of all, when you reference the end of the year, actually we have the option on our side, our call, to extend it to the end of April, which obviously we intend to do so. So, I just want to make that record clear, that we will continue, and obviously we are going to run out the litigation as long as it takes, working towards the end of April.

Our expectation is, under normal or usual circumstances claims like this, we're expecting the trial to begin somewhere around October. And at the outside we're looking at four months. We believe it will be about four months. Obviously it could run a little longer but that's our expectation.

A.J. Rice - UBS - Analyst

Okay, great. Thanks a lot.

Operator

Josh Raskin from Barclays.

Josh Raskin - Barclays Capital - Analyst

Hi, thanks. I think I'm going to ask very similar questions to AJ but just a different perspective. On the MLR, forgetting about the first half versus the second half, just on a year-over-year basis the first half is up 188 basis points, and that's only three months of lowa and you get some ACA benefit. But the second half looks more like an increase of 140 basis points. So, the way I'm looking at it, year over year you're actually expecting some noticeable improvement in the second half. So, my MLR question is what's causing that improvement on a relative basis?



And then, John, on the G&A side I think you mentioned that growth is going up a lot less than the revenue growth but the way I look at it is second quarter you added \$1.5 billion to revenues but took \$600 million of G&A out. So, it looks like there are noticeable savings. And I'm just curious, is that deferred investment or is that some other sort of savings on the G&A side?

John Gallina - *Anthem, Inc. - CFO*

Sure, Josh, great question. First half, we'll be clear, on the MLR, the first half of the year had the benefit of three Rs. The run rate of claims outside of three Rs is worse, and so that's obviously being baked into our outlook and our thought process.

On the admin side, quite honestly the single largest driver of that year over year is the bonus program that I referenced at the end of AJ's question in terms of being a pay-for-performance company. We adjusted our bonus payable appropriately, based on ensuring that we are going to hit our \$10.80. That's certainly a part of the reconciliation.

Josh Raskin - *Barclays Capital - Analyst*

And, John, what was the 3R benefit? Is there a way to size Iowa's impact in 2Q, as well?

John Gallina - *Anthem, Inc. - CFO*

The 3R benefit, in and of itself, we don't provide the level of specificity that you're probably asking for. In terms of Iowa, I will just say that Iowa is a brand-new market, and we expected it to be dilutive in 2016 as we implemented our various medical management and revenue optimization processes.

We ended up with about 25,000 more members in Iowa than we originally expected when we did our plans at the beginning of the year. And, quite honestly, the MLR in Iowa is 25 to 30 basis points higher than we expected when we did our plan, as well. So, you had the additional members and it's more dilutive simultaneously with the elevated claims level.

The really good news for that is that we do believe that our plan -- we look at what we've done here historically, what the team has done historically in terms of new markets and implementing the managed care type processes and procedures, and the fact that the first-year markets have historically been dilutive in that we've guided to target margins within a 18- to 24-month period of time. There's no reason to believe that's not going to occur again here in Iowa even though the starting point is maybe a little bumpier than we had hoped.

Josh Raskin - *Barclays Capital - Analyst*

And you said 25 to 30 basis points? Or points higher?

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

Josh, 25 to 30 points higher, not basis points.

Josh Raskin - *Barclays Capital - Analyst*

Points. Okay. So, it's a huge number. Okay, that makes sense. Okay, thanks, guys.



Operator

Dave Windley from Jefferies.

Dave Styblo - Jefferies & Co. - Analyst

Hi, good morning. It's Dave Styblo in for Windley. Just wanted to come back to maybe if you guys could help us bridge the puts and takes. I know obviously the overall guidance remains the same in terms of EPS. But I think, by the math that you guys presented on the individual book being a mid single-digit loss, it sounds like that's about a \$0.40 change relative to what you were thinking before. And then on top of that you've got the Medicaid challenges that you highlighted. Is that the right way to think about it, and then the offset being largely just the SG&A improvement on top to offset those two negatives?

John Gallina - Anthem, Inc. - CFO

The other part of that is the top-line growth is very clearly a good guy as part of all that. But, yes, those are the most significant pieces. I think the good news is, just to maybe answer your follow-up question before you ask it is that if we look at 2016 versus 2017, let's be very clear, as I said in the prepared comments, when we did our pricing for 2017 we already had taken this elevated level of claims and utilization into account and baked it into our 2017 outlook. So, we believe that this is more of a one-year type of issue and that we are very committed to returning the ACA block of business back to profitability in 2017.

Dave Styblo - Jefferies & Co. - Analyst

You did address my question earlier on the follow-up. It seems like you priced for these things to happen and in some ways it still seems like it's worse than expected. So, if you were filing rates and benefit changes earlier in the year, maybe you can just give us more comfort about specifically how you caught these things earlier on when we are starting to see more of the development come in with higher utilization, the dialysis and COPD and the other elements that you talked about.

John Gallina - Anthem, Inc. - CFO

Sure. The rates were developed in the April-May timeframe. So, if you look back at when we closed the books in March and the information we had available to us at that point in time, we had seen some of these spikes in the elevations, just not to the same -- we weren't crystal-clear then it was going to continue for the rest of the year or not. However, we wanted to be conservative, we wanted to be prudent.

We had hoped that it was not a trend. However, when we did our pricing we felt it was best to assume it was a trend. Here we are 90 days later, I believe our conservatism turned out to be prudent in that something that we weren't sure if it was going to be a trend or not probably is. There's still the opportunity that seasonality could be in our favor and that things could get a little bit better in the second half of the year. We just decided not to assume that at this point in time.

Dave Styblo - Jefferies & Co. - Analyst

Okay. And then if I could just ask on Medicaid. I know obviously you highlighted Iowa and then you mentioned that broadly there was just higher trends. Is it predominantly just Iowa being the drag in Medicaid or are there some specific other states? If you could share a percentage of the weighting of the 75% Iowa, 25% other states, and highlight what those other states might be and the issues that you're seeing there.

John Gallina - Anthem, Inc. - CFO

It is both low as well as other states. And we really don't get into specifics state by state. We are just calling out Iowa as a marker because it's brand-new and it is a significant driver in and of itself.

I will say that the primary drivers of the elevated trends, they are pharmacy, nursing facilities, ER, and outpatient surgery. Those four items are really the most significant part of our trend issue in the other states. But we are seeing elevated trends in several states and we are addressing those accordingly.

Dave Styblo - Jefferies & Co. - Analyst

Okay. But fair to say well above 50% is attributable to Iowa though?

John Gallina - Anthem, Inc. - CFO

We really don't get into that level of detail on a state-by-state basis for competitive reasons.

Dave Styblo - Jefferies & Co. - Analyst

Okay, thanks.

Operator

Andrew Schenker from Morgan Stanley.

Andrew Schenker - Morgan Stanley - Analyst

Just going back to the exchange business here, just thinking about it big picture, in 2014 you guys were actually profitable, last year you were close to breakeven, this year you are now losing money here. So, what has really changed over that timeframe? Is it just the risk pool continued to get worse and therefore is this something you can actually rectify with pricing? Or are there structural issues to the exchanges or are there other more meaningful benefit changes -- IE, networks or other design changes -- that you've also incorporated for next year that are going to be necessary to offset what's been a steady deterioration of profitability of this book every year?

John Gallina - Anthem, Inc. - CFO

Sure, great question. In terms of will pricing by itself rectify it -- no, because there's no one single bullet that actually solves the entire problem. The administration is extremely focused on having a sustainable marketplace. We've been a very active participant in the exchanges and been a great partner with CMS and trying to help with the stability of the marketplace.

They've made changes over the years of tightening the supplemental enrollment a bit and various other requirements. The penalty continues to increase. We think all those things obviously have to be done.

Other things that would certainly help the acceleration of stabilization would be to eliminate the health insurer tax beyond 2017. The risk adjuster model, it does a lot of what it's intended to but, quite honestly, there's a bit of an imbalance, that it over-charges for healthy and over reimburses for certain moderately unhealthy disease states.



We think, as I said, the supplemental enrollment period, we really do need a better up-front verification process. And there should not be any restriction on our efforts to innovate product designs to meet consumer needs. And then modifying the grace periods for nonpayment of premiums would be something else.

Those are just, in addition to the pricing, things that we've been working with the administration on and believe should occur. We do believe that with the medical management and various other issues that we can help get this back to profitability here in 2017.

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

Yes, this is Joe. Let me just weigh in to add to what John just shared with you. Just to reiterate, we've been a very active participant in the exchanges from the very beginning, and recognize the markets have taken longer than expected to stabilize. We've stated that repeatedly. And I think we have been working very closely with the administration and conducting our own modeling to best judge how we're going to continually engage year over year in as profitable a context as possible.

It's interesting, we reflect back to the end of first quarter we told you that the end of June 30 we probably have greater insight into membership we've captured, recognizing that we had a substantial uptick in membership. Deteriorated a little bit into Q2 to around 925,000 or so members. But what we've observed in terms of the intensity of illness is that, as John pointed out in his earlier remarks, we're dealing with some chronic illnesses like cardiac, diabetes, COPD. We've had what we think is a material uptick in dialysis cost that have hit us.

So, we're going through an appraisal of all of that in terms of how to better medically manage those members, as well as begin pricing it into 2017. That's the trick. I think John has stated it and I'll restate it. We believe we are well-positioned for pricing in 2017 given what we now know about the membership we've captured.

So, when you put all that together, what we're waiting for now is rate approvals by state. And I can assure you that we are going to be extremely prudent in our continuing engagement. I think we're in something like 138 or so rating regions, and we are going through an appraisal of every one of those regions.

We will make prudent business decisions in terms of flexing our engagement in appropriate ways going into 2017. So, I just want to assure you that, notwithstanding we've been active participants, we are also very -- I use the word prudent, very thoughtful in terms of executing a good business practice in terms of how we continue to stay engaged in the public marketplace.

Dave Styblo - Jefferies & Co. - Analyst

Thanks. That was very helpful. Thinking maybe a little bit more broadly, you reiterated your local group trend assumptions here. But you did call out timing and medical cost experience for local group. Maybe if you could just talk more about what you are seeing around trend, if there's any pockets you are seeing in patients, et cetera, as it relates to how you define it. Thank you.

John Gallina - Anthem, Inc. - CFO

Yes, sure. In terms of trend on the local group side, that's actually going very well, and we reaffirmed the 7% to 7.5% outlook for that and feel very comfortable with that given the results for the first half of the year.

In terms of the timing, that relates to just a couple really accounting and calendar quirks. The first quarter of 2016 had an extra work day driven by leap year. The second quarter of 2016 had an extra work day in it driven by how the weekends fell. The fourth quarter of 2016 has one less work day in it. It's significant enough to change the timing pattern on a quarter-over-quarter basis.

And then you take that into the fact that our overall product mix on the group side is slightly richer than the overall product mix on the group side a year ago. That changes the timing, as well, given how deductibles work.

Dave Styblo - *Jefferies & Co. - Analyst*

Thank you.

Operator

Gary Taylor from JPMorgan.

Gary Taylor - *JPMorgan - Analyst*

Hi, good morning. Just a couple questions. Did you give us the total exchange enrollment as of the end of 2Q? Did I miss that?

John Gallina - *Anthem, Inc. - CFO*

Yes, it's 923,000.

Gary Taylor - *JPMorgan - Analyst*

And the total, when you talk about the ACA compliant book now being mid single-digit losses, what is the total ACA-compliant enrollment that you are speaking to? Presumably that's some off-exchange and small group ACA-compliant, as well.

John Gallina - *Anthem, Inc. - CFO*

A little more than half of the remainder is ACA-compliant.

Gary Taylor - *JPMorgan - Analyst*

Okay. And I just wanted to come back to the risk adjustment because it seems like potentially it was quite material in the quarter. I know you guys only disclose that you had a payable at year end. We calculate that payable about \$105 million, and the swing factor to \$190 million payment that CMS was citing for 2015 as about \$0.60. You say that you booked some valuation allowances against that because of co-op situations. Should we assume that a material portion of that \$0.60 was trued up in this quarter?

John Gallina - *Anthem, Inc. - CFO*

There was a lot of things that went against it. And I'm not going to really comment on your estimate of the payable. But in terms of valuation, allowance is clearly part of it. Certainly medical loss ratio rebates were part of it. After all the dust settled, we're going to pay over \$100 million in MLR rebates in 2016 related to 2015 calendar year. And, so, so that's part of it.

And you've got the small group versus the individual component is clearly a piece of it. Risk corridor true ups. There's so many moving parts. It's hard to, on a call here, pin that down exactly. And then, quite honestly, whatever benefits existed after all the other offsets have now been baked into our trend outlook and our guidance for the rest of the year.



Gary Taylor - JPMorgan - Analyst

Okay. If I could, just two quick clarifications. I think Josh was asking about the G&A run rate and sustainability of that. The guidance for the second half certainly implies this reduced G&A is fairly sustainable. But as you head into 2017, do you feel like there's going to be a deferred level that has to rebound? Or is this G&A ratio a number that makes sense as a jumping off point heading into 2017?

John Gallina - Anthem, Inc. - CFO

The most significant driver of the G&A benefits here compared to our guidance or our outlook is the top-line revenue growth and the fixed cost leverage associated with that. So, that clearly is run rate and sustainable.

In terms of, certainly as an employee of the Company I'm fully supportive of getting the bonus structure back to target levels. But there's a natural hedge associated with that. So, as results warrant it we then record the expense. If they don't warrant it, we don't record the expense. So, with the impact that might be on an exact ratio is to be seen but the bottom line has a natural hedge built in.

Gary Taylor - JPMorgan - Analyst

My last one, when we think about the year, ACA-compliant business worse than you had anticipated. Iowa and Medicaid overall worse than anticipated. Yet you maintain the guidance. So, the two components that were better, that allowed you to maintain compliance, was risk adjustment and some of the additional enrollment growth -- is that fair?

John Gallina - Anthem, Inc. - CFO

Certainly admin risk adjustment, enrollment growth, we are doing extremely well in the national and large local ASO in terms of enrollment. Our Medicare Advantage and our senior business is going very well and exceeding expectations for the year. And, quite honestly, we had a bit of an initial conservative posture at the beginning of the year, as well.

So, it's a lot of things. Our specialty product line is exceeding expectations. So, I would hate to just point to one or two items because there are far more positives than there are negatives. It's just that the two negatives have really caused our conservative posture to be a more prudent posture.

Gary Taylor - JPMorgan - Analyst

Okay, thank you very much.

Operator

Justin Lake from Wolfe Research.

Justin Lake - Wolfe Research - Analyst

Thanks, good morning. First, just a follow-up on the SG&A number for that bonus program. I understand that, as you said, it's a hedge and other things have to improve to offset it. But can you give us a ballpark number there in terms of how much cost comes back into SG&A if you fully accrue that for next year?



John Gallina - Anthem, Inc. - CFO

In terms of exactly how much that is, the bonus program, the target, is certainly a significant number in and of itself, but, Justin, that's just not a number that we are comfortable giving out.

Justin Lake - Wolfe Research - Analyst

Okay. Is there any way to proportion it, for instance? You are losing you said mid single digits on the individual side. Can you remind us, what is the ACA-compliant premium number for this year, ballpark?

John Gallina - Anthem, Inc. - CFO

It's a bit north of \$6 billion, maybe closer to \$7 billion.

Justin Lake - Wolfe Research - Analyst

Okay. So, you are talking about \$300 million-plus in potential, just getting back to breakeven -- right? -- in the individual business, is how we should think about the earnings power of the business? I assume you're not expecting to run losses for even the intermediate term here, as you talked about.

John Gallina - Anthem, Inc. - CFO

I'm not going to argue with your math.

Justin Lake - Wolfe Research - Analyst

Okay. So, if individual comes back to breakeven or better does this SG&A basically offset that? Or is it larger or smaller than individual coming back to breakeven?

John Gallina - Anthem, Inc. - CFO

There's certainly, it's a natural hedge built in. But to answer your question would be to answer the question that you asked the first time. So, good luck. It's a big number, but we're not going to size it specifically.

Justin Lake - Wolfe Research - Analyst

Okay. But you wouldn't call me crazy if I said it was in the same ballpark, as getting back to breakeven on individual.

John Gallina - Anthem, Inc. - CFO

I would never call you crazy.

Justin Lake - Wolfe Research - Analyst

All right. Last question just on the government side. You've laid out the issues here and you are very clear coming into 2016 saying, for instance, Medicaid, the margins were unsustainable, they were going to come down plus you were going to have the Medicaid pressure in Iowa. What I'm

trying to think about here is these margins are down meaningfully for 2016 in the government overall, and you're saying Medicare is actually improving. So, Medicaid, the full brunt. My question is, is Medicaid now at a target margin for 2016 when you think about it overall, or does the Medicaid margin actually improve going forward from here given how tough it's been and the worse-than-expected costs overall?

John Gallina - *Anthem, Inc. - CFO*

The Medicaid margins are within our target range. Obviously we are hopeful that we can improve it to the high end of the range. But even with all these headwinds and the negative comments that we had earlier in the year we are still within the range.

Justin Lake - *Wolfe Research - Analyst*

So, for the full year you are within the range but closer to the mid point to the low end, and potentially can improve it towards the higher end again where you have typically been.

John Gallina - *Anthem, Inc. - CFO*

That's a reasonable way of thinking about it, yes.

Justin Lake - *Wolfe Research - Analyst*

Okay, great. Thank you very much.

Operator

Kevin Fischbeck from Bank of America.

Kevin Fischbeck - *BofA Merrill Lynch - Analyst*

I've got a couple questions. First, on the exchanges, obviously you guys believe that you've caught everything as far as pricing for next year, and you expect margins to improve next year. But we've seen now five or six quarters in a row where it seems like the costs continue to rise for you, but really for a lot of the players out there. Can you give a sense as to why you feel confident saying that given the experience of most companies over the last year and a half?

John Gallina - *Anthem, Inc. - CFO*

Why we believe that we've caught everything?

Kevin Fischbeck - *BofA Merrill Lynch - Analyst*

Yes, exactly.

John Gallina - *Anthem, Inc. - CFO*

I think a lot of it, obviously, has to do with our data analytics and how we track things. And as you look at the rate increases that we've put in, approaching 20% range on a weighted average basis across our 14 states, very significant. We also believe that we have some of the best-in-class

risk-adjusted capabilities of really understanding what drives risk-adjuster and things like that. And I think the results we saw from the CMS trueup really helped to verify that.

The other piece that gives us a little bit of comfort in terms of having caught everything is that our 2016 risk-adjuster that we are assuming in the 2017 really is based on 2015 experience. We think that gives us a natural cushion associated with how that's being approached.

But, at the end of the day, the question is, how do we know we've gotten everything. We've got six months of information. Obviously there's a lot of new members associated with this block of business. We can't provide absolute certainty but we think we have very good line of sight.

What we saw at the end of the first quarter we predicted from a pricing standpoint, and what we saw at the end of the second quarter was exactly consistent with that pricing prediction. So, we feel good that we've got a good line of sight on that.

Kevin Fischbeck - *BofA Merrill Lynch - Analyst*

Is there anything different about you heading into Q3 this year versus you heading into Q3 last year as far as what you're doing from a data analytics perspective? Anything there that gives you more confidence or visibility this year than what you had heading into the back half of last year?

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

This is Joe. I certainly believe that we are always improving year over year, especially in this space given we've got more and more data. Certainly recognize that this is a company that's had a long-standing engagement in high-risk pools. We have a lot of data that has backed us up for a long period of time.

And I think we just, as I said a moment ago, always expect to continue to improve in this space. However, I'll reiterate what I said earlier, we're going to be very surgical with respect to our analytics in and around rating regions. We're going to be very mindful of what price increases are awarded to us by state. So, we will be making very, call it, accurate business decisions going into 2017 and beyond regarding our continued engagement on a broad scale in the public exchange space.

John Gallina - *Anthem, Inc. - CFO*

And the other comment that I'll just add to that, I think maybe will address here what would be different going into the third quarter, is 2016 we actually had more members come on board on January 1 than we did in 2015 or 2014. 2014 in particular, if you recall, we had a vast majority of members come onboard early second quarter. And in 2015 with the extension of the open enrollment period, a lot of members came on later in the first quarter. 2016, a lot more January 1. So, we actually do have a full six months of information this year, and we had not had that in prior years.

Kevin Fischbeck - *BofA Merrill Lynch - Analyst*

Okay. And then just last question, last quarter when you expected the exchanges to be pretty much breakeven this year, you said next year was probably going to be below your target 3 to 5 but by 2018 you'd be in your target margin. Do you still feel like you still have that same ramp over the next couple of years or does this set back and push back when you are going to get to your target margins on exchanges?

John Gallina - *Anthem, Inc. - CFO*

The pricing increases that we put in really do keep us on that same ramp. And it's very important that we do receive the pricing increases that we've filed for in terms of that. Obviously we expect the market to continue to harden and pricing to be more reasonable.

Clearly there's a reason that so many co-ops have gone insolvent in terms of their pricing methodology. So, as more and more of those folks exit the market it should provide a more sustainable stable marketplace in 2018 and beyond.

Kevin Fischbeck - *BofA Merrill Lynch - Analyst*

Great, thanks.

Operator

Chris Rigg,

Chris Rigg - *Susquehanna Financial Group - Analyst*

Good morning. Just with regard to the ACA-compliant membership, do you have a sense at this point how many of the individuals were new members to Anthem? And if you have that information, is there a pronounced difference in utilization trends among those who are new to Anthem versus those that had been enrolled for a year or two?

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

A very quick response to the question -- a little less than half the membership was new to us in 2016.

Chris Rigg - *Susquehanna Financial Group - Analyst*

Okay. And then just one quick follow-up here. Of the individual that's non ACA-compliant at this point, will most of them roll into ACA-compliant plans in 2017 because of the grandmothing dynamic or will they still stay outside the compliant side? Thanks.

John Gallina - *Anthem, Inc. - CFO*

A great question. We do expect some attrition in that area, as you pointed out. Whether they enroll remains to be seen but historically we haven't seen the uptake in ACA-compliant plans that maybe was estimated by the CBO when the law was passed. But that's certainly a watch area for us.

Operator

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

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

As usual thanks for your questions. They're all very insightful. As a company we remain committed to tackling our healthcare systems' challenges head on and deliver greater value to consumers by expanding access to high-quality affordable healthcare. That's why we are committed to challenging the DOJ's recent decision to block our acquisition of Cigna in court.

We also want to thank all of our associates for their continued commitment to serving our 39.8 million members every day. Thanks for your interest in Anthem and we look forward to speaking with you very soon. Again, thank you very much.

Operator

Ladies and gentlemen, this conference will be available for replay after 11 AM Eastern time today through August 10. You may access the AT&T teleconference replay system at any time by dialing 1-800-475-6701 and entering the access code 378817. International participants dial 320-365-3844. Those numbers once again are 1-800-475-6701, or 320-365-3844, with the access code 378817.

That does conclude your conference for today. Thank you for your participation and for using AT&T executive teleconference service. You may now disconnect.

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